

COMMISSIONER OF INTERNAL REVENUE, PETITIONER, VS. ATLAS CONSOLIDATED MINING AND DEVELOPMENT CORPORATION, COURT OF TAX APPEALS, AND COURT OF APPEALS, RESPONDENTS.

G.R. No. 116820. March 23, 1995

Ponente: FELICIANO, J.

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FELICIANO, J.:

In this Petition for Review, the Commissioner of Internal Revenue asks us to reverse and set aside the decision of the Court of Appeals in CA-G.R. SP No. 31187 dated 12 August 1994 and to order the Atlas Consolidated Mining and Development Corporation ("Atlas") to pay deficiency ad valorem tax for 1977 amounting to P1,059,063.47, including surcharge, plus interest.

On 15 April 1983, the Commissioner of Internal Revenue ("CIR") issued against Atlas assessments for (a) deficiency ad valorem tax plus surcharge amounting to P1,059,063.47 for the year 1977 and (b) deficiency income taxes for 1977 and 1978 in the amounts of P883,460.76 and P16,937.51 respectively.

On 27 April 1983, Atlas seasonably protested the assessments.

On 14 April 1988, the CIR denied the protests and served upon Atlas warrants of distraint and levy. The warrants were later lifted upon the filing by Atlas of a surety bond in the amount of P3,640,831.61.

Atlas appealed the decision of the CIR before the Court of Tax Appeals ("CTA").[1] During the course of the proceedings in the CTA, the CIR and Atlas entered into a compromise settlement insofar as the deficiency income taxes for 1977 and 1978 were concerned.

On 13 May 1993, the CTA rendered its decision declaring null and void the assessment against Atlas for deficiency ad valorem tax plus surcharge for 1977.

On petition for review, the Court of Appeals dismissed the CIR's petition for lack of merit.

In asserting once more before this Court that private respondent Atlas is liable for deficiency ad valorem tax, petitioner CIR contends:

(a) Under section 254 of the 1977 Tax Code, the base of the royalty or ad valorem tax for the privilege of exploring, developing, mining, extracting and disposing of minerals from mineral lands is the actual market value of the gross output of minerals. The tax rate is one and a half percent (1-1/2%) of the actual market value of the gross output for gold and two percent (2%) on all other minerals including copper and silver.[2]

(b) The term "gross output" is defined in Section 257 of the 1977 Tax Code as the "actual market value of minerals or mineral products, or of bullion from each mine or mineral lands operated as a separate entity without any deduction [for] mining, milling, refining, transporting, handling, marketing, or any other expenses." [3]

(c) Under section 256 of the 1977 Tax Code, the ad valorem tax is due and payable upon removal of mineral

products from the locality where mined or within twenty (20) days after the close of each quarter during which the mineral products were removed, in which case a quarterly return of the quantity and market value of the output of the mine removed during each calendar quarter shall be filed.[4]

(d) The ad valorem tax is a tax not on the mineral but upon the privilege of severing or extracting the same from the earth. The right of the government to exact the tax springs from the Regalian Theory that to the State belongs its natural resources.[5]

(e) The basis for the assessment of a deficiency ad valorem tax against private respondent Atlas is its understatement of the market value of the copper metals shipped by it abroad. The understatement comes from Atlas' deduction of certain units or a percentage from the quantity of the metals determined in the final assay.[6]

(f) According to the public respondent Court of Appeals and the CTA, the unit deduction is not part of the gross output of the copper mineral the actual market value of which is the base of the ad valorem tax. This ruling is erroneous. The base of the ad valorem tax is the actual market value of the gross output of minerals. Gross output refers to production, that is, the quantity of the minerals as removed from the mineral land. Gross output does not refer to sale, that is, the quantity of the minerals as sold. It is the actual market value of the quantity as removed which serves as the base of the ad valorem tax. It is not the actual market value of the quantity as sold. Public respondents, in excluding the unit deduction from the gross output, erroneously based the ad valorem tax on the actual market value of the minerals as sold.[7]

(g) The unit deduction is in fact a refining expense prohibited by section 257 of the 1977 Tax Code to be deducted.[8]

(h) While it is true that the unit deduction is intended to cover the unavoidable losses in the processing of copper concentrates, still the deduction is considered in determining the price of copper concentrates.[9]

(i) Public respondent Court of Appeals erroneously relied on Batas Pambansa Blg. 84 which amended section 257 of the 1977 Tax Code insofar as it allows the deduction of smelting, refining and other charges incurred in the process of converting mineral concentrates into refined metal. Batas Pambansa Blg. 84 was approved on 19 September 1980 and is therefore not applicable to an assessment made in 1977.[10] (*Italics supplied*)

In traversing the assessment for deficiency ad valorem tax for 1977, Atlas avers that:

(a) Section 257 of the Tax Code of 1977, which prohibits the deduction of expenses to be incurred in mining, milling, refining as well as transporting, marketing, etc. of copper concentrates, is not applicable in the case at bar since there is actually no expense item that is deducted from the price or value of the copper concentrates produced and sold by Atlas.[11]

(b) The "unit deduction" deducted in the final assay represents the portion of copper concentrates that is unavoidably lost in the processing thereof. In effect, the quantity or amount of copper concentrates less the "unit deduction" is the amount that is actually purchased by the buyer from Atlas.[12]

(c) The "unit deduction" has nothing to do with the price of copper concentrates. Rather, it pertains to the quantity of the copper concentrates. It merely recognizes the reduction of the copper contents subject of the sale.[13]

(d) Assuming *arguendo* that the "unit deduction" is an expense, it would still be deductible. Section 257 provides an exception, i.e., expenses which may be deducted. The "unit deduction" falls under these exceptions.[14]

(e) The "unit deduction" is used as a matter of industry practice. It is a factor considered by the industry in determining the actual market value of copper concentrates.[15]

(f) Petitioner merely cannot use as a basis the price agreed upon for the sale of copper concentrates without factoring in the "unit deduction" since the latter is an integral aspect of the sale in the same manner that the price of the copper is.[16] (Emphases supplied)

The resolution of whether Atlas is liable for deficiency ad valorem tax for 1977, to the mind of the Court, lies in the clarification of the concept of the "unit deduction" and its role and utility in the mining industry.

We begin with a description of the process of producing copper. We are aware that the precise process employed by Atlas may, in some degree, be different from the procedures generally outlined below. Nonetheless, for purposes of clarifying the function or utility of the "unit deduction," we consider a generalized description of the copper-making process useful.

The extraction of copper from ore is commonly carried out in three (3) major phases: mineral processing, smelting or leaching, and refining. The first step, mineral processing, involves the separation of copper minerals from the raw ore and the removal of waste constituents, initially through milling and then through a wet chemical (flotation) process, resulting in the concentration of the copper and other nonferrous minerals into a product containing approximately twenty to thirty percent (20-30%) copper.

"Mineral processing. In the ore-dressing plant, the material received from the mine is crushed in several stages and finely ground to a size which ensures that copper minerals are liberated from the waste materials or gangue. x x x."[17]

The second step, smelting or leaching, involves the further removal of impurities, giving rise to a mineral product with approximately forty-five to seventy (45-70%) percent copper.

"Roasting, smelting and converting. Once a concentrate has been produced containing copper and other metals of value (such as gold and silver), the next step is to remove impure elements. In older processes, the concentrate containing between 5 and 10 percent water, is first roasted in a cylindrical, refractory-lined furnace of either the hearth or fluidized-bed type. As concentrate is fed into the roaster, it is heated by a stream of hot air x x x. Volatile impurities such as arsenic, mercury, and some of the sulfur are driven off, the sulfur being removed as sulfur dioxide. What remains is an oxidized product containing a percentage of sulfur that is sufficiently low for smelting. This is traditionally done in a reverberatory or electric-arc furnace, into which concentrate is fed along with a suitable amount of flux x x x. These are heated by combusted fuel or electric current x x x, producing an artificial copper-iron sulfide that settles in a molten pool at the bottom of the furnace. The sulfide material, known as matte, contains 45 to 70 percent copper, x x x. Gangue minerals and oxidized impurities, including most of the iron, react with the flux and form a light, fluid layer of slag over the matte. A certain percentage of the volatile impurities, such as sulfur is oxidized and leaves with the process gas stream.

