REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

CYANAMID PHILIPPINES, INC.
Petitioner,

- versus -

C.T.A. CASE NO. 4724

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated :
AUG 28 1995

x - x

DECISION

This is a petition to review the letter/decision of respondent, dated February 6, 1992, denying the protest on the assessment of deficiency income tax in the total amount of P13,261,278.23, inclusive of surcharge, interest and compromise penalty, for 1987.

Petitioner is a corporation duly organized and existing under and by virtue of the laws of the Republic of the Philippines. It is engaged in the marketing of various products in the areas of pharmaceutical, animal health and nutrition, and crop protection chemicals as well as medical devices. (TSN, Hearing of March 24, 1993, p. 7.)

The antecedent facts are as follows:

On November 23, 1990, petitioner received a letter of assessment, dated November 14, 1990, from respondent demanding the payment of deficiency income tax allegedly arising from (a) overstatement of cost of goods due to transfer pricing of products, namely; aurofac and minocycline, which petitioner purchased from its parent company, American Cyanamid; and (b) unnecessary and unreasonable payment of royalties to the latter company for the supply of technical know-how in the processing of its own bulk products into petitioner's prepared products in the amount of thirteen million two hundred sixty one thousand two hundred seventy eight pesos and twenty three centavos (P13,261,278.23). (Exhibit "A", CTA records, pp. 9-25.)

In response, petitioner protested the assessment in a letter, dated December 17, 1990, received by respondent on even date, claiming that the purchase price paid by petitioner to its parent company represents fair market price, and that the physical properties and uses of aurofac and minocycline are not altogether comparable with vigofac and doxycycline, respectively. The latter are both products of Pfizer, a corporation also engaged in the same line of business as petitioner.

Anent the royalty payment, petitioner contends that it is for the use of American Cyanamid's trademarks and its supply of technical know-how pursuant to licensing agreements duly registered and approved by the Central Bank of the Philippines and the Bureau of Patents, Trademarks and Technology Transfer.

On July 24, 1991, petitioner wrote a supplemental letter to the respondent refuting the alleged transfer pricing scheme and expounding further on the grounds of its protest.

Subsequently, respondent sent a letter, dated February 6, 1992, to the petitioner which was received on February 11, 1992, basically reiterating the original assessment and stating, to quote:

> "To avoid the accumulation of interest and surcharges, it is requested that you pay within ten (10) days from receipt hereof the aforesaid tax liability/ies at the Accounts Receivable/Billing Division, Room 203, BIR National Office Bldg., ... failing in that, we shall be constrained to refer your case to the Collection Enforcement Division for the issuance of warrants of distraint and levy to enforce its collection, as provided by law, without further notice.
>
> We will appreciate your preferential attention hereon.
>
> Very truly yours,
>
> For the Commissioner of Internal Revenue,
>
> (SGD.)
> MANUEL B. MINA
>
> Asst. Chief, Accounts Receivable/
> Billing Division"

Petitioner deemed the preceding letter as the final decision of the respondent on the protested assessment.

Hence, this instant petition.

In answer, respondent specifically denied the arguments presented by the petitioner, which are similar to those contained in its previous letter-protests, and raised as special and affirmative defense the lack of jurisdiction by this Court banking on the allegation that her letter, dated February 6, 1992, was not a decision on petitioner's letter-protest, dated December 17, 1990, in which case, herein appeal is premature.

The legal matters to be resolve thus center on three issues, namely:

a) whether or not the February 6, 1992 letter of respondent constitutes the final decision on the disputed assessment; and if in the affirmative,

b) whether or not petitioner overstated its cost of goods due to transfer pricing; and,

c) whether or not the disallowance of the royalty payment made by the petitioner to its mother company, American Cyanamid, was valid and in accordance with law.

On the first issue, respondent in her memorandum, filed on July 25, 1994, takes the view that her February 6, 1992 letter was a simple reminder to the petitioner to pay its tax liability within ten (10) days from receipt thereof, and such, being totally different from the usual tenor of her final decision on protested tax assessment and accordingly advises the taxpayer to appeal the same to this Court within 30 days from receipt thereof if not agreeable thereto as mandated by Section 229 of the Tax Code.

Moreover, respondent asserts that under the organizational set up of the Bureau of Internal Revenue, the Appellate Division of the Legal Service is the proper office solely vested with authority to rule on protested tax assessments and not the Accounts Receivable/Billing Division of the Collection Service.

The respondent ends her arguments by citing the case of **Surigao Electric Co., Inc. vs. Court of Tax Appeals** (54 SCRA 523), which defines a "final decision" as, to quote, "one which indicates to the petitioner in clear and unequivocal language what constitutes the final determination of the disputed assessment."

