REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

3M PHILIPPINES, INC.,
Petitioner,

- versus - C.T.A. CASE NO. 3856

COMMISSIONER OF INTERNAL REVENUE,
Respondent.
x - - - - - - - - - - - - - - x

8/14/87

D E C I S I O N

In his letter dated February 7, 1980 to petitioner 3M Philippines, Inc., respondent Commissioner of Internal Revenue informed the former that upon investigation, there has been found due from petitioner the amount of ₱1,193,566.80 as deficiency income tax for the fiscal year ended October 31, 1974, details of which are as follows:

FY Ended October 31, 1974

Net income per return		₱10,508,296.73
Add: Unallowable deductions:		
1. Pre-operational cost (capital expense) . .	₱ 77,940.38	
2. Royalty and Technical Service fees (not ordinary and necessary)	2,323,599.92	2,401,540.30
Net income per investigation		₱12,909,837.03
Tax due thereon		4,508,443.00
Less: Amount paid		3,667,903.00
B a l a n c e		₱ 840,540.00
Add: 14% int. p.a. fr. 2-15-75 to 2-15-78		353,026.80
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 1,193,566.80

Petitioner was therefore requested to pay the aforesaid amount in accordance with the assessment notice attached to the letter, informing respondent's office for proper annotation thereof.

After petitioner had rested its case with the admission of all its exhibits by the Court, respondent manifested during the hearing for the presentation of his evidence on December 3, 1985 that since this case involves questions of law, respondent is not presenting any documentary or testimonial evidence but is submitting the case for decision based on the records and the pleadings. And the background facts as shown in the petition for review and admitted in the answer are as follows:

Petitioner is a corporation organized under Philippine laws with offices at 3M House, Guadalupe, Makati, Metro Manila; respondent is the duly appointed and acting Commissioner of Internal Revenue and has his office at the B.I.R. Building, Diliman, Quezon City, where he may be served with summons.

Petitioner has been engaged in the manufacture of tapes (adhesive, electrical, masking and labelling), abrasive products, reflective products, and chemicals

for the manufacture of adhesives. Petitioner also imports polymeric film and sheet materials, adhesive and coating compositions, chemical products, photographic film products and materials, lithographic plates, medical products, abrading machines, reinforced plastics, resinous films, roofing granules and non-woven fabrics, which it distributes and sells in the local market. To enable petitioner to manufacture, package, promote, market, sell and install these highly specialized products and render the necessary post-sales service and maintenance, petitioner entered into a technical service agreement and license agreement with Minnesota Mining & Manufacturing Co. under which petitioner agrees to pay a technical service fee of 3% and a royalty of 2% of its net sales. Both agreements were submitted to and approved by the Central Bank of the Philippines.

In its income tax return for the fiscal year ended October 31, 1974, petitioner claimed as deductions as business expense the technical service fee and royalty it paid pursuant to the aforementioned two agreements in the amount of ₱3,050,646.00 and the pre-operational cost for its tape coater operations amounting to

₱77,940.38.

After investigation of its aforesaid tax return, respondent disallowed the entire pre-operational cost of ₱77,940.38 because it was a capital expense and should be amortized for five years and the technical service fee and royalty on the imported products of ₱2,323,599.92 because the fee and royalty should be based only on the locally manufactured goods so that said amount was a disguised dividend. Consequently, respondent issued an assessment against petitioner for ₱840,540 with interest at 14% per annum from February 15, 1975 until fully paid.

Petitioner received the abovementioned assessment notice and letter of respondent on Feuruary 19, 1980 and protested the same in its letter dated March 7, 1980, which was received by respondent on March 12, 1980, on the following grounds: (a) the technical service fee and royalty is an ordinary and necessary expense incurred to enable petitioner to promote, market, sell and install highly specialized imported products and render post-sales service and maintenance and the combined fees of 5% of net sales is reasonable; and (b) the pre-operational cost of the tape center was a current expense and should not be amortized.

