REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

may 18, 1967

INDUSTRIAL TEXTILES
MANUFACTURING COMPANY
OF THE PHILIPPINES
(ITEMCOP),
Petitioner

versus

C.T.A. CASE NO. 1528

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 respondent assessing against and demanding from petitioner the sum of ₱10,564.74 as deficiency sales tax and 25% surcharge for late payment thereof in connection with the sales of jute bags and yarn in 1959. Respondent also suggested to petitioner the payment of ₱2,100.00 as compromise penalty imposed under Section 209 of the National Internal Revenue Code in extrajudicial settlement for violation of Sections 183 and 186 of the same Code.

Petitioner, Industrial Textiles Manufacturing Company of the Philippines (hereinafter referred to as ITEMCOP), a domestic corporation located at E. Delos Santos Avenue, Mandaluyong, Rizal, is engaged in the manufacture and sale of jute bags. The Secretary of Finance granted ITEMCOP full exemption from the payment of taxes until December 31, 1958 as a new and necessary industry under Republic Act No. 901. In 1959, the full exemption of ITEMCOP from the payment of taxes was reduced to 90% and it thereby became subject to 10% only of the taxes due from it. In the manufacture and sale of jute bags in 1959, which is subject to 7% sales tax under Section 186 of the Revenue Code, ITEMCOP used raw materials which were either imported abroad or purchased locally.

ITEMCOP filed its monthly sales tax returns for 1959 (Exhs. A to L, CTA rec., pp. 22-24) with the Deputy Provincial Treasurer of Mandaluyong, Rizal. The said returns show that ITEMCOP had a total gross sales of ₱10,395,208.25 after deducting the sales tax of ₱17,890.77 covering the period from January to May 1959. It paid sales tax of ₱39,160.07 during the period in question on the sale of manufactured jute bags. ITEMCOP deducted from its gross sales of ₱10,395,208.25 the amount of ₱4,764,391.44 consisting of (1) imported raw materials in 1958 valued at ₱939,-687.31, which was reflected as inventory at the beginning of 1959; and (2) the cost of raw materials either imported abroad or purchased locally in 1959 valued at ₱3,824,704.13.

In the investigation of the books of account, financial statement, and other records of ITEMCOP, respondent's examiners found that petitioner deducted from its gross sales of jute bags in 1959 the cost of raw materials in the amount of ₱4,849,-051.61 used in the manufacture thereof before the 7% sales tax was computed and imposed. However, despite the deduction of the cost of raw materials from the gross sales of jute bags, the revenue examiners found that the sales tax allegedly paid by ITEMCOP in the sum of ₱39,160.07 is still very much lower than the sales tax of ₱ 47,611.86 legally due from it.

In computing the sales tax due from ITEMCOP in 1959, respondent's examiners (1) disallowed the deduction from the gross sales of jute bags the amount of ₱939,687.31 representing the cost of raw materials imported by petitioner in 1958 and carried as its inventory at the beginning of 1959; and (2) deducted from the ending inventory (consisting of unused raw materials, goods in process, and unfinished goods), the cost of imported raw materials in the alleged amount of ₱4,730,-742.86. The cost of the imported and locally purchased raw materials amounted to ₱3,524,240.18

and ₱11,280.27, or a total of ₱3,535,520.45. By deducting the said cost of raw materials from the gross sales of ₱10,329,149.48, allegedly appearing in petitioner's financial statement, respondent's examiners found that petitioner's taxable sales of jute bags in 1959 was ₱6,801,694.08. By adding thereto the sum of ₱8,065.06 as alleged untaxed sales of yarn, the total taxable sales of petitioner in 1959 amounted to ₱6,801,694.08. The deficiency sales tax due thereon, inclusive of the 25% surcharge for late payment thereof, is ₱10,564.74, computed as follows:

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|---|---|
| Taxable sales of jute bags | ₱6,793,629.02 |
| Add: Untaxed sales of yarn | 8,065.06 |
| Total taxable sales . . . . | ₱6,801,694.08 |
| 10% of 7% sales tax due thereon . . . . . . . . | ₱ 47,611.86 |
| Less: Taxes already paid | 39,160.07 |
| Deficiency sales tax due | ₱ 8,451.79 |
| 25% surcharge for late payment . . . . . . . . . | 2,112.95 |
| TOTAL AMOUNT DUE AND COLLECTIBLE . . . . | ₱ 10,564.74 |

In a letter dated August 23, 1963 (Exh. 5), petitioner requested respondent to cancel the said deficiency sales tax assessment, but said request was denied by respondent in his letter to ITRMCOP dated July 10, 1964. Hence, this appeal.

The issues submitted by the parties for resolution of the Court are as follows:

1. Whether or not the cost of raw materials imported tax-free by petitioner before 1959 valued at ₱939,687.31, and used in the manufacture of jute bags in 1959, is deductible from the gross sales of the finished product under Section 186-A of the National Internal Revenue Code; and

2. Whether the cost of raw materials used in the manufacture of jute bags and deductible from petitioner's gross sales is ₱3,824,704.13 or ₱3,524,240.18.

First Issue

In disputing and contesting the deficiency sales tax assessment, petitioner alleges that the cost of raw materials imported tax-free prior to 1959 is deductible from the gross selling price of the finished product (jute bags) before the 7% sales tax is imposed. Petitioner's defense is predicated on the provisions of Section 186-A of the National Internal Revenue Code which read as follows:

> SEC. 186-A. Whenever a tax-free product is utilized in the manufacture or production of any article, in the determination of the value of such finished article, the value of such tax-free product shall be deducted. (Sec. 5, Republic Act No. 2025)

Petitioner contends that Section 186-A of the Revenue Code, supra, is plain, unambiguous, clear and sufficiently broad to embrace the deduction of the cost of raw materials imported tax-free from the gross selling price of the finished or manufactured product (jute bags).

Respondent countered by alleging that the "tax-free product" mentioned in Section 186-A of the Tax Code has reference to the raw materials purchased from tax-exempt industries established under Republic Act No. 901 because, before the addition of Section 186-A to Section 186 of the Revenue Code, the cost of raw materials purchased from tax-exempt industries is not, for purposes of the sales tax, deductible from the gross selling price of the finished products before imposing and computing the 7% sales tax. In fact, the legal position and stand taken and adopted by respondent are reflected and manifested in General Circular No. V-252 of the Bureau of Internal Revenue, dated July 15, 1957, which implemented Section 186-A of the Tax Code.

The issue of whether or not the cost of raw materials imported tax-free prior to 1959, which were used in the manufacture of an article sold in 1959, is deductible from the gross sales of the finished product, is not an issue of first impression. In the case of Republic Flour Mills, Inc. vs. Commissioner of Internal Revenue, C.T.A.

Case No. 1151, December 12, 1965, involving a similar issue, this Court in sustaining respondent's view ruled as follows:

> The only question involved in this case is whether or not the cost of raw materials imported tax-free in the year 1958, which were utilized in the year 1959 for the manufacture of flour sold in 1959, is deductible from the gross sales in the year 1959.
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> Petitioner seeks to justify the deduction of the cost of the wheat grain from the gross selling price of flour on the theory that its tax exemption is equivalent to a payment of the advance sales tax on the wheat grain used in the manufacture of flour. In support of this theory, it invokes Sec. 186-A of the Revenue Code, which authorizes the deduction of the value of a tax-free product used in the manufacture of an article from the value of such finished article. It is also suggested that the wheat grain, which was imported tax-free in 1958, did not lose its tax-exempt character merely because it was used in 1959, the year the taxability of petitioner's produce or manufacture commenced.
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> We do not subscribe to petitioner's view that tax exemption is equivalent to a tax payment. The Supreme Court, in the case of Tan Chiu vs. Commissioner, L-15005, January 28, 1961, denied the deductibility of the cost of cotton knitted materials (raw materials) used in the manufacture of undershirts (finished articles) from the gross selling price of the finished articles because no sales tax was paid on the raw materials which were bought from a tax-exempt industry. (See also Pacific Oxygen & Acetylene Co. v. Comm., L-17708, April 30, 1965) The fact, therefore, that the raw materials were tax-exempt does not mean payment of the tax so as to

preclude its taxability. A clear indication that exemption of raw materials from the payment of tax is not considered payment therefor is the incorporation of Section 186-A, which expressly allows the deduction of the value of tax-exempt raw materials from the gross selling price of the finished articles.