After an exhaustive study of the material points raised, we firmly conclude that this Court has an indisputable jurisdiction over the appealed case.

In the same Surigao case, the Supreme Court noted that "xxx nothing in Republic Act 1125 as amended, even remotely suggests the elements truly determinative of the appealability to the Court of Tax Appeals of a ruling of the Commissioner of Internal Revenue." It further categorically pronounced the letter of demand in question therein as unquestionably constituting the final action taken by the Commissioner where he not only demanded payment but also gave warning that in the event petitioner failed to pay, he would be constrained to enforce collection by means of the remedies provided by law. It must be observed that the present petition similarly involves a demand for payment with a warning on the issuance of warrant of distraint and levy, a collection remedy under the Tax Code.

In a later case, very much akin to the surrounding circumstances, the High Court even considered a plain letter of the Chief of Manila Examiners of the Office of the Commissioner of Internal Revenue, wholly reiterating the demand by the Bureau of Internal Revenue for the settlement of the assessment already made and sans any form of warning to enforce collection in case of failure to pay, as a clear indication of the final decision of the Commissioner against the reconsideration of the disputed assessment. (**Commissioner of Internal Revenue vs. Ayala Securities Corporation and the Honorable Court of Tax Appeals**, 70 SCRA 209).

In like manner, this Court had the occasion to pass upon as respondent's final decision, a letter coming from the Chief of Accounts Receivable/Billing Division, acting for respondent Commissioner of Internal Revenue, which reiterated the assessments made with a note thereunder on the denial of petitioner's request for reinvestigation. Afterwards, respondent therein served warrants of distraint and/or levy to enforce collection of deficiency taxes. (**Oceanic Wireless Network, Inc. vs. CIR**, CTA Case No. 4668, September 16, 1994).

Of great concern is the fact that herein respondent never questioned the authority of the Chief of the Accounts Receivable/Billing Division to act "FOR THE COMMISSIONER OF INTERNAL REVENUE" in said CTA case. Inexplicably, respondent is now singing a different tune. Under the doctrine of estoppel *in pais*, the respondent has, by her own act intentionally and deliberately led this Court to believe that the Chief of the Accounts Receivable/Billing Division can act for the Commissioner of Internal Revenue, she cannot now be permitted to repudiate or change such representation to satisfy her interests. (Section 2(a), Rule 131, Revised Rules of Court).

In fine, the allegations of the respondent cater only to befuddle and prolong the resolution of the merits of the case of the petitioner which in effect may deprive of vital content the import of the High Court's entreaty for the Commissioner of Internal Revenue to always indicate to the taxpayer in clear and 'unequivocal language her final action on the matter. There is the pressing need for fair play, regularity and ordrerliness of administrative action so as not to leave the taxpayer groping in the dark. (Surigao case, ***supra***.)

On the second issue, respondent anchors her deficiency assessment on the provisions of Section 43 of the National Internal Revenue Code (parallel to Section 482 of the U.S. Internal Revenue Code) which authorizes the Commissioner of Internal Revenue to distribute, apportion, or allocate gross income or deduction between or among two or more organizations, trades or businesses (whether or not incorporated and whether or not organized in the Philippines) owned or controlled directly or indirectly by the same interests, if she determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses. (Memorandum for the Respondent, CTA records, p. 141.)

Proceeding from such authority, respondent's revenue enforcement officers, Lourdes Geocaniga and Leticia Libat, in an investigation report, dated July 24, 1990, stated thusly:

> "Verification of the income aspects of the case revealed a discrepancy in the total amount of P10,241,652.57, inclusive of interest. The [sic] are deductions disallowed particularly cost of sales for overpricing its goods based on the same purchases made by its competitors to its mother company. A thorough analysis of transfer price was considered and as per discussion to its respective representation the variance is the result of generations of tetracycline wherein the items under questions [sic] belong to fourth generation and the other products of the competitors belong to third generation. Considering the cost variance with an average of 8 times more the cost of the competitors for the same products and suppliers the undersigned believes [sic] in the merits of the aforementioned assessments. (see attached breakdown of the cost comparison)." (Exhibit "2", p. 331, BIR records).

Weighing the arguments invoked and testimonies adduced in this issue, we find the conclusions of the respondent largely untenable and without merit.

