Lit.

PACIFIC KAPOK FACTORY,
Petitioner,

June 29, 1959 Entered 7/3/59

- versus -

C.T.A. CASE NO. 342

(1) manufacturer's tax
(2) compromise penalty

JOSE ARAÑAS, Acting
Collector of Internal
Revenue,
Respondent.

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DECISION

This is an appeal by petitioner from the decision of respondent denying the former's claim for refund of the sum of ₱1,968.50.

It appears that petitioner is engaged in the business of buying raw kapok and processing the same to produce clean kapok of two kinds. The finer class is used for stuffing pillows while the inferior one is used for filling and stuffing mattresses and cushions. Respondent assessed against petitioner, as manufacturer of kapok, the sum of ₱1,968.50, representing deficiency sales tax, surcharge and "penalty" on its sales of kapok from 1952 to 1954, itemized as follows:

Deficiency sales tax	₱1,458.80
25% surcharge	364.70
Penalty	145.00
Total	₱1,968.50

Petitioner contested the assessment, but because respondent threatened to enforce collection by distraint and levy, the said amount was paid on September 28, 1956 to the City Treasurer of Quezon City.

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The claim for refund of said amount having been denied, petitioner has elevated the case to this Court for review.

The sole question presented for our consideration is whether or not petitioner is a manufacturer of kapok. Respondent claims that petitioner is a manufacturer pursuant to Section 194(x) of the Revenue Code, which provides:

> "(x) 'Manufacturer' includes every person who by physical or chemical process alters the exterior texture of form or inner substance of any raw material or manufactured or partially manufactured product in such manner as to prepare it for a special use or uses to which it could not have been put in its original condition, or who by any such process alters the quality of any such raw material or manufactured or partially manufactured product so as to reduce it to marketable shape or prepare it for any of the uses of industry, or who by any such process combines any such raw material or manufactured or partially manufactured products with other materials or products of the same or of different kinds and in such manner that the finished product of such process of manufacture can be put to a special use or uses to which such raw material or manufactured or partially manufactured products in their original condition could not have been put, and who in addition alters such raw material or manufactured or partially manufactured products, or combines the same to produce such finished products for the purpose of their sale or distribution to others and not for his own use or consumption."

The method employed by petitioner in processing kapok is described in the report of Conrado E. Lotho, Technologist of the Institute of Science and Technology, dated March 2, 1957, as follows:

> "This is the report on the inspection of Pacific Kapok Factory at A. Bonifacio St., corner 14th Street, Quezon City, by

the undersigned who was accompanied by Mr. Lirio Z. Ambrosio, an agent of the Bureau of Internal Revenue, in compliance with the request of the Collector of Internal Revenue dated February 19, 1957, for the purpose of ascertaining the process employed by the said factory in the processing of shelled kapok pods to produce floss (kapok) in two grades. The fine grade is used for stuffing pillows while the inferior one is for filling and stuffing matresses and cushions.

"The process involved is essentially the processing of shelled kapok pods, as raw materials, which consists of separating the floss from cores, seeds and dirt.

"This is accomplished by milling the shelled kapok pods, which come in 60-kilo bales wrapped with buri mats. The bales are opened and its contents are then fed to the machines which consist of two horizontal chambers (3'2" x 12'26") with wire screen bottom, placed in tandem.

"The material as it passes through this machine is beaten up by a series of wooden blades which are attached to a revolving shaft and revolve close to the side of the horizontal chambers which are arranged so that the material moves from the first chamber to the second. As the floss comes out at the end of the last chamber, it is carried by a current of air through a delivery funnel which leads to the receiving room where it is bagged in paper and weighed. This is now ready for the market, or for use in the manufacture of pillows. The seeds, cores and dirt find their way through the wire screen at the bottom of the chamber by gravity. The cores with short floss are then collected and again milled in a vertical chamber (25" x 60") with revolving blades that beat the cores.

"The current of air from the bottom carries the short floss to the top of the chamber then to the receiving room where it is collected as second product, used primarily for filling and stuffing mattresses and cushions. The beaten cores which are heavy, drop at the bottom of the mill chamber as wastes.

"The process is purely mechanical using a 20-H.P. diesel engine as a source of power." (Exh. C for petitioner; Exh. 2 for respondent.)

In Cosmos Kapok Factory v. Araneta, C.T.A. No. 125, March 29, 1957, wherein the facts are the same as in the instant case, it was held that -

"x x x petitioner falls squarely under the second classification mentioned in section 194(x) of the Tax Code, viz: 'any one who by any such (physical or chemical) process alters the quality of any such raw material or manufactured or partially manufactured product so as to reduce it to marketable shape or prepare it for any of the uses of industry.' x x x.

"The above described process clearly indicate that the kapok is sufficiently changed by means of machinery, such that a thick and tough raw kapok is transformed into a cleaned and light kapok, thereby altering its quality so as to reduce it to marketable shape or prepare it for any of the uses of industry and thus become a distinct class of merchandise (see Ngo Siek v. Collector, 52 O.G. No. 16, p. 6873). We are therefore of the opinion and so hold that petitioner is a manufacturer as defined in section 194(x) of the National Internal Revenue Code and as such liable for the 7% tax on its sale of processed kapok prescribed by section 186 thereof."

The records do not reveal anything which would justify reversal of our opinion in the case of Cosmos Kapok Factory cited above. It is, however, argued that kapok being an agricultural product, petitioner is exempt from the sales tax on its sales of kapok pursuant to Section 188(b) of the Revenue Code. Section 188(b) exempts from the sales tax agricultural products when they are sold, bartered, or exchanged in this country by the producer or owner of the land where produced. But petitioner is neither the producer of the kapok nor the owner of the land where it was produced. It merely purchased the kapok which it processed and later sold. Therefore, Section 188 (b) does not apply to petitioner.]

For the foregoing considerations, we find that the deficiency sales tax in the sum of ₱1,458.80 and the 25% surcharge of ₱364.70, or a total of ₱1,823.50, were validly assessed and collected, and petitioner's claim for refund thereof was properly denied. With respect, however, to the "penalty" of ₱145.00, it appears that respondent required petitioner to pay the same as "compromise penalty" for violation of Section 183(a) in relation to Section 186, penalized under Section 209, of the Revenue Code. As the imposition by respondent of a "compromise penalty", without a compromise agreement, is unauthorized and illegal (University of Sto. Tomas vs. Coll. of Int. Rev., C.T.A. No. 10, Sept. 10, 1956, affd. on this point in G. R. Nos. L-11274 & L-11280, Nov. 28, 1958), and it appearing that no such compromise agreement has been entered into by the parties, the said sum of ₱145.00 was illegally collected.

WHEREFORE, respondent is hereby ordered to refund to petitioner the sum of ₱145.00. No prenouncement as to costs.

SO ORDERED.

Manila, June 29, 1959

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge