Notes on Taxation Law[1]

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[1] Culled from the Tax Code, Sababan's Magic Notes & Mamalateo's Reviewer on Taxation; supplemented by Atty. Barlis [SLU-Baguio] lecture.

GENERAL PRINCIPLES

One thing is certain in taxation: capital cannot be taxed without violating the principle of due process.

Taxation as a power: Taxation is the inherent power of the sovereign, exercised through the legislature, to impose burdens upon subjects and objects within its jurisdiction for the purpose of raising revenues to carry out the legitimate objects of government.

Taxation as a process: It is also defined as the act of levying a tax, i.e. the process or means by which the sovereign, through its law-making body, raises income to defray the necessary expenses of government. It is a method of apportioning the cost of government among those who, in some measure, are privileged to enjoy its benefits and must therefore bear its burdens.

It is a mode of raising revenue for public purposes, [***Cooley***]

Note: the power of taxation is inherently legislative. Thus, congress has the power to determine: [CONES]

1. Coverage of taxation
2. Object or purpose of taxation
3. Nature or kind of product taxed
4. Extent or rate of tax
5. *Situs* of taxation

TAXES: Taxes are the enforced proportional contributions from persons and property levied by the law-making body of the State by virtue of its sovereignty for the support of the government and all public needs, [***Cooley***]

They are not arbitrary exactions but contributions levied by authority of law, and by some rule of proportion which is intended to ensure uniformity of contribution and a just apportionment of the burdens of government.

Thus:

a. Taxes are enforced contributions - Taxes are obligations created by law. [***Vera v. Fernandez, L-31364, March, 30, 1979***]. Taxes are never founded on contract or agreement, and are not dependent for their validity upon the individual consent of the person taxed.

b. Taxes are proportional in character, since taxes are based on one's ability to pay.

c. Taxes are levied by authority of law - The power to impose taxes is a legislative power; it cannot be imposed by the executive department nor by the courts.

d. Taxes are for the support of the government and all its public needs.

ESSENTIAL ELEMENTS OF A TAX

1. It is an enforced contribution.
2. It is generally payable in money.
3. It is proportionate in character.
4. It is levied on persons, property, or the exercise of a right or privilege (Excise tax).
5. It is levied by the State which has jurisdiction over the subject or object of taxation.
6. It is levied by the law-making body of the State.
7. It is levied for public purpose or purposes.

SCOPE OF TAXING POWER

The power of taxation is the most absolute of all powers of the government *[Sison v. Ancheta 130 SCRA 654].* It has the broadest scope of all the powers of government because in the absence of limitations, it is considered as *unlimited, plenary, comprehensive and supreme.*

However, the power of taxation should be exercised with caution to minimize injury to the proprietary rights of the taxpayer. It must be exercised fairly, equally, and uniformly, lest the tax collector kill "the hen that lays the golden egg" *[Roxas v. CTA, 23 SCRA 276].*

It is noteworthy that the power to tax knows no limits except solely the will of Congress. However, the unlimitedness of the power presupposes that the taxing power is exercise properly and not confiscatory, oppressive and unreasonable.

Congress passed a law stating that taxpayers may pay their tax liability through personal and real properties. Is the law valid?

Yes, there is no Constitutional prohibition. The power of Congress regarding taxation is plenary, thus it has the prerogative to determine the mode of paying tax obligations whether it be paid in cash, in the form of real property, or personal property. Besides the tax payer is given a choice either to pay his tax liability in cash or in kind.

However, if the tax measure **levies property as taxes**, then it is invalid. It violates the Constitutional mandate that no person shall be deprive of life, liberty and property without due process of law, since the state exercises eminent domain without just compensation.

PURPOSES OF TAXATION

1. ***Revenue of fiscal:*** The primary purpose of taxation on the part of the government is to provide funds or property with which to promote the general welfare and the protection of its citizens and to enable it to finance its multifarious activities.

2. ***Non-revenue or regulatory:*** Taxation may also be employed for purposes of regulation or control. e.g.:
   a) Imposition of tariffs on imported goods to protect local industries.
   b) The adoption of progressively higher tax rates to reduce inequalities in wealth and income.
   c) The increase or decrease of taxes to prevent inflation or ward off depression.

SUMPTUARY PURPOSE OF TAXATION - More popularly known as the **non-revenue or regulatory purpose of taxation**. While the primary purpose of taxation is to raise revenue for the support of the government, taxation is often employed as a devise for regulation by means of which certain effects or conditions envisioned by the government may be achieved. The non-revenue purpose of taxation includes the following:

1. ***The taxing power can be used as an implement of police power-*** the power of taxation can be used to attain the objectives of police power.

   In *Walter Lutz v. J. Antonio Araneta, 98 Phil 148*, the SC upheld the validity of the tax law increasing the existing tax on the manufacture of sugar. "The protection and promotion of the sugar industry is a matter of public concern; the legislature may determine within reasonable bounds what is necessary for its protection and expedient for its promotion. If objective and methods alike are constitutionally valid, there is no reason why the state may not levy taxes to raise funds for their prosecution and attainment. Taxation may be made the implement of the state's police power."

2. ***The power of taxation can be used to redistribute wealth.***

   Example: estate taxes- the gov't collects estate taxes which in return distributed to the people in the form of basic services [hopefully!☺☺]

3. ***The power of taxation can be used as an implement of the power of eminent domain.***

   This is exemplified in a situation where the government does not pay in cash the property of a person but it offers incentives such as tax credit or tax deductions. The tax credit or tax deduction is the just compensation of the property.

   Is it possible to attain the objectives of eminent domain through taxation? Yes, in the case of CIR vs. Mercury Drug Corporation, wherein a law was passed granting 20% percent discount to senior citizens, the company complained that the gov't took its property without just compensation, the court ruled that there was a just compensation since, the 20% discount given to senior citizens can be claimed as a tax credit [it is an allowable deduction under the present law].

4. ***The power of taxation can used to protect local businesses-*** For example, government may provide tax incentives to protect and promote new and pioneer industries.

   The imposition of **special duties**, like *dumping duty*, *marking duty*, *retaliatory [discriminatory]* duty, and *countervailing duty*, promote the non-revenue or sumptuary purpose of taxation.

What is an anti-dumping duty? Taxes imposed to products which are sold in the Philippines below the fair market value in the country of origin.

Rationale: Anti-dumping duties are imposed since the act of dumping can be used to commit illegal acts, such as unfair competition; as such it is a form of protection, especially to local businesses.

Example: If an imported cement is sold at 150 per bag and a locally manufactured cement is sold at 200 per bag, then lugi ang local manufacturers kasi ung imported ang bibilhin ng mga tao. ***What is the remedy?*** Impose anti-dumping duty to jack up the price.

PAL v. Edu, 164 SCRA 320 The legislative intent and purpose behind the law requiring owners of vehicles to pay for their registration is mainly to raise funds for the construction and maintenance of highways and, to a much lesser degree, pay for the operating expenses of the administering agency. It is possible for an exaction to be both a tax and a regulation. License fees are charges, looked to as a source of revenues as well as means of regulation. The fees may properly be regarded as taxes even though they also serve as an instrument of regulation. If the purpose is primarily revenue, or if revenue is at least one of the real and substantial purposes, then the exaction is properly called a tax.

Tio v. Videogram, 151 SCRA 208- PD 1987 which created the Videogram Regulatory Board also imposed a 30% tax on the gross receipts payable to the local government. SC upheld the validity of the law ruling that the tax imposed is not only a regulatory but also a revenue measure prompted by the realizations that earnings of videogram establishments of around P600 million annually have not been subject to tax, thereby depriving the government of an additional source of revenue. It is a user tax imposed on retailers for every video they make available for public viewing. The 30% tax also served a regulatory purpose: to answer the need for regulating the video industry, particularly the rampant film piracy, the flagrant violation of intellectual property rights, and the proliferation of pornographic video tapes.

Caltex v. Commissioner, 208 SCRA 755- Taxation is no longer a measure merely to raise revenue to support the existence of government. Taxes may be levied with a regulatory purpose to provide means for the rehabilitation and stabilization of a threatened industry which is affected with public interest as to be within the police power of the State. The oil industry is greatly imbued with public interest as it vitally affects the general welfare.

THEORY AND BASIS OF TAXATION

The power of taxation proceeds upon the theory that the existence of government is a necessity; that it cannot continue without means to pay its expenses; and that for these means, it has a right to compel all its citizens and property within its limits to contribute.

The basis of taxation is found in the reciprocal duties of protection and support between the State and its inhabitants. In return for his contribution, the taxpayer received benefits and protection from the government. This is the so called "*Benefits received principle".*

Taxation has been defined as the power by which the sovereign raises revenue to defray the necessary expenses of government. It is a way of apportioning the cost of government among those who in some measure are privileged to enjoy the benefits and must therefore bear its burden, [*51 Am. Jur. 34*].

