REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

ARMANDO L. ABAD, doing business under the trade name of REPUBLIC ALCOHOL DISTILLERY,
Petitioner,

- versus - C.T.A. CASE No. 717

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

This is an appeal from the decision of the Commissioner of Internal Revenue assessing against and demanding from petitioner Armando L. Abad the amounts of ₱570,829.10, as specific tax, and ₱207,890.30, as deficiency sales tax and surcharge, plus compromise penalty of ₱300.00 for the loss of books of accounts and records, or a total of ₱779,019.40.

The facts are as stipulated by the parties.

Petitioner, doing business under the registered trade name of Republic Alcohol Distillery, is engaged in business as a distiller, and operates two alcohol distilleries, a bonded warehouse and a bonded denaturing warehouse. During the period from January, 1955 to August, 1958, petitioner manufactured and sold, without paying specific tax, 836,483 proof liters of specially denatured alcohol in, and from, its denaturing warehouse in accordance with four (4) formulas, and for the uses applied for by the grantees, and approved by respondent, as follows:

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"(a) To every 100 gauge liters of ethyl alcohol of not less than 180 degrees proof, there shall be added two (2) liters of methanol and a sufficient quantity of flourescin to impart a distinctive yellowish color to the resulting maxture;

"(b) To every 100 gauge liters of ethyl alcohol of not less than 180 degrees proff, there shall be added two (2) liters of methanol and a sufficient quantity of uranin solution to impart a distinctive yellowish color to the resulting mixture;

"(c) For every 100 liters of ethyl alcohol, 189 proof, there shall be added 10 liters of acetone; and

"(d) To every 100 gauge liters of ethyl alcohol of not less than 180 proof, there shall be added 5 liters of methyl alcohol."

The specially denatured alcohol was used by the grantees in the manufacture of various non-beverage industrial products such as varnish, pre-mixed rice, solid alcohol fuel, detergents, emulsifiers, and industrial solvents, shellac, wood dye, thinner, cleansing mixtures, embalming mixtures and barbershop disinfectants like Tonix and Bayrum, which products contained more than 50% ethyl alcohol by volume.

During the same period of from January, 1955, to August, 1958, petitioner also produced and sold completely denatured alcohol of not less than 180 degrees proof (ninety per cent absolute alcohol), on the gross sales of which he paid 7% sales tax computed after deducting the cost of ethyl alcohol purchased from suppliers and used in the manufacture of the completely denatured alcohol. It is, however, admitted that the "x x distillers from whom said rectified (ethyl) alcohol was purchased did not pay any specific tax on said rectified (ethyl) alcohol used by x x (petitioner) as raw materials and neither did they declare their sales of said rectified alcohol for purposes of the sales tax imposed by Section 186 of the Tax Code."

On December 12, 1958, respondent, after an investigation conducted by his agents, ascertained that petitioner has not paid the tax on the 836,483 proof liters of specially denatured alcohol. Hence, he assessed and demanded the sum of ₱570,829.10 as specific tax on the 836,483 proof liters of rectified alcohol used in the production of specially denatured alcohol, and the amount of ₱207,890.30, representing deficiency sales tax and 25% surcharge on the completely denatured alcohol, plus ₱300.00 as compromise penalty for the loss of the books of accounts and records of petitioner.

Petitioner having contested the assessment, the case was elevated to the Appellate Division of the Bureau of Internal Revenue. After the hearing therein, respondent reiterated his assessment. Hence, this appeal.

The parties admit that the amount of ₱207,890.30 represents the amount which should be due from petitioner as deficiency sales tax, inclusive of 25% surcharge, in the event this Court holds that the cost of the ethyl alcohol he purchased from other distillers and used in producing the completely denatured alcohol is not deductible from the gross selling price of the denatured alcohol. It is also agreed that petitioner should not be held liable for the said amount if the cost of ethyl alcohol is held to be deductible. Furthermore, respondent admits that petitioner cannot be held liable for the compromise penalty of ₱300.00 without the latter's consent.

The issues presented for our consideration are: (1) Whether or not the 836,483 proof liters of specially denatured alcohol manufactured, removed and sold by petitioner are subject to specific tax; and (2) whether or not the cost of ethyl alcohol purchased from other distilleries and used in the manufacture of completely denatured alcohol by the petitioner is deductible from the gross selling price of the said completely denatured alcohol.

The pertinent provisions of the Tax Code involved in these two (2) issues are as follows:

> "SEC. 124. Payment of specific tax on domestic products.- Specific taxes on domestic products shall be paid by the manufacturer, producer, owner or person having possession of the same; and, except as otherwise especially allowed, such taxes shall be paid immediately before removal from the place of production."