We now come to the question of whether or not petitioner comes within the purview of Section 186-A of the Revenue Code, which provides as follows:

> "SEC. 186-A. Whenever a tax-free product is utilized in the manufacture or production of any article, in the determination of the value of such finished article, the value of such tax-free product shall be deducted." (Underlining supplied)

Congress passed laws (Republic Acts Nos. 35 and 901) exempting new and necessary industries from the payment of taxes. However, Section 186 of the Revenue Code does not allow the deduction of the cost of raw materials bought from new and necessary industries from that of the finished articles if the sales tax on the raw materials has not been previously paid (Tan Chiu vs. Commissioner, supra). Thus, Section 186-A was added to the Revenue Code to allow the deduction of the cost of raw materials bought from new and necessary industries which were utilized in the manufacture of another article. And since petitioner imported the wheat grain in question, it cannot justify the deduction of its cost from the value of the flour on the provisions of Section 186-A of the Revenue Code. The "tax-free product" mentioned in the said Section 186-A refers to a product or raw material bought from tax-exempt new and necessary industries. Moreover, to sustain the view of petitioner would extend the full tax exemption on the flour beyond December 31, 1958, contrary to the time limit set forth in the certificate of exemption granted to petitioner.

The Bureau of Internal Revenue in implementing Section 5, Republic Act No. 2025 (now Sec. 186-A, Revenue Code), issued General Circular No. V-251 dated July 15, 1957 (Phil. Tax Journal, Vol. 2, p. 605) which reads:

> "Deductibility of cost of tax-exempt raw materials from the gross selling price of manufactured articles. - Section 186-A is a new section. The 'tax-free product' mentioned in this new section has reference to raw materials purchased from tax-exempt industries. Before its enactment, the cost of raw materials purchased from tax-exempt industries is not, for purposes of the sales tax, deductible from the gross selling price of the articles manufactured therefrom. By virtue of its enactment, the cost of said raw materials is now deductible.
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> "In applying the provisions of this new section, the cost of raw materials purchased from tax-exempt industries prior to June 22, 1957 shall not be allowed as a deduction although they are or may be used after said date. In other words, only the cost of such raw materials purchased on or after June 22, 1957 shall be deductible."

We do not think that the above-mentioned circular is contrary to Section 186-A of the Revenue Code, as contended by petitioner. The construction of a statute placed by the department whose duty it is to carry

> it into execution is entitled to great weight (Regalado v. Yulo, 61 Phil. 173). And it is a cardinal rule in taxation that "exemptions from taxation are highly disfavored in law, and he who claims exemption must be able to justify his claim by the clearest grant of organic or statute law. An exemption from the common burden cannot be permitted to exist upon vague implications" (Coll. v. Manila Jockey Club, L-8755, March 23, 1956; House v. Posadas, 53 Phil. 338; Asiatic Petroleum v. Llanes, 49 Phil. 466). Petitioner failed to justify its claim for tax exemption and, therefore, the cost of tax-exempt surplus wheat grain imported in the year 1958 but utilized in 1959 cannot be deducted from its gross selling price in 1959.

We find no cogent and compelling reason to reconsider the above-quoted ruling.

Second Issue

Petitioner contends that the amount of ₱3,824,704.13 correctly represents the landed cost of its imported raw materials plus 25% mark-up. However, respondent avers that the landed cost of the said imported raw materials plus 25% mark-up, as adjusted, is the amount of ₱3,524,-240.18 and not ₱3,824,704.13.

A detailed examination of the sales tax returns filed by petitioner for 1959 shows that the total amount of deductions from its sales of jute bags in the amount of ₱10,359,208.25 is ₱4,764,391.44 (Exhs. A to L; A-1 to L-1; and P, CTA rec. pp. 22-45, 70). The deduction consists of ₱939,687.31 and ₱3,824,704.13, or a total of ₱4,764,391.44, representing the cost of raw materials imported tax-free in 1958 and the cost of imported and locally purchased raw materials in 1959, respectively, which were used in the manufacture of jute bags in 1959 and sold during the year. The correctness of the said sales tax returns filed by petitioner has not been assailed or impugned by respondent.

There is no dispute between the party litigants as to the amount of ₱939,687.31 representing the cost of raw materials imported tax-free by petitioner in 1958. There is also no dispute that the cost of locally purchased raw materials in 1959 was in the amount of ₱22,644.20 (Exhs. O-6 and O-2). The dispute involves the cost of the imported raw materials in the amounts of ₱3,824,704.13 and ₱3,524,240.18 as claimed by petitioner and respondent, respectively.