The traditional two-stage process described above has to a large extent been replaced by newer flash or bath smelting processes. These begin with a dry concentrate containing less than 1 percent water, which, along with flux, is contacted in a furnace by a blast of oxygen or oxygen enriched air. Iron and sulfur are oxidized, and the heat generated by these exothermic reactions is sufficient to smelt the concentrate to liquid. x x x. New smelters are designed to capture 90 percent or more of the sulfur contained in the feed materials.

After the slag, which contains a large percentage of the impurity elements, is removed from the matte, the remaining iron and sulfur are removed in the conversion process. x x x. After being charged with matte, flux, and copper scrap (to control temperature), the converter is rotated in order to immerse tuyeres in the molten bath. Air or oxygen-enriched air is then blown through the tuyeres into the fluid. Iron and sulfur are converted to oxides and are removed in either the gas stream or the flux x x x leaving a 'blister' copper containing between 98.5 and 99.5 percent copper and up to 0.8 percent oxygen. The converter is rotated for skimming the slag and pouring the blister copper."[18]

The final step, refining, entails the removal of most of the remaining traces of impurities resulting in a refined copper metal product that is close to (but not quite) a hundred percent (100%) pure.

"The final step consists of fire refining the blister copper to reduce the sulfur and oxygen to even lower levels. This oxidation-reduction process is usually carried out in a separate furnace to ensure that the final smelter products reaches the level of 99.5 percent copper that is required for electrolytic refining. At this point, the copper is cast into anodes, the shape and weight of which are dictated by the particular electrolytic refinery." [19]

Common to all these stages of production of high grade copper is the extraction and removal of impurities by machinery or facilities using mechanical and chemical processes. In mineral processing, a machine is used to crush ore in order to separate copper minerals and gangue, [20] while large vats with chemical reagents are used to produce flotation concentrates from the finely ground material. In the smelting of copper, either a furnace or a converter is used. Finally, in the refining of the copper, facilities utilizing electrolytic processes are used.

Machines, however, are not one hundred percent (100%) efficient. The inability of a machine to attain 100% efficiency may be largely due to friction. [21] Thus, in computing the efficiency with which a mechanical system performs, it is commonly recognized that, because of friction, the resulting ratio is always less than one, i.e., always less than one hundred percent (100%). [22] Similarly, equipment or facilities employing electrical or chemical processes are not one hundred percent (100%) efficient due to operating constraints or limitations.

Coming to the instant case, the point that bears stressing is the fact that the processes Atlas employs in crushing and treating copper-bearing raw ore and producing copper concentrates, inherently involve the use of machinery and equipment. Like all other machines and equipment, the milling and concentrating facilities of Atlas are not one hundred percent (100%) efficient.

The inability of the facilities of Atlas and those of the purchaser-smelter or refinery to perform at 100% efficiency translates into quantitative as well as qualitative losses. Qualitatively, the copper metal produced is not one hundred percent (100%) pure copper. Despite having undergone extensive concentrating and refining measures aimed at removing impurities, the copper metal produced will never be absolutely pure or completely free of chemical impurities. [23] Quantitatively, the amount of copper metal, in terms of weight or tonnage, actually derivable from copper concentrates of a given chemical assay is never the same as, but is instead always smaller than, the quantity of copper theoretically, i.e., chemically present in the concentrates sold by Atlas to the buyer. The output, i.e., the amount of refined copper metal eventually produced is not equivalent to and will always be less than the input, i.e., the amount of copper in the concentrates sold, which amount is in turn less than the amount of copper minerals associated with the raw ore severed from the earth and subjected to lengthy processing and refining.

The reality of unavoidable losses occurring in the processing and refining of copper gave rise to the mechanism called "unit deduction." The "unit deduction" is the device utilized by the mining industry, both here and abroad, including Atlas and its buyer(s) to recognize and offset the inevitable quantitative losses that take place in the processing and refining of copper. The "unit deduction," deducted from the final assay [24] represents the diminution, in terms of percentage, in the quantity of copper minerals, theoretically, chemically or "naturally" present in the raw ore extracted by the time such ore is processed and ultimately refined into high-grade copper metal. This was the gist of the testimonies of Messrs. Teodorico Parco and Deogracias Madrid, witnesses for Atlas on which both the Court of Tax Appeals and Court of Appeals relied in reaching the following characterization:

"x x x. It is simply a deduction intended to cover unavoidable losses when the copper concentrate is physically

processed because no smelter or refining company can recover 100% intake of the metal, a portion of which is lost or stays with the waste. To be truly reflective of the quantity to be purchased by the buyer, the said unavoidable losses resulting therefrom are taken out of the amount of the copper concentrate.”[25]

The Commissioner of Internal Revenue seeks to avoid the force of the above considerations by attempting to distinguish between the "actual market value of the quantity as removed" from the "actual market value of the quantity as sold." This argument has a certain logical attractiveness to it; but that attractiveness may be seen to be more apparent than real upon close examination.

The precise reference of the Commissioner in distinguishing "actual market value of the quantity as removed" from the "actual market value of the quantity as sold," is ambiguous. His intended reference could be to (a) the raw ore which is "removed" or severed from the matrix of the earth, or to (b) the copper concentrates which, upon production, are removed from Atlas' premises and shipped to its buyer(s) abroad.

If the reference of the Commissioner is to the raw ore, we are bound to note that such raw ore is not at all marketable at this stage, especially if Atlas' ore is of the widely disseminated type. Such raw ore simply has no market value and is in fact not sold by Atlas. If the reference, upon the other hand, of the Commissioner is to the copper concentrates which are produced and sold by Atlas, then we are also bound to note that there is no market quotation anywhere in the world of prices for copper concentrates, *qua* concentrates. This being so, the actual market value of copper concentrates must be measured in terms of the actual market value of the refined metal content of such concentrates less the expenses of, e.g., smelting and refining the copper concentrates. It is the price of refined copper that is quoted in the metals markets of the world, e.g., the London Metal Exchange and the New York Commodities Exchange. Succinctly put, the market value of the "minerals or mineral products or bullion" existing in the form of copper concentrates at the time of removal from Atlas' premises is measured by the market value of the refined metals that would emerge at the completion of the final process of refining. It follows, therefore, that the Commissioner's attempted distinction between the actual market value of the quantity of copper concentrates as removed from Atlas' premises from the actual market value of the quantity of copper concentrates as sold by Atlas, is unreal and meaningless.

In the very recent case of *Commissioner of Internal Revenue v. Court of Appeals, et al.*, [26] this Court had before it the related contention of the Commissioner that the actual market value of the mineral products sold by Atlas should be the gross sales realized from copper concentrates without deducting therefrom mining, milling, refining, transporting, handling, marketing, or any other expenses. In rejecting this contention, the Court restated the general principle involved in the following terms:

"Therefore, the imposable *ad valorem* tax should be based on the selling price of the quarried minerals, which is its actual market value, and not on the price of the manufactured product. If the market value chosen for the reckoning is the value of the manufactured or finished product, as in the case at bar, then all expenses of processing or manufacturing should be deducted in order to approximate as closely as is humanly possible the actual market value of the raw mineral at the mine site." [27] (*Italics supplied*)

The Court quoted with approval (and we do so again here) from the decision of the CTA in an earlier (23 January 1981) case also entitled "*Atlas Consolidated Mining and Development Corporation v. Commissioner of Internal Revenue*" (CTA Case No. 2842):

"In resume:

1. The mineral or mineral product of petitioner the extraction or severance from the soil of which the *ad valorem* tax is directed is copper concentrate.
2. The *ad valorem* tax is computed on the basis of the actual market value of the copper concentrate in its

condition at the time of removal from the earth [should be: shipment from Atlas' premises] and before it is substantially changed by chemical or manufacturing process without any deduction from mining, milling, refining, transporting, handling, marketing, or any other expenses. However, since the copper concentrate is sold abroad by petitioner under C.I.F. terms, the actual cost of ocean freight and insurance is deductible.

3. There being no market price quotation of copper concentrate locally or in the commodity exchanges or markets of the world, the London Metal Exchange price quotation of copper wire bar, which is used by petitioner and Mitsubishi Metal Corporation as reference to determine the selling price of copper concentrate, may likewise be employed in this case as reference point in ascertaining the actual market value of copper concentrate for ad valorem tax purposes. By deducting from the London Metal Exchange price quotation of copper wire bar all charges and costs incurred after the copper concentrate has been shipped from Toledo City to the time the same has been manufactured into wire bar, namely, smelting, electrolytic refining and fabricating, the remainder represents to a reasonable degree the actual market value of the copper concentrate in its condition at the time of extraction or removal from its bed [should be: shipment from Atlas' premises] in Toledo City for the purposes of the ad valorem tax."[28] (italics and brackets supplied)

Returning to the "unit deduction," the Court notes that the utilization of the "unit deduction" has been customary practice in the copper industry and is a standard feature of copper concentrates sales contracts. Thus, when the "unit deduction" is deducted from gross output, the market value of the remaining quantity is in fact the "actual market value of the gross output." Put a little differently, the amount of metal embraced by the "unit deduction" is physically lost in the process of producing refined copper metal. That amount of metal is accordingly not in fact received eventually by the purchaser in a copper concentrates sales contract. This being so as a matter of physics, chemistry and metallurgy, the amount of metal embraced in or represented by the "unit deduction" has in fact no market value.

From the foregoing, we consider it clear that the "unit deduction" is a component element in the determination of the quantity of copper ("minerals or mineral products or bullion") which is taxable. The buyer (smelter) attaches no value to the metal equivalent of the "unit deduction" since he will never receive that metal equivalent. Upon the other hand, the seller (Atlas) does not expect to be remunerated for the metal equivalent of the "unit deduction;" he neither sells it nor retains it. The copper industry simply does not attribute market value to the refined metal equivalent of the "unit deduction." That metal equivalent has effectively no more than a notional existence. It appears to the Court at once unfair and unreal to impose an ad valorem tax on the privilege of extracting and producing a notional article. We conclude, therefore, that the Court of Appeals did not err when it ruled:

"x x x. Accordingly, the quantity of the copper concentrates minus this unit deduction is now the actual market value of the gross output from where the ad valorem tax should be based."[29]

We should perhaps add the caveat that the "unit deduction" must be a realistic one, that is, it must, in reasonably faithful terms, reflect the limitations of the physical, chemical and metallurgical processes actually employed in the copper mining industry. In particular, the "unit deduction" cannot, by mere contractual stipulation, exceed what is, in general and bona fide engineering and industrial practice, recognized as the amount of copper metal lost in the course of producing such copper metal. It would also follow that should the average efficiency of current production processes used in concentrating, smelting and refining metals significantly improve in the future, it may be expected that the "unit deduction," in percentage terms would correspondingly be reduced, efficiency being inversely proportional to the amount of the "unit deduction." The metal content used as the basis for computing the tax due would thereupon increase.

WHEREFORE, the Petition for Review is hereby DENIED. The Decision of the Court of Appeals in C.A.-G.R. SP No. 31187 dated 12 August 1994 is hereby AFFIRMED. No Pronouncement as to costs.

SO ORDERED.

Romero, Melo, Vitug, and Francisco, JJ., concur.

[1] Court of Tax Appeals Case No. 4264.

[2] Petition, Rollo, pp. 16-17; Section 254 of the Tax Code reads:

"Sec. 254. Rentals and royalties on mineral lands under lease. — For the privilege of exploring, developing, mining, extracting, and disposing of the minerals from the lands covered by lease, there is hereby imposed upon the lessee rentals and royalties as follows:

x x x x x x x x

(b) Royalties -

x x x x x x x x

(2) On gold, a royalty of one and one-half per centum of the actual market value of the annual gross output thereof.

(3) On all other minerals, extracted from, or mineral products of, mineral lands of the first, second, fourth and fifth groups as provided in the Mining Act, a royalty of two per centum of the actual market value of the gross output thereof.

x x x x x x x x." (Italics supplied)

[3] Petition, Rollo, p. 17.

[4] Petition, Rollo, p. 17.

[5] Petition, Rollo, p. 19.

[6] Id.

[7] Petition, Rollo, pp. 21-23.

[8] Id., p. 24.

[9] Id., p. 25.

[10] Id., pp. 29-30.

[11] Comment, Rollo, pp. 65-66.

[12] Id., p. 66.

[13] Id.

[14] Id., p. 67.

[15] Id., p. 71.

[16] Id., 73.

[17] Encyclopedia Britannica (Macropaedia), Industries, Extraction and Processing, p. 451 [1992].

[18] Id., pp. 451-452; The processes of smelting and leaching are separate and distinct purification processes.

18 (Cont.) See Encyclopaedia Britannica (Macropaedia), Industries, Extraction and Processing, *supra*.

[19] Encyclopaedia Britannica (Macropaedia), Industries, Extraction and Processing, p. 452[1992][.]

[20] Associated with ore minerals in an ore deposit are worthless materials called gangue. Gangue consists of rock and unwanted minerals which is mined with the ore minerals, subsequently separated in the milling process and discarded as dumps of waste. (Encyclopaedia Britannica [Macropaedia], Industries, Extraction and Processing, p. 386 [1992])

[21] Encyclopaedia Britannica (Micropaedia), Machines, p. 630 (1992):

"In the science of mechanics, 'work' is something that forces do when they move in the direction in which they are acting, and it is equal to the product of the average force and the distance moved. $x \times x$. Mathematically, if F equals the force (in pounds or kilograms) and S equals, distance (in feet or meters), work is then equal to the applied force F multiplied by the distance this force moves S ; or $WORK = F \times S$.

When a force causes a body to rotate about a fixed axis, or pivot, the work done is obtained by multiplying the torque (T) by the angle of rotation.

Calculating efficiency. These concepts of work are fundamental in defining the mechanical work function of machines in terms of force and motions, and they bring out the inseparability of forces and motions in machines. Because of friction, the work output from a machine is always less than the work input, and the efficiency, which is the ratio of the two, is always less than 100 percent." (Italics supplied)

[22] *Id.*, Mechanical Efficiency, p. 994 [1992].

[23] In the preparation and purification of compounds as well as determining the level of impurity of the compound, "[i]t is probably fair to say that no ordinary compound is ever entirely free of foreign molecules as impurities. The degree of purity of any particular substance depends on the effort that is made to remove the last traces of impurities, and the effort expended generally depends on the use to be made of the compound. $x \times x$. Once a compound is obtained as homomolecular (that is, in a form in which all the molecules present are identical) as is reasonably possible it may be analyzed quantitatively for each element to determine the relative amount of it in the molecule. The final step in establishing the molecular formula of the compound in question is the determination of the molecular weight. $x \times x$ " (Italics supplied; Encyclopaedia Britannica [Macropaedia], Chemical Compounds, pp. 764-765 [1992])

[24] When copper concentrates are shipped and sold to smelters or buyers abroad, the ad valorem taxes paid by the seller are based on the provisional assay of the concentrates at the prevailing price of the metals at the London Metal Exchange or New York Comex Quotations. When the copper concentrates reach the buyer-smelter or refinery, the provisional assay is redetermined by the assayers of the buyer and seller in order to arrive at a "Final Assay for Settlement." Should the assayers of the parties disagree on the "final assay for settlement," the difference is settled by a third party or the umpire assayer. The final assay for settlement is commonly reached at the plant premises of the buyer-smelter.

[25] Court of Appeals Decision, Rollo, p. 51; The testimony of Mr. Parco reads in part:

"Q.

Will you please illustrate concretely for our benefit you[r] concept of unit deduction.

A.

Unit deduction is intended to cover unavoidable losses of metal contents in the processing of copper

concentrates.

Q.

What losses are you referring to?

A.

When I say losses, they are losses when copper concentrate is processed. A portion of that always stays with the waste and some of them could even be losses in the cases that evaporates therefor. As a normal thing the custom smelters always provided for unit deduction intended to cover unavoidable losses. This is true not only in copper concentrates but also in other metals as gold bullion which we deliver to Central Bank. They do not pay us one hundred percent."

On the other hand, the testimony of Mr. Madrid reads in part:

"Q.

Where is this unit deduction used?

A.

It is usually found in copper concentrates supply contracts.

Q.

Can you explain to the court the meaning of this phrase 'unit deduction'?

A.

Unit deductions are allowances for process losses that are deducted from the metal content of the copper concentrates taken in various smelters like us. There is a gross metal content and then you deduct this unit deduction and you come up with what we call in the industry 'payable content' which is the basis under which mine or the supplier is paid."

[26] The full title of which is G.R. No. 104151, Commissioner of Internal Revenue v. Court of Appeals, Atlas Consolidated Mining and Development Corporation and Court of Tax Appeals, and G.R. No. 105563, Atlas Consolidated Mining and Development Corporation v. Court of Appeals, et al., promulgated 10 March 1995.

[27] G.R. Nos. 104151 & 105563, pp. 10-11.

[28] Id., pp. 14-15.

[29] Rollo, p. 51.

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