Supreme Court E-Library

FIRST DIVISION

[G.R. No. 82833. September 26, 1988]

3M PHILIPPINES, INC., *petitioner, vs.* **COMMISSIONER OF INTERNAL REVENUE,** *respondent.*

SYLLABUS

1. **TAXATION; INCOME TAX; ROYALTY PAYMENTS CLAIMED AS DEDUCTIONS FOR BUSINESS EXPENSES IN INCOME TAX RETURN, DISALLOWED.** — Section 3-c of CB Circular No. 393 provides for payment of royalties only on commodities *manufactured* by the licensee under the royalty agreement not on the wholesale price of finished products imported by the licensee from the licensor.

2. **COMMERCIAL LAW; BANKING LAWS; CENTRAL BANK; CENTRAL BANK CIRCULAR NO. 393, NOT THE TAX CODE, DEFINES PROPER PAYMENTS OF ROYALTY.** — 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. Improper payments of royalty are not deductible as legitimate business expenses.

3. **ID.; ID.; ID.; CIRCULAR ISSUED BY THE CENTRAL BANK IN THE EXERCISE OF ITS AUTHORITY AND DULY PUBLISHED IN THE OFFICIAL GAZETTE, CONSIDERED AS LAW.** — Central Bank Circulars, like CB Circular No. 393 (dated December 7, 1973, published in the Official Gazette issue of December 17, 1973 issued by the Central Bank in the exercise of fits authority under the Central Bank Act, duly published in the Official Gazette, have the force and effect of law and binding on everybody.

APPEARANCES OF COUNSEL

Bito, Misa & Lozada for petitioner.
The Solicitor General for respondent.

Supreme Court E-Library

DECISION

GRIÑO-AQUINO, *J.*:

This is a petition for review of the decision of the Court of Tax Appeals which affirmed the assessment of deficiency income tax on the petitioner's 1974 income tax return, for deductions of "business expenses" in the form of royalty payments to its foreign licensor which the respondent Commissioner of Internal Revenue disallowed. This case hinges on the propriety or impropriety of the deductions.

3M Philippines, Inc. is a subsidiary of the Minnesota Mining and Manufacturing Company (or "3M-St. Paul") a non-resident foreign corporation with principal office in St. Paul, Minnesota, U.S.A. It is the exclusive importer, manufacturer, wholesaler, and distributor in the Philippines of all products of 3M-St. Paul. To enable it to manufacture, package, promote, market, sell and install the highly specialized products of its parent company, and render the necessary post-sales service and maintenance to its customers, petitioner entered into a "Service Information and Technical Assistance Agreement" and a "Patent and Trademark License Agreement" with the latter under which the petitioner agreed to pay to 3M-St. Paul a technical service fee of 3% and a royalty of 2% of its net sales. Both agreements were submitted to, and approved by, the Central Bank of the Philippines.

In its income tax return for the fiscal year ended October 31, 1974, the petitioner claimed the following deductions as business expenses:

(a) royalties and technical service fees of ₱3,050,646.00; and

(b) pre-operational cost of tape coater of ₱97,485.08.

On the first item, the respondent Commissioner of Internal Revenue allowed a deduction of ₱797,046.09 only as technical service fee and royalty for *locally manufactured* products, but disallowed the sum of ₱2,323,599.92 alleged to have been paid by the petitioner to 3M-St. Paul as technical service fee

Supreme Court E-Library

and royalty on ₱46,471,998.00 worth of *finished products imported* by the petitioner from the parent company, on the ground that the fee and royalty should be based only on locally manufactured goods. The improper deduction was treated by respondent as a disguised dividend or income.

On the second item, respondent allowed ₱19,544.77 or one-fifth (1/5) of petitioner's capital expenditure of ₱97,046.09 for its tape coater which was installed in 1973 because such expenditure should be amortized for a period of five (5) years, hence, payment of the disallowed balance of ₱77,740.38 should be spread over the next four (4) years. Respondent ordered petitioner to pay ₱840,540 as deficiency income tax on its 1974 return, plus ₱353,026.80 as 14% interest per annum from February 15, 1975 to February 15, 1976, or a total of *₱1,193,566.80.*

Petitioner protested the assessment in a letter dated March 7, 1980. The respondent Commissioner did not answer the protest. Instead, he issued warrants of distraint and levy on October 1, 1984. On October 23, 1984, petitioner appealed to the Court of Tax Appeals by petition for review with a prayer for the issuance of a writ of preliminary injunction to stop the enforcement of the warrants of distraint and levy. The writ was issued upon petitioner posting a ₱1,850,000 bond.

After the respondent had filed his answer to the petition for review and hearings were held, the Tax Court rendered a decision on August 14, 1987 upholding the Commissioner's ruling. Petitioner's motion for reconsideration of the decision was denied by the Tax Court on April 6, 1988. A copy of the resolution was received by petitioner on April 21, 1988.

On April 25, 1988, petitioner sought a review in this Court of the Tax Court's decision.

The pertinent legal provisions in this case are Section 29(a)(1) of the Internal Revenue Code and Circular No. 393 of the Central Bank.

Because remittances to foreign licensors of technical service fees and royalties are made in foreign exchange, CB Circular No. 393 (Regulations Governing Royalties/Rentals) dated

Supreme Court E-Library

December 7, 1973 was promulgated by the Central Bank as an exchange control regulation to conserve foreign exchange and avoid unnecessary drain on the country's international reserves (69 O.G. No. 51, pp. 11737-38). Section 3-C of the circular provides that royalties shall be paid only on commodities *manufactured* by the licensee under the royalty agreement:

"Section 3. Requirements for Approval and Registration. — The requirements for approval and registration as provided for in Section 2 above include, but are not limited to the following:

"a. x x x xxx xxx

"b. x x x xxx xxx

"c. The royalty/rental contracts involving manufacturing' royalty, *e.g.*, actual transfers of technological services such as secret formula/processes, technical know-how and the like shall not exceed five (5) per cent of the wholesale price of the commodity/ties *manufactured* under the royalty agreement. For contracts involving 'marketing' services such as the use of foreign brands or trade names or trademarks, the royalty/rental rate shall not exceed two (2) per cent of the wholesale price of the commodity/ties *manufactured* under the royalty agreement. The producer's or foreign licensor's share in the proceeds from the distribution/exhibition of the films shall not exceed sixty (60) per cent of the net proceeds (gross proceeds less local expenses) from the exhibition/distribution of the films. x x x. (Italics supplied.)" (p. 27, *Rollo*.)

Clearly, no royalty is payable on the wholesale price of finished products imported by the licensee from the licensor.

However, petitioner argues that the law applicable to its case is only Section 29(a)(1) 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,

Supreme Court E-Library

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, 1983 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.

WHEREFORE, finding no reversible error in the decision of the Court of Tax Appeals, the petition for review is denied. Costs against the petitioner.

SO ORDERED.

Narvasa, Cruz, Gancayco, and *Medialdea, JJ.,* concur.