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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

BERLIMED PHILIPPINE
CORPORATION,
Petitioner,

- versus - CTA CASE NO. 3159

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

4/28/89

D E C I S I O N

Disputed by petitioner Berlimed Philippine Corporation is respondent Commissioner of Internal Revenue's deficiency income tax and interest assessment for the calendar year 1974 in the total amount of P218,533.74, computed as follows: (par. 5, petition for review, admitted in the answer, par. 1.)

INCOME TAX

Net Income per return			P184,120.00
Add:			
a]	Excessive royalties as disguised dividend (amount paid)	P171,460.00	
	Less: Allowed by Central Bank 5% of gross sales of P3,171,567.02	158,578.35	12,881.65
b]	Consigned samples from mother company		
	JV - December 1966	P215,563.00	
	JV - December 1973	210,394.00	425,957.00

Since these are consigned samples of the mother company, only the importation expenses are chargeable to the taxpayer. The subsidies received are compensation for the promotional activities carried for the mother company.

c] Excess Donation

Claimed			P 20,223.00	
Less:	Allowable -	P624,959.65		
	Plus	20,223.00		
		P645,182.65		
		x .03		
		P 19,355.00	19,355.00	867.52
Total net income per review				P625,826.17
Amount of tax				P209,039.00
Tax paid				55,142.00
Deficiency tax				P153,897.00
Interest at 42%				64,636.74
T o t a l				P218,533.74

Respondent's assessment resulted from the disallowance of certain expenses, consisting of: (par. 8, petition for review; admitted in answer, par. 1.)

a.) Alleged excessive royalties or disguised dividends paid by petitioner to its parent company, Schering Aktiengesellschaft, hereinafter referred to as Schering; respondent believing that the royalties were paid in violation of Central Bank Circular No. 393;

b.) Expenses other than importation expenses on alleged consigned samples received by petitioner from Schering, respondent believing that the said samples were designed to promote the business of Schering and not of petitioner and therefore the cost of such samples may not be deducted; and

c.) Alleged excessive donation.

According to petitioner, the disallowance of the aforesaid expenses is erroneous for the following reasons: (p. 9, petition for review.)

a.) The royalties paid to Schering pursuant to the License Agreement between Schering and petitioner are clearly not excessive. Moreover, Central Bank Circular No. 393 does not govern the validity of royalty agreements. Hence, the entire amount of royalties is deductible expense on the part of petitioner.

b.) Alleged consigned samples were not really consigned by Schering to petitioner as petitioner was charged by Schering for the value of the samples. The samples were designed to promote the goodwill and business of petitioner. Hence, the cost of such samples may clearly be deducted.

c.) The items listed as donations are not really donations but constitute deductible business expense.

After investigation upon protest of petitioner, respondent in a letter dated October 7, 1980 confirmed the subject assessment and demanded the payment of P218,533.74 as deficiency income tax, inclusive of interest. Hence, this appeal.

It appears that petitioner is a domestic corporation engaged in the business of importing, manufacturing and marketing pharmaceutical products. In 1969, it entered into a license agreement with Schering Aktiengesellschaft (Schering for short) to enable it to manufacture Schering's products using Schering's formulae, processes and knowhow and to use Schering's trademarks in the Philippines, from January 1, 1969 to December 31, 1979. As consideration for the transfer of manufacturing knowhow and the use of trademarks, petitioner had to pay royalties amounting t 7% on the net sales value of the agreement products sold by petitioner. (pp. 119-120, CTA records.)

Pursuant to Article 13 of the license agreement, petitioner paid to Schering as royalties in 1974 the amount of P171,460.00 or 7% of petitioner's sales of the agreement products for the year. The record shows that the royalty remittance of P171,460.00 to Schering was approved by the Central Bank. Petitioner claimed the said amount as deductible business expense for the year 1974 under Section 30(a)(1)(A) of the applicable Tax Code. On the theory however that the royalty expense claimed by petitioner was excessive because Central Bank Circular No. 393 allows only the remittance of royalties not in excess of 5% of the sales, respondent disallowed P12,891.65 of the total royalty payment of P171,460.00.

Is Section 30(a)(1)(A) of the Tax Code the proper basis for determining the deductibility of royalty payments as business expenses?

A similar issue was recently settled by the Supreme Court in 3M Philippines, Inc., vs. Commissioner of Internal Revenue, G.R. No. 82833, September 26, 1988, where the factual setting is identical to that in the case at bar, and wherein it was ruled that it is Central Bank Circular No. 393 that defines what royalty payments are proper, hence, improper payments of royalty are not deductible as legitimate business expenses. To quote the pertinent portions of the decision:

However, petitioner argues that the law applicable to its case is only Section 29(a)(1) [sic] of the Tax Code which provides:

"(a) Expenses. – (1) Business expenses.

(A) In general. – All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; travelling expenses while away from home in the pursuit of a trade, profession or business, rentals or other payments required to be made as a condition to the continued use or possession, for the purpose of the trade, profession or business, for property to which the taxpayer has not taken or is not taking title or in which he has no equity."

Petitioner points out that the Central Bank "has no say in the assessment and collection of internal revenue taxes as such power is lodged in the Bureau of Internal Revenue," that the Tax Code "never mentions Circular 393 and there is no law or regulation governing deduction of business expenses that refers to said circular." (p. 9, Petition.)

The argument is specious, for, although the Tax Code allows payments of royalty to be deducted from gross income as business expenses, it is CB Circular No. 393 that defines what royalty payments are proper. Hence, improper payments of royalty are not deductible as legitimate business expenses.

> CB Circular No. 393 dated December 7, 1973 was published in the Official Gazette issue of December 17, 1973 (69 O.G. No. 51, p. 11737). Circulars issued by the Central Bank in the exercise of its authority under the Central Bank Act, and which have been duly published in the Official Gazette, have the force and effect of law (People vs. Que Po Lay, 94 Phil. 640; Lim Hoa Ting vs. Central Bank, 104 Phil. 573). They are binding on everybody, the petitioner, as much as the public respondent.

The disallowance by respondent of the amount of P12,881.65 of the total royalty payment of P171,460.00 was therefore proper.

On the amounts of P215,563.00 and P210,394.00, which are reflected as subsidies from Schering for sample consignments (Exhibits D, D-a, D-1, D-1-a, pp. 69-70, CTA records), respondent disallowed them as compensation for the promotional activities carried by petitioner for the mother company. It appears that Schering shipped free of charge samples of pharmaceutical products to petitioner for the purpose of allegedly introducing new products to the Philippines. Thus, samples were marked: "samples - sale punishable by law." Believing that said samples were designed to promote the business of Schering and not that of petitioner, respondent considered these subsidies as payments for the consigned samples and therefore the cost thereof may not be deducted except that "only the importation expenses are chargeable to the taxpayer." Petitioner now claims that the disallowed deductions of P215,563.00 and P210,394.00 represent the compensating taxes and brokerage fees paid by it on the samples.

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, 593, 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, Reviewer in Taxation, 1985 ed., p. 106.) Has petitioner sufficiently sustained the burden which is placed up it to be entitled to the claimed deductions of P215,563.00

and P210,394.00 as compensating taxes and brokerage fees, respectively, allegedly paid by it on the samples?

We believe not.

To begin with, as treated and reflected in petitioner's journal vouchers (Exhibits D and D-1), the amounts of P215,563.00 and P210,394.00, which allegedly were compensating taxes and brokerage fees paid to release the samples shipped by Schering to petitioner, were taken up and entered as subsidies from Schering for/on sample consignments. (See Exhibits D-A and D-1-a of petitioner which are Annexes A and B of this decision.)

Nothing there speaks of compensating taxes or brokerage fees paid. The corresponding entries explicitly and clearly state "subsidies on sample consignment" and "subsidy from Schering for the following sample consignments" - without more. Hence, the allegation of petitioner or testimony of its witness that these amounts were compensating taxes and brokerage fees could, at best, be self-serving.

At any rate, the entries in taking up or recording these subsidies specify the invoices, their respective serial numbers and amounts. Why did not petitioner present or introduce as evidence these invoices? These invoices would show the nature of the items covered therein and could have established that the amounts stated were in payments of compensating taxes and brokerage fees. Petitioner presented in evidence the vouchers. Would the supporting invoices of these vouchers be adverse to petitioner if produced?

Again, to establish that the amounts of P215,563.00 and P210,394.00 were compensating taxes and brokerage fees to release the samples, the best evidence would have been the official receipts issued by the Bureau of Customs and the broker or brokerage f. m. Why is it that petitioner did not present these receipts, whether original, duplicate, duly certified or authenticated copies thereof? Then, Section 66, Revenue Regulations No. 2, requires that any claim for deduction must be substantiated by record showing in detail the amount and nature of the expenses incurred. But on the assumption that the receipts or invoices are no longer available, the evidence presented by petitioner do not prove that the amounts of P215,563.00 and P210,394.00 were for compensating taxes or brokerage fees but were subsidies from Schering for sample consignments. And which seems to suggest, as stated by respondent, that these subsidies received were compensation for the promotional activities carried by petitioner for the mother company.

These claimed deductions cannot therefore be allowed.

Coming to the amount of P867.52 which was disallowed by respondent as excess donation, respondent treated the sum of P20,225.00 classified in petitioner's books as "gifts and donations" as donations and subjected it to the 3% limitation on deductibility of charitable contributions pursuant to Section 30(h) of the National Internal Revenue Code of 1974. We are inclined to agree with petitioner that the so-called "gifts and donations" are not actually donations. An examination of Exhibit E, which is a summary of these "gifts and donations" for the year ended December 31, 1974, will show that most of the so-called gifts were given to hospitals, doctors and related persons. According to petitioner's witness, its finance manager, these company give-aways were given to promote petitioner's business, which is a general practice in the pharmaceutical industry. (t.s.n., May 14, 1986, p.24.) The testimony was not contradicted by respondent.

The rule has been established that promotion expenses constitute one of the deductions in conducting a business. (Collector of Internal Revenue vs. Zamora, L-15280 & L-15289-90, May 31, 1963, 8 SCRA 163.) Representation expenses are deductible if they are reasonable in amount, ordinary and necessary, and incurred in connection with business. (Roxas vs. Court of Tax Appeals, L-25043, April 26, 1968, 23 SCRA 285.) An examination of these company give-aways reveals that they are reasonable, ordinary and necessary, and there is a close link between the expenses and petitioner's business.

Accordingly, respondent erred in allowing only

P19,355.00 of the P20,223.00 spent as promotional and representation expenses which should be allowed in full.

In view of the foregoing, petitioner's deficiency income tax for the year 1974 is computed as follows:

Net income per return			P186,120.00
Add:			
Consigned sample from mother company			
J.V. - December 1966	P215,563.00		
J.V. - December 1973	210,394.00	425,957.00	
Net income per decision			P612,077.00
Income tax due thereon			P204,227.00
Less: Tax already paid			55,142.00
Deficiency Tax			P149,085.00
Interest at 42%			62,615.70
Total amount due and collectible			P211,700.70

WHEREFORE, petitioner Berlimed Philippine Corporation is hereby ordered to pay to respondent Commissioner of Internal Revenue the amount of P211,700.70 as deficiency income tax for the year 1974, plus surcharges and interest incident to delinquency pursuant to the provisions of Section 51(a)(2)(3) of the applicable National Internal Revenue Code, as amended.

SO ORDERED.

Quezon City, Metro Manila, April 28, 1989.

AMANTE FILLER
Presiding Judge

WE CONCUR:

CONSTANTE C. ROAQUIN
Associate Judge

ALEX Z. REYES
Associate Judge

C E R T I F I C A T I O N

I hereby certify that this decision was reached after due consultation among the members of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

AMANTE FILLER
Presiding Judge
Court of Tax Appeals

Annex A

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BERLIMED PHILIPPINE CORPORATION

Concorde Condominium Bldg., Legaspi Village
Makati, Rizal — Tel. Nos. 87-37-71 to 73
Box 331 (Commercial Center Post Office) Makati, Rizal, 3117

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Exh "D"

JOURNAL VOUCHER

DATE	ACCT. NO.	ACCOUNT NAME	REF.	SUBSIDIARY DEBIT	SUBSIDIARY CREDIT	GENERAL DEBIT	GENERAL CREDIT
		12 - 64					
December 31,1974	0980	Deferred Charges				1,250.00	
	1510	Other Prepayments made					1,250.00
		To reclassify the following:					
		1. Downpayment - Phil. Drug Reference		1,050.00			
		2. Deposit- Saulog Transit Inc.		200.00			
				1,250.00			
		12 - 65					
	2060	Exchange Losses				174,731.72	
	1701	Schering A.G. Goods Account					143,599.44
	1703	Schering A.G. Current Account					11,045.95
	1715	Duco A.G. Loan Account					20,086.33
		To take up exchange Adjustment II Semester.					
		12 - 66					
	40-1	Information Expense				215,562.65	
		4880-Samples					
	9600	Subsidies - Information					215,562.65
		To take up subsidies on sample consignment as follows:					

Exh D-A

Inv. #	DM Amount	Peso Amount
48225	5,940.00	14,671.80
49583 ✓	4,040.00	10,988.80
48226/I	4,040.00	10,988.80
49584 ✓	22,620.00	64,341.05
50669 ✓	33,000.00	87,539.04
51623 ✓	5,794.00	14,985.[illegible]
53124 ✓	4,800.00	12,048.00
	80,234.00	215,562.65

PREPARED BY: MANUEL S. PENALES

APPROVED BY:

Annex B

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BERLIMED PHILIPPINE CORPORATION

Concorde Condominium Bldg., Legaspi Village
Makati, Rizal — Tel. Nos. 87-37-71 to 73
Box 331 (Commercial Center Post Office) Makati, Rizal, 3117

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Exh D-1
Pet

JOURNAL VOUCHER

DATE	ACCT. NO.	ACCOUNT NAME	REF.	SUBSIDIARY DEBIT	SUBSIDIARY CREDIT	GENERAL DEBIT	GENERAL CREDIT
		12 - 71					
...cember 31, 1974	2174	Income from Reduction of Provision				5,225.00	
	0971	Provision for Compensation & Pension					5,225.00
		To reverse entry fro provsion written off for the 1st semester 1974.					
		12 - 72					
	1703	Schering A.G. Current Account				210,394.00	
	9600	Subsidy					210,394.00
		To record subsidy from Schering for the following sample consignments:					
		12 - 73					
	40-1	Information Expenses 4880-Samples				210,394.00	
	1703	Schering A.G. Goods Account					210,394.00
		To take up subsidies on sample consignments.					
		12 - 74					
	2400	Income Tax				55,142.00	
	0974	Provisions for Taxation					55,142.00
		To take up corporate income tax for the year 1974.					

Sample consignments under entry 12 - 72:

Inv. No.	DM. Amount	Peso Amount
54043	11,320.00	33,394.00
51624	48,000.00	141,600.00
49583/1	12,000.00	35,400.00
	71,320.00	210,394.00

Exh Q-...
Pet

PREPARED BY: MANUEL ... GONZALES

APPROVED BY: HELMUT K...