To date, respondent has not resolved petitioner's protest. However, on August 13, 1983 respondent issued a Warrant of Distraint of Personal Property and Warrant of Levy on Real Property (both Nos. N-A-806-84) against petitioner for non-payment of the alleged unpaid deficiency income tax of ₱840,540, exclusive of 14% interest, which warrants were served on petitioner on October 1, 1984. In said warrants respondent has ordered his Collection Enforcement Division to distrain, levy and sell so much of petitioner's personal and real properties as may be necessary to cover the alleged unpaid deficiency income tax, interest and expenses.

Hence, the instant appeal.

As special and affirmative defenses in his answer to the petition for review, respondent alleges:

The records of the case disclose(s) that the deficiency income tax assessment resulted from the disallowance of the deductions for royalty and technical service fees in the amount of ₱2,323,599.92 they being not ordinary and necessary expenses under Section 30(a)(1) of the Tax Code, and the pre-operational expenses amounting to ₱77,940.38 as capital expenditures;

Section 3-C of the Central Bank Circular No. 393

dated December 7, 1973 regulates the payment of royalty and technical fees between residents and non-residents. The percentage of royalty and technical service fees should be based on the sale of locally manufactured goods and not on the sale of imported finished goods;

In the case of petitioner, the latter deducted the aforesaid royalty and technical service fees amounting to ₱2,323,599.92, which represents 5% of sales of imported finished goods in the amount of ₱46,471,998.00. Since no local processing was done on said goods, said fees run counter to the provision of C.B. Circular No. 393, and therefore were disallowed as they are not ordinary and necessary expenses;

Considering, therefore, that the payment of the aforesaid royalty and technical service fees is based on the sale of imported finished goods, the same is not considered ordinary and necessary business expenses deductible under Section 30(a)(1) of the Tax Code. On the contrary, they are considered disguised dividends;

Investigation also disclosed that herein petitioner deducted the amount of ₱97,425.47 as pre-operational cost representing various expenses incurred in 1973 and 1974 for the installation of its tape coater,

the operation of which only began in 1973. Since the amortization of this capital expense is 5 years, 4/5 thereof or ₱77,940.38 was disallowed as capital expense;

The assessment in question was issued in accordance with law.

Petitioner poses two issues in this case:

(1) Whether the royalty and technical service fees in the amount of ₱2,323,599.92 are deductible as business expense;

(2) Whether the cost of the tapes used in the test run for the repair of the tape coater is a capital expenditure.

In disallowing the deduction of the amount of ₱2,323,599.92 paid by petitioner as royalty and technical service fees as business expense, it is the stand of respondent that the same is not ordinary and necessary expense in view of the following circumstances obtaining in this case.

1. No manufacturing process was undertaken by petitioner on the imported finished goods.

2. The royalty for the use of the trademark

of the imported finished goods is already included in the purchase price of said goods.

3. The payment of royalty and technical service fees based on the sale of imported finished goods is in violation of Central Bank Circular No. 393.

4. Petitioner is a subsidiary of Minnesota Mining & Manufacturing Co., the recipient of the royalty and technical service fees.

At the outset, it should be stated that while it is true that there is a number of decisions in the United States delving on the interpretation of the phrase "ordinary and necessary" as used in the federal tax laws, no adequate or satisfactory definition of those words is possible. Similarly, the Supreme Court has never attempted to define with precision the term "ordinary and necessary". There are however, certain guiding principles worthy of serious consideration in the proper adjudication of conflicting claims. Ordinarily, an expense will be considered "necessary" where the expenditure is appropriate and helpful in the development of the taxpayer's business. It is

"ordinary" when it connotes a payment which is normal in relation to the business of the taxpayer and the surrounding circumstances. The term "ordinary" does not require that the payments be habitual or normal in the sense that the same taxpayer will have to make them often; the payment may be unique or non-recurring to the particular taxpayer affected. (Atlas Consolidated Mining & Development Corporation vs. Commissioner of Internal Revenue, L-26911; Commissioner of Internal Revenue vs. Atlas Consolidated Mining & Development Corporation, L-26924, January 27, 1961, 102 SCRA 246.)