"SEC. 127. Tax on preparation containing distilled spirits as chief ingredient.- Medicinal preparations, flavoring extracts, and all other preparations, except toilet preparations, of which, excluding water, distilled spirits form the chief ingredient, shall be subject to the same tax as such chief ingredient. x x x "

"SEC. 128. Exemption in favor of domestic denatured alcohol.- Domestic alcohol of not less than one hundred eighty degrees proof (ninety *per centum* absolute alcohol) may, when denatured, be withdrawn from a registered distillery or bonded warehouse without the prepayment of specific tax prescribed in section 133, for the purpose of being used for fuel, or light, or for use generally in the arts, industries, hospitals, sanitaria, and clinics, or for research or experimental purposes, or for the official use of the Government of the Republic of the Philippines or its instrumentalities or political subdivisions." (As amended by sec. 3, R.A. No. 1608)

"SEC. 133. Specific tax on distilled spirits.- On distilled spirits there shall be collected subject to the provisions of section one hundred and twenty-eight of this Act, except as hereinafter provided, specific taxes as follows:

(a) If produced from sap of the nipa, coconut, cassava, camote, or buri palm, or from the juice, syrup, or sugar of the cane, per proof liter, seventy centavos:

(b) If produced from any other materials, per proof liter, ten pesos. x x x

'Distilled spirits', as here used, include all substances known as ethyl alcohol, hydrated oxide of ethyl, or spirits of wines, which are commonly produced by the fermentation and subsequent distillation of grain, starch, molasses, or sugar, or of some syrup or sap, including all dilutions or mixtures; and the tax shall attach to this substance as soon as it is in existence as such, whether it be subsequently separated as pure or impure spirits, or be immediately or at any subsequent time transformed into any other substances either in process of original production or by any subsequent process." (As amended by sec. 7, R.A. No. 1608)

"SEC. 186. Percentage tax on sales of other articles.- There shall be levied, assessed and collected once only on every original sale,

> barter, exchange, and similar transaction either for nominal or valuable considerations, intended to transfer ownership of, or title to, the articles not enumerated in sections one hundred and eighty-four and one hundred and eighty-five a tax equivalent to seven per centum of the gross selling price or gross value in money of the articles so sold, bartered, exchanged, or transferred, such tax to be paid by the manufacturer or producer: Provided, That where the articles subject to tax under this section are manufactured out of materials likewise subject to tax under this section and section one hundred and eighty-nine, the total cost of such materials, as duly established, shall be deductible from the gross selling price or gross value in money of such manufactured articles; x x x" (Underscoring supplied.)

Petitioner does not dispute the correctness of the computation of the specific tax on the 836,483 proof liters of specially denatured alcohol in the amount of ₱570,829.10. However, he contends that he is not liable therefor on the ground that the said specially denatured alcohol is not "distilled spirits" as contemplated in Section 133 of the Tax Code; and that when distilled spirits are denatured, as in the case at bar, they become subject to the provisions of Section 128, and, therefore, are exempt from the specific tax imposed by Section 133.

On the other hand, respondent asserts that the specially denatured alcohol having been used as raw materials in the manufacture of other finished products, i. e., varnish, premixed rice, solid alcohol fuel, detergents, solvents, shellac, etc., the chief ingredient of which is distilled spirit, it is subject to specific tax in accordance with Section 127 of the Tax Code.

We find no merit in petitioner's contention that the specially denatured alcohol is not subject to specific tax. Petitioner had entirely overlooked the fact that the specially denatured alcohol which he manufactured and sold under the four (4) formulas consists of more than 50% ethyl alcohol by volume. Hence, it cannot be denied that distilled spirits compose the chief ingredient of the specially denatured alcohol in question. In resolving an issue similar to the one at bar, in the La Tondeña case, we held the following:

> "We shall now proceed to determine whether or not distilled spirits is the chief ingredient of the denatured ethyl alcohol in question. Distilled spirits as defined in Section 133 of the Tax Code include:
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> "'all substances known as <u>ethyl alcohol</u> hydrated oxide of ethyl, or spirits of wines, which are commonly produced by the fermentation and subsequent distillation of grain,starch, molasses, or sugar, or of some syrup, or sap, <u>including</u> all dilutions or mixtures.' (Underscoring supplied)
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> "Thus, under this definition, ethyl alcohol is considered distilled spirits. Considering this statutory definition and General Circular No. 468 of the Bureau of Internal Revenue, dated September 18, 1940, which states in part that 'alcohol shall be considered the chief ingredient of medicinal preparations if after excluding water, alcohol constitutes more than 50% of the preparation by volume, we are of the opinion and so hold that the specially denatured alcohol prepared and produced by the petitioner herein, some of which were used by it in the manufacture of its "Jai Alai" rubbing alcohol and the rest sold to its customers who used the same as rubbing alcohol and for medical and surgical pur-

> poses, is subject to the specific tax prescribed by Section 127 in relation to Section 133 of the Tax Code. A cursory perusal of the different formulas used by the petitioner in making the specially denatured alcohol supports this conclusion. All these formulas show that ethyl alcohol which by express provision of law is classified as 'distilled spirits' is the chief ingredient of said preparations." (La Tondeña, Inc. vs. Collector of Internal Revenue, C.T.A. Case No. 182, Dec. 16, 1957; Underscoring supplied.)

On the strength of our opinion in the above-cited case, we hold that the specially denatured alcohol under consideration is subject to the payment of specific tax pursuant to Section 127 in relation to Section 133 of the Tax Code.

Anent the claim of petitioner that the specially denatured alcohol is exempt under Section 128 of the Tax Code, we find the same not well taken. We have held, in the case of La Tondeña, Inc., supra, that the exemption under said Section 128 refers to domestic denatured alcohol used in the operation of industries and not to denatured alcohol to be used merely as an ingredient in the manufacture of another product. Inasmuch as the specially denatured alcohol in question was used as raw material in the manufacture of other products by the manufacturers to whom the said specially denatured alcohol was sold, and not used in the operation of industries, the specially denatured alcohol is not therefore exempt from the payment of specific tax.

The case of Commissioner of Internal Revenue vs. Central Azucarera Don Pedro, G.R. No. L-14015 May 31, 1960, can not be applied in support of petitioner's proposition that it is the manufacturers of varnish, premixed rice, solid fuel, detergents, emulsifiers, and industrial solvents, shellac, wood dye, thinner, cleaning mixtures, embalming mixtures and barbershop disinfectants like Tonix and Bayrum who are liable for payment of specific tax. The specially denatured alcohol sold by petitioner in the former case was removed by the buyers, while in the present case, the removal was made by petitioner himself.

Petitioner's basis for deducting the total cost of the ethyl alcohol purchased by it from other distillers and used as raw materials in the manufacture of completely denatured alcohol from the gross selling price of said completely denatured alcohol is the proviso of Section 186 of the Tax Code, which reads:

> "SEC. 186. Percentage tax on sales of other articles.- x x x Provided, That where the articles subject to tax under this section are manufactured out of materials likewise subject to tax under this section and section one hundred and eighty-nine the total cost of said materials, as duly established, shall be deductible from the gross selling price or gross value in money of such manufactured articles."

The completely denatured alcohol in question is unquestionably subject to sales tax under the above-cited codal section. And for the total cost of the ethyl alcohol to be deductible from the gross selling price of the denatured alcohol for purposes of computing the sales tax authorized by law, the ethyl alcohol must likewise be subject to sales tax under either Section 186 or Section 189 of the Tax Code. We shall now consider whether or not it is thus subject to sales tax.

Ethyl alcohol is subject to specific tax under Section 133 of the Tax Code. However, when it is denatured, as in the case at bar, it ceases to be liable for specific tax in pursuance of the provisions of Section 128 of the Tax Code. Upon denaturation, it consequently becomes liable for the sales tax provided in Section 186 of the Tax Code, it being not included among the articles taxable under Sections 184 and 185 thereof. And inasmuch as the ethyl alcohol is subject to sales tax, its total cost should, therefore, be deducted from the gross selling price of the completely denatured alcohol. The fact that the sales tax was not actually paid does not foreclose the deductibility of the total cost of the ethyl alcohol.

The Tan Chiu case, G.R. No. L-15008, January 28, 1961, cited by respondent, is not authoritative on the stand that the cost of the ethyl alcohol in question is not deductible from the gross selling price of the completely denatured alcohol because the raw materials thereon, consisting of cotton knitted materials, were not subject to sales tax as they were exempt therefrom under the provisions of Republic Act No. 901.

WHEREFORE, the decision appealed from is modified in the sense that petitioner is hereby ordered to pay only the sum of ₱570,829.10 as specific tax on the specially denatured alcohol, with costs against petitioner.

SO ORDERED.

Manila, January 4, 1963.

MARIANO NABLE
Presiding Judge

I concur:

AUGUSTO M. LUCIANO
Associate Judge

Associate Judge ROMAN M. UMALI reserved his vote.