The standard used by the abovementioned officers in making their findings/report resulting in alleged transfer pricing is what is known in American jurisprudence as "arm's-length pricing" which is the price an unrelated party would have paid under similar circumstances for the property involved in a transaction between two or more organizations, trades or businesses owned or controlled directly or indirectly by the same interests. In practice, the parameters of arm's-length dealing have been the subject of much commentary and controversy. (Vol. 12, Merten's Law of Federal Income Taxation, §45I. 26, 451.27; pp. 80-84)

Specifically, the standard applies only in situations where related taxpayers do not deal with each other on an arm's-length basis, just like what is being alleged by the respondent in the case at bar.

Consequently, in this case where a distribution, apportionment or allocation of income or deduction, etc. has been made by the respondent, the burden of proof is on the petitioner to show that the determination of arm's-length pricing is arbitrary, capricious and unreasonable, or an abuse of authority. (Vol. 12, Merten's Law of Federal Income Taxation, §45I.06, p. 14)

The petitioner has ably shown the merits of its case.

It correctly averred that respondent adopted the "comparable uncontrolled price method" in determining the arm's-length pricing of its products. (CTA records, p. 12). Under the method, the arm's-length price of a sale between group members (controlled sale) is equal to the price paid in comparable sales in which the sellers and the buyers are not members of the same controlled group (uncontrolled sales), with certain adjustments. (Vol. 12, Merten's Law of Federal Income Taxation, §45I.55, p. 164)

By provision of law, uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. xxx. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place... " [U.S. Treasury Regulations 1, Section 482-2(e)(2); CTA records, p. 13 ; underscoring supplied.]

Applying the above method to the instant case, there is a necessity of knowing the physical property and circumstances of the products involved in both the controlled and uncontrolled sales, namely, aurofac and minocycline as compared with vigofac and doxcycycline respectively, in order to arrive at a determination on whether the two sales are comparable or not, before concluding on the alleged transfer pricing committed through overstatement of cost of goods.

Let us start with petitioner's aurofac vis-a-vis Pfizer's vigofac. The former contains aureomycin, an antibiotic for curing animal diseases applied at prescribed dosages. (Exhibits "F-1" and "F-2")

On the other hand, vigofac (listed as Super Vigofact in Exhibit "F-3", and Super Vigofac in Exhibit "G") is a growth promotant composed of dried extracted streptomycin meal and fermentation solubles, dried penicillin fermentation solubles, corn distillers, corn distillers dried grains, other solubles and vitamins, minerals and amino acids applied at varying dosages. It increases rate of gains and improves feed efficiency. (Exhibits "F-3" and "F-4", Super Vigofac and Growth Promotants, p. 196)

At a glance, the two products are dissimilar. One is an antibiotic and the other is a growth promotant. While respondent insists that vigofac contains an antibiotic which is penicillin (TSN, October 27, 1993, p. 20), presumably from her reading of dried extracted penicillin fermentation solubles, petitioner, speaking through George N. Gagliardi, Executive Director of Biochemical and International Process Development, Agricultural Division of American Cyanamid, has explained the difference of the latter, to quote:

"Q Have you had any occasion in the past to hear of competitive product such as VIGOFAC, which is manufactured by Pfizer?

A. Yes. I've never -- until recently, I never heard of VIGOFAC itself, but I'm quite familiar of the class of materials they are, which is they're known as <u>unidentified growth factors</u>. And they've been around for 30, 40 years in the business.

But VIGOFAC is a trade name which I was not familiar with until, you know, recent involvement in this case. But unidentified growth factors have been around for many years.

Q. When you say unidentified growth factors, can you explain further what you mean by that, Mr. Gagliardi.

A. These products, unidentified growth products, factors and VIGOFAC, there's three of them, which are by - products of the fermentation processes, And they're the by - products after you have removed

> the product you intensely want to produce, whether it be an antibiotic or an alcohol.
>
> In VIGOFAC, it contains -- I want to get the right terminology -- dried extracted streptomyces fermentation residue. What that is, after your run your fermentation for some products, you want to remove the product by an extraction process, an extraction to be done either with a solvent or by pH adjustment and it solubilizes the antibiotic.
>
> Now you make a separation and the antibiotic is removed in the liquid phase and the cake is the residue or what is not contained in the antibiotics. <u>It is a waste product from that process</u>." (Exhibit "D", Deposition, dated September 16, 1992 p. 15-16, underscoring supplied.)

The above statement is fully supported by a cursory reading of the literature of super vigofac which shows that it provides a low-cost and highly dependable source of unidentified growth factors (UGFs) sourced from dried fermentation solubles for increasing weight gains and feed efficiency of chicken, turkeys, etc. (Exhibits "G", CTA records, p. 451.)

Prescinding from the comparisons, the Veterinary Product Catalogue of the Philippine Veterinary Drug Association presented by petitioner definitely establishes in a nutshell the abysmal differences of the two products, where aurofac is listed under the classification "antibiotics" with vigofac placed under "growth promotants." (Exhibit "F", "Table of Contents", p. ix).