There is thus no hard and fast rule on the matter. The right to a deduction depends in each case on the particular facts and the relation of the payment to the type of business in which the taxpayer is engaged. The intention of the taxpayer often may be the controlling fact in making the determination. Assuming that the expenditure is ordinary and necessary in the operation of the taxpayer's business, the answer to the question as to whether the expenditure is an allowable deduction as a business expense must be determined from the nature of the expenditure itself, which in turn depends on the extent and permanency of the work

accomplished by the expenditure. (Atlas Consolidated Mining & Development Corporation vs. Commissioner of Internal Revenue, supra.)

The National Internal Revenue Code refers to reasonableness solely with respect to salaries and other compensation for personal services. (Section 30(a)(1)(A).) Courts, however, have held that for a business expense to be "ordinary and necessary" it must also be "reasonable" in amount. (Commissioner vs. Lincoln Electric Co., 49-2 USTC, Par. 9388, 38 AFTR 411, 176 F. 2d 815.)

It is the position of respondent that petitioner's claim for deduction of the royalty and service fees in the amount of ₱2,323,599.92 is not ordinary and necessary and not within the scope of Section 30(a)(1) of the Tax Code because it runs counter to the pertinent provisions of Section 3-C of Central Bank Circular No. 393 which took effect on December 7, 1973. Said Circular regulates the payment of royalty and technical fee between residents and non-residents, and the percentage of royalty and technical fee should be based on the sales of locally manufactured goods and not on the sales of imported finished products. Petitioner

claimed the amount of ₱3,050,046 as total royalty and technical service fees, but only the amount of ₱727,046 (₱3,050,646 less ₱2,323,599 rounded to ₱2,323,600) representing 5% of the manufactured sales of ₱14,540,922 was allowed.

In its controlling provisions, Section 3-C of Central Bank Circular No. 393 reads:

> "Section 3. Requirements for Approval and Registration.- The requirements for approval and registration as provided for in Section 2 above include, but are not limited to the following:
>
> a. x x x x x x x x x
>
> b. x=x x x x x x x x
>
> c. The royalty/rental contracts involving "Manufacturing" royalty, e.g., actual transfers of technological services such as secret formulate/processes, technical know-how and the like shall not exceed five (5) per cent of the wholesale price of the commodity/ties <u>manufactured</u> under the royalty agreement. For contracts involving "marketing" services such as the use of foreign brands or trade names or trademarks, the royalty/rental rate shall not exceed two (2) per cent of the wholesale price of the commodity/ties <u>manufactured</u> under the royalty agreement. The producer's or foreign licensor's share in the proceeds from the distribution/exhibition of the films shall not exceed sixty (60) per cent of the net proceeds (gross proceeds less local expenses) from the exhibition/distribution of the films. x x x x x x" (Underscoring supplied.)

Adverting to the terms of Section 3-C of Central Bank Circular No. 393, which regulates the payment of royalty and technical fees between residents and non-residents, it is quite apparent that the percentage of royalty and technical service fees should be based on the sales of locally manufactured goods and not on the sale of imported finished goods. Whether the royalty/rental contract involves manufacturing royalty or marketing services, the circular employs the terms "royalty/rental contracts involving 'manufacturers royalty' x x x x shall not exceed five (5) per cent of the wholesale price of the commodity/ties manufactured under the royalty agreement", and for "contracts involving 'marketing'services x x x x the royalty/rental rate shall not exceed two (2) per cent of the wholesale price of the commodity/ties manufactured under the royalty agreement". The circular is specific and mandatory. It merely calls for application as worded. There is no room for interpretation. Since the royalty and technical service fees involved herein were computed on the basis of the wholesale value of finished goods imported by petitioner from its non-resident licensor Minnesota Mining and Manufacturing

Company and not on the sales of products manufactured by petitioner under the licensing agreement, it seems clear beyond doubt that the same are in violation of Central Bank Circular No. 393, and hence cannot be allowed as ordinary and necessary expense.

