

## EN BANC

**[ G.R. No. 125346, November 11, 2014 ]**

**LA SUERTE CIGAR & CIGARETTE FACTORY, PETITIONER, VS.  
COURT OF APPEALS AND COMMISSIONER OF INTERNAL  
REVENUE, RESPONDENTS.**

**[G.R. Nos. 136328-29]**

**COMMISSIONER OF INTERNAL REVENUE, PETITIONER, VS.  
FORTUNE TOBACCO CORPORATION, RESPONDENT.**

**[G.R. No. 144942]**

**COMMISSIONER OF INTERNAL REVENUE, PETITIONER, VS. LA  
SUERTE CIGAR & CIGARETTE FACTORY, RESPONDENT.**

**[G.R. No. 148605]**

**STERLING TOBACCO CORPORATION, PETITIONER, VS.  
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.**

**[G.R. No. 158197]**

**LA SUERTE CIGAR & CIGARETTE FACTORY, PETITIONER, VS.  
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.**

**[G.R. No. 165499]**

**LA SUERTE CIGAR & CIGARETTE FACTORY, PETITIONER, VS.  
COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.**

## DECISION

**LEONEN, J.:**

These cases involve the taxability of stemmed leaf tobacco imported and locally purchased by cigarette manufacturers for use as raw material in the manufacture of their cigarettes. Under the National Internal Revenue Code of 1997 (1997 NIRC), before it was amended on December 19, 2012 through Republic Act No. 10351<sup>[1]</sup> (Sin Tax Law), stemmed leaf tobacco is subject to an excise tax of P0.75 for each kilogram thereof.<sup>[2]</sup> The 1997 NIRC further provides that stemmed leaf tobacco — “leaf tobacco which has had the stem or midrib removed”<sup>[3]</sup> — “may be sold in bulk as raw material by one manufacturer directly to another without payment of the tax, under such conditions as may be prescribed in the rules and regulations prescribed by the Secretary of Finance.”<sup>[4]</sup>

This is a consolidation of six petitions for review of several decisions of the Court of Appeals, involving three cigarette manufacturers and the Commissioner of Internal Revenue. **G.R. No. 125346** is an appeal<sup>[5]</sup> from the Court of Appeals (Sixth Division) that reversed<sup>[6]</sup> the Court of Tax Appeals' decision<sup>[7]</sup> and held petitioner La Suerte Cigar & Cigarette Factory (La Suerte) liable for deficiency specific tax on its purchase of imported and locally produced stemmed leaf tobacco and sale of stemmed leaf tobacco to Associated Anglo-American Tobacco Corporation (AATC) during the period from January 1, 1986 to June 30, 1989. **G.R. Nos. 136328–29** is an appeal<sup>[8]</sup> by the Commissioner of Internal Revenue (Commissioner) from the decision<sup>[9]</sup> of the Court of Appeals that affirmed the Court of Tax Appeals' rulings<sup>[10]</sup> that Fortune Tobacco Corporation (Fortune) was not obliged to pay the excise tax on its importations of stemmed leaf tobacco for the periods from January 1, 1986 to June 30, 1989 and July 1, 1989 to November 30, 1990. In **G.R. No. 148605**, Sterling Tobacco Corporation (Sterling) appeals<sup>[11]</sup> the decision<sup>[12]</sup> of the Court of Appeals that reversed the Court of Tax Appeals' decision<sup>[13]</sup> and held it liable to pay deficiency excise taxes on its importation and local purchases of stemmed leaf tobacco from November 1986 to June 24, 1989. **G.R. No. 144942** is an appeal<sup>[14]</sup> from the Court of Appeals' decision<sup>[15]</sup> that affirmed the Court of Tax Appeals' decision<sup>[16]</sup> and ordered the refund of specific taxes paid by La Suerte on its importation of stemmed leaf tobacco in April 1995. In **G.R. No. 158197**, La Suerte sought to appeal<sup>[17]</sup> the decision<sup>[18]</sup> of the Court of Appeals holding it liable for deficiency specific tax on its local and imported purchases of stemmed leaf tobacco and those it sold for the period from June 21, 1989 to November 20, 1990. Finally, in **G.R. No. 165499**, La Suerte again sought to appeal by certiorari<sup>[19]</sup> the decision<sup>[20]</sup> of the Court of Appeals reversing the Court of Tax Appeals and holding it liable for deficiency specific tax on its importation of stemmed leaf tobacco in March 1995.

