

### Title:

3M Philippines, Inc. vs. Commissioner of Internal Revenue

### Facts:

3M Philippines, Inc., a subsidiary of Minnesota Mining and Manufacturing Company (3M-St. Paul) based in the USA, entered into agreements with its parent company for technical services and patent/trademark licensing, agreeing to pay fees based on its net sales. These agreements were approved by the Central Bank of the Philippines. For the fiscal year ending October 31, 1974, 3M Philippines claimed deductions for royalties, technical service fees, and pre-operational costs related to a tape coater as business expenses in its income tax return.

The Commissioner of Internal Revenue allowed partial deductions but disallowed certain amounts, particularly the royalty and technical service fees related to finished products imported from the parent company, justifying that only fees related to locally manufactured goods qualify as deductible. The Commissioner deemed the improper deductions as disguised dividend or income, leading to an assessment of a deficiency income tax against 3M Philippines.

3M Philippines protested the assessment but received no response. Eventually, it challenged the assessment before the Court of Tax Appeals, which upheld the Commissioner's ruling. The motion for reconsideration was denied, prompting 3M Philippines to seek review from the Supreme Court.

### Issues:

1. Whether the payments made by 3M Philippines to 3M-St. Paul for royalties and technical service fees on imported finished products qualify as deductible business expenses under Section 29(a)(1) of the Internal Revenue Code.
2. The applicability and effect of Central Bank Circular No. 393 on the deductibility of royalty payments as business expenses.
3. The interplay between tax law as outlined in the Internal Revenue Code and exchange control regulations by the Central Bank concerning deductible expenses.

### Court's Decision:

The Supreme Court denied the petition for review, upholding the decision of the Court of Tax Appeals. It concurred with the Commissioner's stance that improper payment of royalty, as defined by CB Circular No. 393, cannot be considered deductible legitimate business

expenses. The Supreme Court emphasized that while the Tax Code allows for the deduction of royalty payments as business expenses, Circular No. 393 explicitly restricts such payments to commodities manufactured under the royalty agreement, thereby excluding imported finished products from deduction eligibility. The Court further highlighted that Circulars issued by the Central Bank, when duly published, have the force and effect of law and are binding on all parties, including the petitioner.

**### Doctrine:**

Payments for royalties and technical service fees related to imported finished products are not deductible as business expenses under the Philippine Tax Code when such payments contravene the limits and conditions set forth in relevant Central Bank circulars. Central Bank Circulars, upon proper publication, have the force and effect of law and affect the interpretation and application of tax law provisions regarding deductible expenses.

**### Class Notes:**

- Deductible business expenses must be ordinary, necessary, and directly related to the business operation.
- Central Bank Circulars, when properly published, influence the interpretation and enforcement of tax laws, particularly when it comes to cross-border transactions involving foreign exchange.
- The distinction between costs related to locally manufactured goods versus imported finished products is critical in determining the eligibility of certain expenses as deductible for tax purposes.
- The exchange control regulations serve dual purposes: to conserve foreign exchange and to ensure that payments remitted abroad for royalties and technical services fees adhere to established guidelines, affecting tax liability calculations.

**### Historical Background:**

This case illustrates the conflict between tax deductibility criteria under the Internal Revenue Code and the constraints imposed by exchange control regulations, represented by Central Bank Circular No. 393. It underscores the broader economic context of the 1970s Philippines, marked by heightened regulation of foreign exchange movements and a focus on developing local industries and technology transfer under controlled conditions.