As correctly pointed to by respondent, payments made in violation of a law or made incidental to such violation are generally not allowed as business expense deductions because they are not ordinary and necessary. (Mertens, Law of Federal Income Taxation, Vol. 4, 25.131, Chap. 25, p. 277.) The phrase "ordinary and necessary" has been construed to imply a condition that the payments themselves must not be illegal. (Mertens, Law of Federal Income Taxation, Vol. 4, Cum. Supp., 25.09, p. 115.)

Petitioner contends, however, that Section 3 of Central Bank Circular No. 393 is not an iron-clad provision providing for maximum requirements because the last paragraph thereof reserved to the Central Bank the power to approve in meritorious cases agreements containing more onerous terms and conditions, to wit:

> However, in meritorious cases, the Monetary Board, in consultation with the Board of Investments, may authorize, subject to such conditions it may impose, remittance of royalties on contracts providing for higher royalty/rental rates or for terms longer than five (5) years or containing restrictive provisions prohibiting the local licensees to export the products manufactured under the royalty/rental agreements or limiting their exportation abroad only through the foreign licensors as exclusive distributors.

Reliance on the aforequoted provision is misplaced. We do not see in the provision what may be considered as authorizing in royalty/rental contracts involving "manufacturing" royalty or contracts involving "marketing" services that the percentage of royalty and/or technical service fees can be, or maybe, based on the sale of imported finished goods. Note that the above provision may allow the Monetary Board, in meritorious cases, in consultation with the Board of Investments, subject to such conditions it may impose, may authorize:

(a) Remittance of royalties on contracts providing for higher royalty/rental rates; or

(b) For terms longer than five (5) years; or

(c) Containing restrictive provisions prohibiting the local licensees to export the products manufactured under the royalty/rental agreements; or

(d) Limiting their exportation abroad through the foreign licensors as exclusive contributors.

Nothing there speaks of the percentage of royalty and/or technical service fees, in meritorious cases, the basis of which, as authorized by the Monetary Board, in consultation with the Board of Investments, subject to such conditions it may impose, is on the sale of finished goods imported by the licensee from its non-resident licensor. We are not to indulge in statutory construction because Circular 396 is clear. Where the circular expressly provides that the royalty in contracts involving "manufacturing", e.g., actual transfers of technological services such as formulate/processes, technical know-how and the like as well as in contracts involving "marketing" services such as the use of foreign brands, trade names or trade marks, shall be based on the wholesale price of the commodities manufactured under the royalty agreement, the royalty and technical service fees thereon should be based on the sales of manufactured products and not on the wholesale value of finished goods imported by the licensee from its licensor. If it had been the intent to include the sale of imported finished goods in the computation

of royalty and technical service fees, in meritorious cases, as authorized by the Monetary Board in consultation with the Board of Investments, that could have easily been done by merely expanding Section 4-C of Circular No. 493 and adding such words as "imported articles" and the like.

Since the language of Central Bank Circular No. 393 is plain and free from ambiguity and expresses a definite and sensible meaning, it must be applied literally for that is the conclusive presumption of the meaning intended to convey. (See Regalado vs. Yulo, 61 Phil. 173.) The express mention of "wholesale price of the commodity/ties manufactured under the royalty agreement" would therefore preclude reading into it wholesale price of imported finished goods.

On this point, respondent argues, and correctly in the light of the above, that in importing the finished products and reselling them, petitioner acted as a trader. For the use of the trade mark of these products, it paid royalty to the trade mark owner, so that the royalty is already presumably included in the purchase price of the products. Royalties are not deductible if they are paid as part of the purchase price. (Mertens, Law of Federal Income Taxation,

Vol. 4, 25.113, Chap. 25, p. 245.)

We do not question petitioner's argument or observation that:

> . . . Before any product is introduced, product evaluation tests are conducted to determine their suitability and applicability to the Philippines because of its different climatic and environmental conditions. If the tests are favorable so that it is decided to introduce the product here, petitioner's sales personnel undergo product introduction and performance training to enable them to promote and sell the product. Service personnel also undergo training for product maintenance and repair to enable them to undertake post-sales service. To perform the test and conduct the training, petitioner needed technical assistance and information and proprietary data from Minnesota Mining & Manufacturing Co. of St. Paul, Minnesota, U.S.A. (hereinafter called "3M St. Paul") so that a Service Information and Technical Assistance Agreement was entered into on March 20, 1974.
>
> To effectively promote, advertise and sell the products, it is necessary to print and publish catalogues, brochures and handbills, and post and exhibit display signs bearing their trademarks and tradenames. Dealers are appointed to sell and also service the products and it also is necessary for them to be identified as authorized sales and service dealers so that they can use and display said trademarks and tradenames. Petitioner therefore also entered into a Patent and Trademark License Agreement with 3M St. Paul on March 20, 1974 granting petitioner the right to use 3M St. Paul's industrial property rights.

Nevertheless, following settled and recognized business practices, all these research and experimental expenses, expenses of selling the products or maintaining taxpayer's trade name, acquainting the public with the quality of its products and preserving its goodwill, are all considered and included in the determination of the purchase price or costs of products. As respondent aptly put it, "It is in a high degree extraordinary for a corporation to incur business expenses in connection with goods or services in an amount greatly in excess of what it knows it will obtain for such goods or services". (Mertens, Law of Federal Income Taxation, Vol. 4A, Chapter 25, p. 53.)

And on the argument of petitioner that the payments of royalty and technical license fees were approved by the Central Bank, the observations of respondent on this point find relevance:

> The approval by the Central Bank of the Patent and Trademark License Agreement and Service and Technical Assistance Agreement between Petitioner and its parent company is without consequence because after the approval thereof, the Central Bank would not know whether the royalty and technical service fees paid under the agreements are based on the wholesale price of

goods manufactured or on the wholesale price of goods imported. This is evident in the Central Bank approval of the remittance of technical service fees (Exhibit "I") which mentions only the "net sales subject to technical service fees" without distinguishing between sales of manufactured products and sales of imported products. Likewise, in petitioner's application with the Central Bank for the remittance of royalties (Exhibit "J-1"), there is no indication that the royalties are based on the sale of manufactured products or on the sale of imported products.

Otherwise stated, as long as the agreement appears on its face to comply with the requirements of Central Bank Circular No. 925, the Central Bank will approve it "in principle", but as to the actual implementation of the provisions of the agreement by the parties thereto, the Central Bank would have no control.

That is why the approval by the Central Bank of the Patent and Trademark License Agreement and Service and Technical Assistance Agreement "in principle" is subject to certain conditions, one of which is that the "remittance of royalties/technical service fees due thereunder shall be subject to x x x applicable tax laws x x x (letter of R.S. Cruz, Director, page 312, BIR records, Folder I). The phrase "applicable tax laws" encompasses the provisions of the Tax Code on the treatment of royalty and technical service fees as deductible expense; specifically, whether it is ordinary and necessary /Section 38(a)(1) Tax Code/.

The Court recognizes that an income tax deduction is a matter of legislative grace and that the burden of

clearly showing the right to the claimed deduction is on the part of the taxpayer. (Interstate Transit Lines vs. Commissioner, 319 U.S. 590, 595, 63 S. Ct. 1279.) As a matter of fact, the taxpayer seeking a deduction must point to some specific provisions of the statute in which that deduction is authorized, and must be able to prove that he is entitled to the deduction which the law allows. (1955 PH Fed. Tax Course, Par. 1801, cited in Umali, Roman, Reviewer in Taxation, 1985 ed., p. 106.) The applicable principles of law are clear and to our mind, petitioner 3M Philippines, Inc., has not sufficiently sustained the burden which is placed upon it to be entitled to the claimed deduction.

Upon the facts of the case, the amount of ₱2,323,599.92 paid as royalty and technical service fees for goods traded was 5% of the sale of imported goods of ₱46,471,998.40. Under Central Bank Circular No. 393, the percentage of royalty and technical service fees should be based on the sale of locally manufactured goods and not on the sale of imported finished goods. Since no manufacturing process was

done by petitioner on the imported finished goods, it is thus clear beyond doubt that it is not ordinary and necessary for petitioner to incur expenses for royalty and technical service fees in merely reselling imported finished goods. The burden of proof was upon petitioner 3M Philippines, Inc., to establish that the percentage of royalty and technical service fees fell within purview and limitation of Section 3-C of Central Bank Circular No. 395. This burden, 3M Philippines, Inc., had failed to satisfactorily discharge.

On the question of the deductibility of the pre-operational cost of the tapes used in the test run for the repair of the tape coater in the amount of ₱77,940.58, it appears that while petitioner protested the assessment with respect to the disallowance of the royalty and technical service fees of ₱2,423,599.92, it did not dispute the disallowance of this pre-operational cost, which respondent construed as acquiescence to the correctness thereof.

As pointed to by respondent, even before the assessment was issued and the issuance thereof was still being proposed, petitioner never objected to the proposed disallowance of the pre-operational cost.

(See letter of Messrs. Bito, Misa & Lozada, May 10, 1977, pages 276-299, BIR records, Folder I and letter of Cesar S. Cuaos, Corporate Attorney of petitioner, dated May 29, 1979, pages 385-388, BIR records, Folder I.) In denying petitioner's protest against the assessment, respondent thus stated:

> "The disallowance of the deduction of pre-operational expenses amounting to ₱77,940.38 as capital expenditures is not being disputed by the taxpayer. Accordingly, the said amount is also subject to tax" (page 34, BIR records, Folder II).

And during the hearing of this case before this Court, when petitioner offered to present testimonial evidence on the disallowance of the pre-operational cost, respondent objected to the introduction of such evidence on the ground of immateriality. The Court however allowed the introduction of such evidence with the understanding that the matter will be discussed in detail in the memorandums and in the decision. (t.s.n., pp. 15-21, August 14, 1985.)

While this matter of petitioner not having protested administratively the disallowance of the deduction of the pre-operational cost of ₱77,940.38, as well as the legal consequences thereof, was discussed exhaustively by respondent in his memorandum

dated May 7, 1986 (pp. 151-155, CTA records), petitioner failed, or preferred not to answer or react in its reply memorandum dated June 11, 1986 (pp. 157-163, CTA records) to the allegations and arguments of respondent thereof. Neither did petitioner call the attention of this Court during the hearing of this case or in its memorandum (pp. 105-177, CTA records) that it protested or disputed administratively in the Bureau of Internal Revenue the disallowance of the deduction of the pre-operational expense of ₱77,948.38 as capital expenditure.

Since petitioner did not protest or dispute administratively the disallowance of this pre-operational expense as capital expenditure, petitioner cannot raise this issue for the first time on appeal in this Court. This cannot be permitted, for the same reason that underlies the requirement of prior exhaustion of administrative remedies to give administrative authorities the prior opportunity to decide controversies within their competence, and in much the same way that, on the judicial level issues not raised in the lower court cannot be raised for the first time on appeal. To sanction such a

procedure whereby the court - which is supposed to review administrative determinations - would not review, but determine and decide for the first time, a question not raised at the administrative forum. (Aquinaldo Industries Corporation vs. Commissioner of Internal Revenue and the Court of Tax Appeals, L-29790, February 25, 1982, 112 SCRA 136.) Even more, such assessment should be protested administratively by filing a request for reconsideration or reinvestigation within thirty (30)days from receipt thereof, otherwise, it becomes final and unappealable. (Secs. 16(d), 319-A, now Sec. 270, National Internal Revenue Code.)

Accordingly, petitioner 3M Philippines, Inc., is ordered to pay to respondent Commissioner of Internal Revenue the amount of ₱1,195,566.80 as deficiency income tax for fiscal year ended October 31, 1974, plus surcharges and interest incident to delinquency pursuant to the provisions of Section 51(c)(2)(3) of the applicable National Internal Revenue Code, as amended.

WHEREFORE, the decision appealed from is hereby

affirmed at petitioner's costs.

SO ORDERED.

Quezon City, Metro Manila, August 14, 1987.

AMANDO TAGLE
Presiding Judge

WE CONCUR:

CONSTANTE P. ROAQUIN
Associate Judge

ARTEMIO V. RIVERA
Associate Judge