## **Factual background**

### **Overview of cigarette manufacturing**

The primary component of cigarettes is tobacco, a processed product derived from the leaves of the plants in the genus *Nicotiana*.<sup>[21]</sup> Most cigarettes contain a mixture or blend of several types of tobacco from a variety of sources.

The tobacco types grown in the Philippines are: **Virginia (or 'flue-cured')**,<sup>[22]</sup> which accounts for 59.35% of tobacco production, **Burley (or 'bright air-cured')**,<sup>[23]</sup> which makes up 22.21%, and the **Native (or 'dark air-cured')**,<sup>[24]</sup> which makes up the remaining 18.44%.<sup>[25]</sup> "[T]he 'native' type is normally categorized into three: cigar filler type, wrapper type and chewing type, or . . . 'Batek' tobacco."<sup>[26]</sup> Virginia and Burley, considered as the aromatic type, are intended for cigarette manufacturing.

### **Growing and harvesting**

"Tobacco seeds undergo a process of germination, which takes about 7 to 10 days, depending on the tobacco varieties. . . . The tobacco seedlings are then sown in cold

frames or hotbeds to prevent attacks from insects, and then transplanted into the fields”<sup>[27]</sup> after 45 to 65 days.<sup>[28]</sup>

Harvesting begins 55 to 60 days after transplanting.<sup>[29]</sup> A farmer carries out either *priming* (leaf by leaf) or *stalk harvesting* (by the whole plant).<sup>[30]</sup>

## **Curing**

“After harvest, tobacco is stored for curing, which allows for the slow oxidation and degradation of carotenoids. This allows for the leaves to take on properties that are usually attributed to the ‘smoothness’ of the smoke.”<sup>[31]</sup>

“Curing methods vary with the type of tobacco grown. The tobacco barn design varies accordingly.”<sup>[32]</sup> There are two main ways of curing tobacco in the Philippine setting:

- 1) Air-curing (for Burley and Native tobacco) “is carried out by hanging the tobacco in well-ventilated barns, where the tobacco is allowed to dry over a period of 4 to 8 weeks. Air-cured tobacco is generally low in sugar content, which gives the tobacco smoke a light, smooth, semi-sweet flavor. These tobacco leaves usually have a high nicotine content[;]”<sup>[33]</sup> and
- 2) Flue-curing (for Virginia tobacco) process “starts by the sticking of tobacco leaves, which are then hung from tier-poles in curing barns. The procedure will generally take about a week. Flue-cured tobacco generally produces cigarette tobacco, which usually has a high content of sugar, with medium to high levels of nicotine.”<sup>[34]</sup>

Once cured, the leaves are sorted into grades based on size, color, and quality, and packed in standard bales.<sup>[35]</sup> The bales are then moved to accredited trading centers where they are purchased by leaf buyers such as wholesale tobacco dealers and exporters or cigarette manufacturing companies.<sup>[36]</sup>

## **Redrying and aging**

After purchase, leaf tobacco is re-dried and then added with moisture to make the tobacco pliable enough to remove its large stems.<sup>[37]</sup> The leaves are stripped or destemmed, either by hand or machine, cleaned and compressed into boxes or porous wooden vats called hogsheads, and aged.<sup>[38]</sup> Thereafter, the leaves are either exported or used for the manufacture of cigarettes, cigars, and other tobacco products.

## **Primary processing**<sup>[39]</sup>

In the cigarette factory, the tobacco leaves undergo a conditioning process where “high temperatures and humidity restore moisture to suitable levels for cutting and blending tobacco and completing the cigarette-making process.”<sup>[40]</sup>

“[T]obaccos are precisely cut and blended according to . . . formulas, or recipes, to

produce tobaccos for various brands of cigarettes. These brand recipes include ingredients and flavors that are added to the tobacco to give each brand its unique characteristics.”<sup>[41]</sup>

### **Cigarette making and packing**<sup>[42]</sup>

“The blended tobacco — often referred to as “filler” or “cut-filler” — . . . is delivered by a pneumatic feed system to cigarette making machines . . . within the factory.”<sup>[43]</sup> The machine disperses the shredded tobacco over a continuous roll of cigarette paper and cuts the paper to the desired length. The completed cigarettes are subsequently packed, sealed, and placed in cartons.