Next, we try to compare the characteristics and circumstances attendant to petitioner's minocycline and Pfizer's doxycycline.

Minocycline uses declomycin, a natural antibiotic whereas doxycycline uses oxytetracycline, also a natural antibiotic in their respective production processes. (Petitioner's Memorandum, CTA records p. 106 and 109,).

Mr. Charles Vincent Hilderbrand, manager of American Cyanamid, who had extensive experience in handling minocycline production summed up the subject in this way:

> "Q. If you were to summarize Mr. Hilderbrand, the basic difference between Doxycycline and Minocycline, how would you summarize this basic difference between Doxycycline and Minocycline?
>
> A. In summary, Doxycycline uses a much cheaper and more readily-available raw material. The process is a shorter process, three steps versus Minocycline's five steps, and it, therefore, uses less raw materials.
>
> If one would review each step requiring individual raw materials, there's only three steps to require raw materials versus Minocycline's five. And assuming reasonable yields through the process, you would also say that the yield would be higher in a Doxycycline process just because there's less steps, less physical handling.

> In addition, the requirement for precious metal catalyst, being only one-third the requirement of the Minocycline process. You also have far less handling of very expensive precious metals and the associated recovery cost of those previous metals and replacing losses with precious metals.
>
> So it would be my expectation that the production of Doxycycline would be far cheaper and easier than the production of the complex Minocycline product. (Exhibit "C", Deposition, p. 19).

Respondent's witness, Lourdes Geocaniga, on the other hand, testified on her lack of knowledge of the technical attributes of the two products but stated otherwise, to quote:

> "A. Yes, but my point is the difference between minocycline and doxycyline -- you stated in your position paper that doxycyline is a third generation and minocycline is a fo[u]rth generation.
>
> But considering the price which is about eight times, is it not unreasonable the cost of improving that product is eight times more than the third generation which is doxycyline which is the product of Pfizer. That is our reason." (TSN, October 27, 1993, pp. 24-26).

Earlier in its letter-protest, dated December 14, 1990, petitioner categorized minocycline and doxycycline as fourth and third generation tetracyclines, respectively.

Respondent seems to ground her findings on the mere observation that a fourth generation antibiotic should not be allowed to incur cost of improvement eight times higher than its supposed precursor doxycycline, a third generation antibiotic. That is an erroneous belief.

Analyzing the physical characteristics and circumstances involved in their production, minocycline is a completely different kind of antibiotic from doxycycline with each one having separate and unique chemical structure and production processes. (CTA records, p. 16)

It is already demonstrated that minocycline did not originate from doxycyline but rather from declomycin, another type of natural antibiotic. Also, their production process and cost of development are at variance with one another. Most important of all, there is no sufficient basis to compare the two as they are not within the same level of generation. If ever, the cost of improvement for minocycline should be gauged with another fourth generation tetracycline developed likewise from declomycin in order to produce a comparable and reliable data.

In conclusion, respondent gathered her findings in an arbitrary, unreasonable and capricious manner. There was no apparent attempt to verify with technical circumspection the comparability of the products in question. It can be gleaned readily from the facts that the physical property and circumstances in the processing and sale of petitioner's products are not "identical" or "so nearly identical that any difference can either have no effect on price, or such difference can be reflected by a reasonable number of adjustments to the price" of Pfizer's products. (U.S. Treasury Regulations, *ibid*) By the adjective "identical" or the phrase "so nearly identical," the compared products must be exactly or essentially alike. (Merriam Webster's Dictionary.) Even if penicillin could be established to be a part of vigofac, it would remain physically distinct and beyond compare with aurofac. This also applies with minocycline and doxycycline. In other words, comparability must be based on generic similarity before any adjustments can be considered. Those adjustments for nearly identical products could either refer to addition of ingredients such as vitamins, minerals and amino acids, or differences in the production process and the like but the main component or essential materials between the compared products must be alike.

Assuming **arguendo** that there are differences on petitioner's products which can be adjusted by a reasonable number to reflect on the price of Pfizer's

We so hold, therefore, that respondent never had any valid justification to declare the cost of goods of petitioner's products, aurofac and minocycline, as having been overstated in price when bought from its parent company, American Cyanamid.

On the third and last issue, respondent's revenue enforcement officer, Lourdes Geocaniga, stated in her testimony that the royalties were disallowed on account of the following reasons:

> a) the know-how obtained by the petitioner in the processing of the parent company's bulk products enhances the latter's products consequently increasing the sales thereof, thereby rendering such additional royalties unnecessary and unreasonable as a business expense;
>
> b) the petitioner charges eight times higher (transfer pricing) on the cost of its products.
>
> (TSN, October 27, 1993, pp. 12-13, 30-31; Respondent's Memorandum, CTA records, p. 145.)