Respondent contends that the cost of raw materials purchased by petitioner in 1959 amounted to ₱4,849,051.61, as found in petitioner's financial statement (Exh. O-1), is erroneous because the correct amount should be ₱4,730,742.86 if computed on the basis of the advance sales tax paid by petitioner in the amount of ₱41,394.00 (Exh. 1, BIR rec., p. 2). However, in the payment of the 7% sales tax on the manufactured jute bags in 1959, petitioner only deducted from the gross sales thereof the total amount of ₱4,764,391.44 (Exh. P, CTA rec., p. 70) and not ₱4,849,051.61 as declared in petitioner's financial statement (Exh. O-1, p. 5 of Financial Statement).

The dispute in the figures involving the actual cost of the imported raw materials in 1959 may be attributed to the procedure adopted by respondent's examiners in the determination thereof and the basis laid down and pursued by petitioner. The procedure adopted by respondent is uncertain and unreliable because there is no satisfactory showing that petitioner paid advance sales tax in the amount of ₱41,394.00 in its importation of raw materials in 1959. Respondent's claim of such payment is merely based on the memorandum of the investigating revenue examiners to the Chief, Investigation Division, of the Bureau of Internal Revenue.

We find the procedure adopted by petitioner to be accurate and more reliable because petitioner based its landed cost of imported raw materials, plus 25% mark-up, by considering the actual figures shown in the import entry declarations as checked by the examiners and appraisers of the Bureau of Customs. Moreover, petitioner added to the landed cost of the imported raw materials the storage fees, losses from pilferage and deterioration, and the expenses of hauling from the customs premises to its warehouse and finally to its factory. The inclusion of the said expenses in the landed cost of the imported raw materials is justified and sanctioned by Section 186 of the Revenue Code which provides, among others, as follows:

> That where the articles subject to tax under this section are manufactured out of materials likewise subject to tax under this section and 189, <u>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</u>. (Underscoring supplied)

Consequently, there is no merit in the charge that petitioner inflated the cost of imported raw materials which was deducted from its gross sales of jute bags in 1959. If the cost of the imported raw materials in the amount of ₱4,849,051.61, as allegedly found in petitioner's financial statement, is more than the landed cost of the imported raw materials computed by respondent's examiners, this can be explained by the fact that the cost of handling the imported raw materials from the pier to the factory was taken into account by petitioner. At any rate, it is to be noted that the amount of ₱4,849,051.61, which was allegedly inflated, was not the same amount of deduction made by petitioner and found in its sales tax returns for 1959. The amount of ₱3,824,704.13 declared and found in the said returns is the correct amount of raw materials deductible from petitioner's gross sales of jute bags in 1959.

Inasmuch as the amount of ₱939,687.31, representing the cost of raw materials imported tax-free by petitioner in 1958, cannot be allowed as a deduction from its gross sales of jute bags in 1959, the said amount should, therefore, be included in petitioner's taxable sales. Accordingly, petitioner is liable for 1959 deficiency sales tax in the amount of ₱8,222.26, inclusive of 25% surcharge, computed as follows:

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| Taxable sales . . . . . . . . . | ₱939,687.31 |
| 7% sales tax due thereon. . . | 65,778.11 |
| Due from petitioner | |
| (10% thereof). . . . . . . . | ₱ 6,577.81 |
| Add: 25% surcharge . . . . . . | 1,644.45 |
| Deficiency sales tax . . . . | ₱ 8,222.26 |

The tax due on the sales of yarn amounting to ₱8,065.06 was not included in the computation of the deficiency sales tax because it was proven by the witness of petitioner that the said amount was already included in the sales tax returns of petitioner for 1959 and that the sales tax due thereon had been paid.

With respect to the amount of ₱2,100.00 suggested to be paid by petitioner as compromise penalty, it is conceded by respondent, and is now well-settled jurisprudence, that compromise penalty cannot be imposed by respondent without the agreement and conformity of the taxpayer (U. S. T. v. Collector, G.R. Nos. L-11274 & L-11280, November 28, 1958; Collector v. Pio Barretto Sons, Inc., G.R. No. L-11805, May 31, 1960).

WHEREFORE, the decision appealed from has to be, as it is hereby modified. Petitioner is hereby ordered to pay respondent or his duly authorized collection agent the sum of ₱8,222.26 as deficiency sales tax for 1959, inclusive of the 25% surcharge. With costs against petitioner.

SO ORDERED.

Quezon City, May 18, 1967.

ESTANISLAO R. ALVAREZ
Associate Judge

WE CONCUR:

ROMAN M. UMALI
Presiding Judge

RAMON L. AVANCEÑA
Associate Judge