### **Cigarette manufacturers**

La Suerte Cigar & Cigarette Factory (La Suerte),<sup>[44]</sup> Fortune Tobacco Corporation (Fortune),<sup>[45]</sup> and Sterling Tobacco Corporation (Sterling)<sup>[46]</sup> are domestic corporations engaged in the production and manufacture of cigars and cigarettes. These companies import leaf tobacco from foreign sources and purchase locally produced leaf tobacco to be used in the manufacture of cigars and cigarettes.<sup>[47]</sup>

The transactions of these cigarette manufacturers pertinent to these consolidated cases are the following:

1. La Suerte’s local purchases, importations, and sale of stemmed leaf tobacco from January 1, 1986 to June 30, 1989 (G.R. No. 125346), and from June 1989 to November 1990 (G.R. No. 158197), and importations in March 1995 (G.R. No. 165499) and April 1995 (G.R. No. 144942);
2. Fortune’s importation of tobacco strips from January 1, 1986 to June 30, 1989, and from July 1, 1989 to November 30, 1990 (G.R. Nos. 136328–29); and
3. Sterling’s importations and local purchases of stemmed leaf tobacco from November 1986 to June 24, 1989 (G.R. No. 148605).

### **History of applicable tax provisions**

The first tax code came into existence in 1939 with the enactment of Commonwealth Act No. 466<sup>[48]</sup> (1939 Code). Section 136 of the 1939 Code imposed specific (excise) taxes on manufactured products of tobacco, but excluded cigars and cigarettes, which were subject to tax under a different section.<sup>[49]</sup> Section 136 provided thus:

SECTION 136. Specific Tax on Products of Tobacco. – On manufactured products of tobacco, except cigars, cigarettes, and tobacco specially prepared for chewing so as to be unsuitable for consumption in any other manner, but including all other tobacco twisted by hand or reduced into a condition to be consumed in any manner other than by the ordinary mode of drying and curing; and *on all tobacco prepared or partially prepared for sale or consumption, even if prepared without the use of any machine or instrument and without being pressed or sweetened*; and on all fine-cut shorts and refuse, scraps, clippings, cuttings, and

sweepings of tobacco, there shall be collected on each kilogram, sixty centavos.

On tobacco specially prepared for chewing so as to be unsuitable for use in any other manner, on each kilogram, forty-eight centavos. (Emphasis supplied)

Section 132 of the 1939 Code, however, by way of exception, provided that "stemmed leaf tobacco . . . may be sold in bulk as raw material by one manufacturer directly to another, *under such conditions as may be prescribed in the regulations of the Department of Finance*, without the prepayment of the tax." Section 132 stated:

SECTION 132. Removal of Tobacco Products Without Pre-payment of Tax.  
– Products of tobacco entirely unfit for chewing or smoking may be removed free of tax for agricultural or industrial use, under such conditions as may be prescribed in the regulations of the Department of Finance; and *stemmed leaf tobacco*, fine-cut shorts, the refuse of fine-cut chewing tobacco, refuse, scraps, cuttings, clippings and sweepings of tobacco *may be sold in bulk as raw material by one manufacturer directly to another, **under such conditions as may be prescribed in the regulations of the Department of Finance***, without the pre-payment of the tax.

"Stemmed leaf tobacco," as herein used means leaf tobacco which has had the stem or midrib removed. The term does not include broken leaf tobacco. (Emphasis supplied)

On September 29, 1954, upon the recommendation of then Acting Collector of Internal Revenue J. Antonio Araneta, the Department of Finance promulgated Revenue Regulations No. V-39 (RR No. V-39), or "The Tobacco Products Regulations," relative to "the enforcement of the provisions of Title IV of the [1939 Tax Code] in so far as they affect the manufacture or importation of, and the collection and payment of the specific tax on, manufactured tobacco or products of tobacco."<sup>[50]</sup> Section 20(a) of RR No. V-39, which lays the rules for tax exemption on tobacco products, states:

**SECTION 20. Exemption from tax of tobacco products intended for agricultural or industrial purposes. — (a) Sale of stemmed leaf tobacco, etc., by one factory to another. —** Subject to the limitations herein established, products of tobacco entirely unfit for chewing or smoking may be removed free of tax for agricultural or industrial use; and stemmed leaf tobacco, fine-cut shorts, the refuse of fine-cut chewing tobacco, refuse, scraps, cuttings, clippings, and sweepings of tobacco may be sold in bulk as raw materials by one manufacturer directly to another without the prepayment of specific tax.

Stemmed leaf tobacco, fine-cut shorts, the refuse of fine-cut chewing tobacco, scraps, cuttings, clippings, and sweeping of leaf tobacco or partially manufactured tobacco or other refuse of tobacco *may be transferred from one factory to another under an official L-7 invoice* on which shall be entered the exact weight of the tobacco at the time of its removal, *and entry shall be made in the L-7 register in the place*