To buttress her point, respondent cited the case of L. Schepp Co., 25 BTA 419, where an idea, likened to know-how by respondent, covering a method of selling a product which was not susceptible of patent, copyright or trademark was disallowed payment of royalties; and also the case of Atlantic Monthly Co., 5 TC 1025, where notwithstanding the existence of an obligation to pay royalties by virtue of a contract, the court found the payments voluntary, the subsidiary being under no obligation to pay therein, hence, they were not deductible. (Respondent's Memorandum, CTA records, pp. 13-17; 146-147)

We disagree.

At the outset, let it be understood that, under our jurisdiction, petitioner is a domestic corporation independent of its mother corporation, American Cyanamid, no matter how related it might be to the latter.

It appears that respondent somehow misconstrued the whole situation. She attributes and credits the enhancement and increase in sales resulting from the processing of the bulk products to the parent company, American Cyanamid, instead of the petitioner, who in actuality is the one doing the activity. The parent company only sells bulk products. The one using the know-how to process such bulk products into finished products is obviously the domestic corporation, Cyanamid Philippines.

Said acquisition of know-how is made possible by a license agreement between the parties duly registered with and approved by the Bureau of Patents, Trademark and Technology Transfer, and the Central Bank of the Philippines. (Exhibits "H" to "H-37", and "I")

Although know-how is not exactly mentioned in our National Internal Revenue Code, it qualifies under Section 36(a) (4)(A), on rentals and royalties of the National Internal Revenue Code. Under the said provision, American Cyanamid can earn income on royalties for "the use of or the right or privilege to use in the Philippines any xxx secret formula or process xxx" by the petitioner. An examination of the abovestated license agreement would reveal under Article IV thereof that in the preparation of prepared products for sale in the Philippines, American Cyanamid shall make available to the petitioner "know how" regarding their formulae, their preparation and packaging specifications, and that petitioner shall avoid and prevent the disclosure of the parent company's know-how to others. This would only exemplify that know-how pertains to a secret formula or process.

In the same vein, "secret formula or process," is one among those considerations where royalty payment can be validly made under the 1976 RP-US Tax Treaty.

From the foregoing, it is crystal clear that "know-how" is a distinct consideration, aside from patents, copyrights, trademarks, etc. which can be the subject of royalty payments.

The position of the respondent is entirely surprising because as early as 1988 or way before the assessment was made, the Bureau of Internal Revenue priorly issued a ruling under reference number 456-88 confirming IBM Phils. opinion to the effect that in consideration of the "technical knowledge and know-how," ***inter alia***, provided to IBM Phils. by World Trade pursuant to the World Trade Agreement, IBM Phils. will withhold tax on royalties paid to World Trade equivalent to 10%. Again, like in the issue of jurisdiction, **supra**, respondent is misleading the Court in telling us that "know-how" is not susceptible of patent, copyright and trademark, hence, the disallowance of royalties.

On another level, respondent seems to contend that though there exists a contract between petitioner and its parent company, royalty payments made by petitioner are simply voluntary and under no obligation to pay.

This Court says otherwise. The obligation to pay royalties is founded on a licensing agreement duly sanctioned by proper government agencies. Without the license to use know-how, petitioner cannot engage in the processing and selling of its products. Petitioner continues to exist as a legitimate domestic corporation solely by virtue of its licensing agreement and any attempt to deny it the use of know-how would simply result in the natural cessation of its business. The elements of necessity and reasonableness are easily appreciated in the use of know-how in petitioner's business.

Regarding the last reason, overstatement of cost of goods due to transfer pricing has no causative relation to the payment of royalties. Anyone may commit transfer pricing and at the same time validly pay royalties, vice versa. They are treated differently. Cost of goods is deducted from gross sales while royalties are deducted from gross income. Cost of goods is based on bulk purchases while royalties are paid for the use of trademark and know-how in the processing and selling of petitioner's products.

In sum, we uphold the validity and the legality of the payment of royalties for know-how made by petitioner to its parent company, American Cyanamid.

WHEREFORE, finding the petition for review meritorious, the same is hereby **GRANTED**. The deficiency income tax assessment of P13,261,278.23 issued by respondent against the petitioner for the year 1987 is hereby cancelled and set aside. No costs.

SO ORDERED.

RAMON O. DE VEYRA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Associate Judge

MANUEL K. GRUBA
Associate Judge

CERTIFICATION

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.

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals