

COMMISSIONER OF INTERNAL REVENUE, PETITIONER, VS. COURT OF TAX APPEALS AND SMITH KLINE & FRENCH OVERSEAS CO. (PHILIPPINE BRANCH), RESPONDENTS.

G.R. No. 54108. January 17, 1984

Ponente: AQUINO, J.

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AQUINO, J.:

This case is about the refund of a 1971 income tax amounting to P324,255. Smith Kline and French Overseas Company, a multinational firm domiciled in Philadelphia, Pennsylvania, is licensed to do business in the Philippines. It is engaged in the importation, manufacture and sale of pharmaceuticals, drugs and chemicals.

In its 1971 original income tax return, Smith Kline declared a net taxable income of P1,489,277 (Exh. A) and paid P511,247 as tax due. Among the deductions claimed from gross income was P501,040 (\$77,060) as its share of the head office overhead expenses. However, in its amended return filed on March 1, 1973, there was an overpayment of P324,255 "arising from underdeduction of home office overhead" (Exh. E). It made a formal claim for the refund of the alleged overpayment.

It appears that sometime in October, 1972, Smith Kline received from its international independent auditors, Peat, Marwick, Mitchell and Company, an authenticated certification to the effect that the Philippine share in the unallocated overhead expenses of the main office for the year ended December 31, 1971 was actually \$219,547 (P1,427,484). It further stated in the certification that the allocation was made on the basis of the percentage of gross income in the Philippines to gross income of the corporation as a whole. By reason of the new adjustment, Smith Kline's tax liability was greatly reduced from P511,247 to P186,992 resulting in an overpayment of P324,255.

On April 2, 1974, without awaiting the action of the Commissioner of Internal Revenue on its claim, Smith Kline filed a petition for review with the Court of Tax Appeals.

In its decision of March 21, 1980, the Tax Court ordered the Commissioner to refund the overpayment or grant a tax credit to Smith Kline. The Commissioner appealed to this Court.

The governing law is found in section 37 of the old National Internal Revenue Code, Commonwealth Act No. 466, which is reproduced in Presidential Decree No. 1158, the National Internal Revenue Code of 1977 and which reads:

"SEC. 37. Income from sources within the Philippines. —

x x x x x x x x

"(b) Net income from sources in the Philippines. – From the items of gross income specified in subsection (a) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the Philippines.

x x x x x x x x."

Revenue Regulations No. 2 of the Department of Finance contains the following provisions on the deductions to be made to determine the net income from Philippine sources:

"SEC. 160. Apportionment of deductions. - From the items specified in section 37(a) as being derived specifically from sources within the Philippines there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses or deductions which cannot definitely be allocated to some item or class of gross income. The remainder shall be included in full as net income from sources within the Philippines. The ratable part is based upon the ratio of gross income from sources within the Philippines to the total gross income.

"Example: A non-resident alien individual whose taxable year is the calendar year, derived gross income from all sources for 1939 of P180,000, including therein:

Interest on bonds of a domestic corporation P 9,000

Dividends on stock of a domestic Corporation 4,000

Royalty for the use of patents within the Philippines 12,000

Gain from sale of real property located within the Philippines 11,000

Total P36,000

that is, one-fifth of the total gross income was from sources within the Philippines. The remainder of the gross income was from sources without the Philippines, determined under section 37(c).

"The expenses of the taxpayer for the year amounted to P78,000. Of these expenses the amount of P8,000 is properly allocated to income from sources within the Philippines and the amount of P40,000 is properly allocated to income from sources without the Philippines.

"The remainder of the expense, P30,000, cannot be definitely allocated to any class of income. A ratable part thereof, based upon the relation of gross income from sources within the Philippines to the total gross income, shall be deducted in computing net income from sources within the Philippines. Thus, there are deducted from the P36,000 of gross income from sources within the Philippines expenses amounting to P14,000 [representing P8,000 properly apportioned to the income from sources within the Philippines and P6,000, a ratable part

(one-fifth) of the expenses which could not be allocated to any item or class of gross income]. The remainder P22,000, is the net income from sources within the Philippines."

From the foregoing provisions, it is manifest that where an expense is clearly related to the production of Philippine-derived income or to Philippine operations (e.g. salaries of Philippine personnel, rental of office building in the Philippines), that expense can be deducted from the gross income acquired in the Philippines without resorting to apportionment.

The overhead expenses incurred by the parent company in connection with finance, administration, and research and development, all of which directly benefit its branches all over the world, including the Philippines, fall under a different category however. These are items which cannot be definitely allocated or identified with the operations of the Philippine branch. For 1971, the parent company of Smith Kline spent \$1,077,739. Under section 37(b) of the Revenue Code and section 160 of the regulations, Smith Kline can claim as its deductible share a ratable part of such expenses based upon the ratio of the local branch's gross income to the total gross income, worldwide, of the multinational corporation.

In his petition for review, the Commissioner does not dispute the right of Smith Kline to avail itself of section 37(b) of the Tax Code and section 160 of the regulations. But the Commissioner maintains that such right is not absolute and that as there exists a contract (in this case a service agreement) which Smith Kline has entered into with its home office, prescribing the amount that a branch can deduct as its share of the main office's overhead expenses, that contract is binding.

The Commissioner contends that since the share of the Philippine branch has been fixed at \$77,060, Smith Kline itself cannot claim more than the said amount. To allow Smith Kline to deduct more than what was expressly provided in the agreement would be to ignore its existence. It is a cardinal rule that a contract is the law between the contracting parties and the stipulations therein must be respected unless these are proved to be contrary to law, morals, good customs and public policy. There being allegedly no showing to the contrary, the provisions thereof must be followed.

The Commissioner also argues that the Tax Court erred in relying on the certification of Peat, Marwick, Mitchell and Company that Smith Kline is entitled to deduct P1,427,484 (\$219,547) as its allotted share and that Smith Kline has not presented any evidence to show that the home office expenses chargeable to Philippine operations exceeded \$77,060.

On the other hand, Smith Kline submits that the contract between itself and its home office cannot amend tax, laws and regulations. The matter of allocated expenses which are deductible under the law cannot be the subject of an agreement between private parties nor can the Commissioner acquiesce in such an agreement.

Smith Kline had to amend its return because it is of common knowledge that audited financial statements are generally completed three or four months after the close of the accounting period. There being no financial statements yet when the certification of January 11, 1972 was made, the treasurer could not have correctly computed Smith Kline's share in the home office overhead expenses in accordance with the gross income formula prescribed in section 160 of the Revenue Regulations. What the treasurer certified was a mere estimate.

Smith Kline likewise submits that it has presented ample evidence to support its claim for refund. To this end, it has presented before the Tax Court the authenticated statement of Peat, Marwick, Mitchell and Company to show that since the gross income of the Philippine branch was P7,143,155 (\$1,098,617) for 1971 as per audit report prepared by Sycip, Gorres, Velayo and Company, and the gross income of the corporation as a whole was \$6,891,052, Smith Kline's share at 15.94% of the home office overhead expenses was P1,427,484 (\$219,547) (Exh. G to G-2, BIR Records, 4-5).

Clearly, the weight of evidence bolsters its position that the amount of P1,427,484 represents the correct ratable share, the same having been computed pursuant to section 37(b) and section 160.

In a manifestation dated July 19, 1983, Smith Kline declared that with respect to its share of the head office overhead expenses in its income tax returns for the years 1973 to 1981, it deducted its ratable share of the total Overhead expenses of its head office for those years as computed by the independent auditors hired by the parent company in Philadelphia, Pennsylvania, U. S. A. as soon as said computations were made available to it.

We hold that Smith Kline's amended 1971 return is in conformity with the law and regulations. The Tax Court correctly held that the refund or credit of the resulting overpayment is in order.

WHEREFORE, the decision of the Tax Court is hereby affirmed. No costs.

SO ORDERED.

Makasiar, (Chairman), Concepcion, Jr., Guerrero, De Castro, and Escolin, JJ., concur.
Abad Santos, J., no part.

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