The power of taxation is essential because the government can neither exist nor endure without taxation. "*Taxes are the lifeblood of the government and their prompt and certain availability is an imperious need", [Bull v. United States, 295 U.S. 247, 15 APTR 1069, 1073].* The collection of taxes must be made without any hindrance if the state is to maintain its orderly existence.

Government projects and infrastructures are made possible through the availability of funds provided through taxation. The government's ability to serve and protect the people depends largely upon taxes. Taxes are what we pay for a civilized society, ***[Commissioner v. Algue, 158 SCRA 9].***

DOCTRINES RELATIVE TO TAXATION

1. **Lifeblood Doctrine**
2. **Necessity Theory**
3. **Benefits Received Principle**
4. **Doctrine of Symbiotic Relationship**

LIFEBLOOD DOCTRINE - The lifeblood theory constitutes the theory of taxation, which provides that the existence of government is a necessity; that government cannot continue without means to pay its expenses; and that for these means it has a right to compel its citizens and property within its limits to contribute.

In *Commissioner v. Algue,* the Supreme Court said that taxes are the lifeblood of the government and should be collected without necessary hindrance. They are what we pay for a civilized society. Without taxes, the government would be paralyzed for lack of motive power to activate and operate it. The government, for its part, is expected to respond in the form of tangible and intangible benefits intended to improve the lives of the people and enhance their moral and material values.

Taxes are the lifeblood of the government and so should be collected without unnecessary hindrance. Philex's claim that it had no obligation to pay the excise tax liabilities within the prescribed period since it still has pending claims for VAT input credit/refund with the BIR is untenable**,*[Philex Mining Corporation v. CIR, 294 SCRA 687]***

Collolaries of Lifeblood theory

1. Collection of taxes cannot be enjoined by injunction.
2. Taxes could not be the subject of compensation or set off.
3. A valid tax may result in the destruction of the taxpayer's property.
4. Taxation is unlimited and plenary power.

NECESSITY THEORY- Taxation as stated in the case of *Phil. Guaranty Co., Inc. v. Commissioner [13 SCRA 775],* is a power predicated upon necessity. *It is a necessary burden to preserve the State's sovereignty and a means to give the citizenry an army to resist aggression, a navy to defend its shores from invasion, a corps of civil servants to serve, public improvements for the enjoyment of the citizenry, and those which come within the State's territory and facilities and protection which a government is supposed to provide.*

BENEFITS RECEIVED PRINCIPLE - This theory bases the power of the State to demand and receive taxes on the reciprocal duties of support and protection. The citizen supports the State by paying the portion from his property that is demanded in order that he may, by means thereof, be secured in the enjoyment of the benefits of an organized society. *Thus, the taxpayer cannot question the validity of the tax law on the ground that payment of such tax will render him impoverished, or lessen his financial or social standing, because the obligation to pay taxes is involuntary and compulsory, in exchange for the protection and benefits one receives from the government.*

However, it does not mean that only those who are able to and do pay taxes can enjoy the privileges and protection given to a citizen by the government.

In fact, from the contribution received, the government renders no special or commensurate benefit to any particular property or person. The only benefit to which the taxpayer is entitled is that derived from the enjoyment of the privilege of living in an organized society established and safeguarded by the devotion of taxes to public purpose. The government promises nothing to the person taxed beyond what may be anticipated from an administration of the laws for the general good, ***[Lorenzo v. Posadas].***

Taxes are essential to the existence of the government. The obligation to pay taxes rests not upon the privileges enjoyed by or the protection afforded to the citizen by the government, but upon the necessity of money for the support of the State. For this reason, no one is allowed to object to or resist payment of taxes solely because no personal benefit to him can be pointed out as arising from the tax, ***[Lorenzo v. Posadas].***

DOCTRINE OF SYMBIOTIC RELATIONSHIP - This doctrine is enunciated in *CIR v. Algue, Inc. [158 SCRA 9],* which states that "*Taxes are what we pay for civilized society. Without taxes, the government would be paralyzed for lack of the motive power to activate and operate it. Hence, despite the natural reluctance to surrender part of one's hard-earned income to the taxing authorities, every* *person who is able must contribute his share in the burden of running the government. The government for its part, is expected to respond in the form of tangible and intangible benefits intended to improve the lives of the people and enhance their material and moral values."*

TAX SYSTEMS

Constitutional Mandate - The rule of taxation shall be uniform and equitable. The Congress shall evolve a progressive system of taxation. [*Sec. 28, Art. VI, Constitution*]

Tolentino v. Secretary if Finance. Regressivity is not a negative standard for courts to enforce. What the Constitution requires the Congress to do is to "*evolve a progressive system of taxation*." This is a directive to Congress, just like the directive given to it, to give priority to the enactment of laws for the enhancement of human dignity. The provisions are put in the Constitution as moral incentives to legislation, not as judicially enforceable rights.

Progressive system of taxation and regressive system of taxation - A progressive system of taxation means that tax laws shall place emphasis on direct taxes rather than on indirect taxes, with ability to pay as the principal criterion.

A regressive system of taxation exists when there are more indirect taxes imposed than direct taxes.

Regressive tax rates - Tax the rate of which decreases as the tax base or bracket increases. There are no regressive taxes in the Philippine jurisdiction.

Regressive tax rates should be differentiated from a regressive system of taxation which exists when there are more indirect taxes imposed than direct taxes.

THREE BASIC PRINCIPLES OF A SOUND TAX SYSTEM-[FAT]

1. ***Fiscal adequacy-*** It means that the sources of revenue should be sufficient to meet the demands of public expenditures. [*Chavez v. Ongpin, 186 SCRA 331*].

2. ***Equality or theoretical justice-*** It means that the tax burden should be proportionate to the taxpayer's ability to pay. This is the so-called "*ability to pay principle."*

3. ***Administrative feasibility-***It means that tax laws should be capable of convenient, just and effective administration.

> ***Suppose that Congress did not follow these principles, can a taxpayer file a case in court?*** No except when there is a gross violation of the principle of theoretical justice, to the point that the tax system is confiscatory, oppressive and unreasonable which is also violative of the due process clause of the constitution.

DEFINATION OF TERMS

Tariff and Duties

- The term tariff and duties are used interchangeably in the Tariff and Customs Code (PD No. 1464).

- Customs duties or simply duties, are taxes imposed on goods exported from or imported into a country. Customs duties are really taxes but the latter term is broader in scope.

- On the other hand, tariff may use in any of the three senses:
  1) A book of rates drawn usually in alphabetical order containing the names of several kinds of merchandise with the corresponding duties to be paid for the same; or
  2) The duties payable on goods imported or exported; or
  3) The system or principle of imposing duties on the importation or exportation of goods.

License or regulatory fee and Tax

- License fee is legal compensation or reward of an officer for specific services while a tax is an enforced contribution from persons or property by the law-making body of the State by virtue of its sovereignty and for the support of the government and all public needs.
- License fee is imposed for regulation, while a tax is levied for revenue.
- License fee involves the exercise of police power, while tax the exercise of power of taxation.
- Amount of license fees should be limited to the necessary expenses of inspection and regulation, while there is generally no limit on the amount of the tax to be imposed.
- License fees are imposed only on the right to exercise a privilege, while taxes are also imposed on persons and property.
- Failure to pay a license fee makes the act or business illegal, while failure to pay a tax does not necessarily make the act or business illegal.

Examples of regulatory tax - Motor vehicle registration fee, Sugar levy, Coconut levy, regulation of non-useful occupations.

PAL v. Edu: This involves the imposition of motor vehicle registration fees which the Supreme Court ruled as taxes. Fees may be regarded as taxes even though they also serve as instruments of regulation because taxation may be made the implement of the State's Police Power. But*, if the purpose is primarily revenue, or if revenue is, at least one of the real and substantial purposes, then the exaction is properly called a tax.*

Criteria for determining license fees

1. Imposition must relate to an occupation or activity which involves the health, morals, safety and

development of the people and which needs regulation for the protection and promotion of public interest.

2. Imposition must also bear a reasonable relation to the probable expenses of regulation, taking into account the costs of direct regulation as well as the incidental expenses.

Instances when license fee may exceed cost of regulation, control or administration

1. When the collection or the license fee is authorized under both the power of taxation and police power.

2. When the license fee is collected to regulate a non-useful occupation.

Special Assessment and Tax

1. A special assessment is an enforced proportional contribution from owners of lands, especially or peculiarly benefited by public improvements.
2. A special assessment is levied on land.
3. A special assessment is not a personal liability of the person assessed; it is limited to the land.
4. A special assessment is based wholly on benefits, not necessity.
5. A special assessment is exceptional both as to time and place; a tax has general application.

Republic v. Bacolod Murcia, 17 SCRA 632- A special assessment is a levy on property which derives some special benefit from the improvements. Its purpose is to finance such improvement. It is not a tax measure intended to raise revenues for the government. The proceeds thereof may be devoted to the specific purpose for which the assessment was authorized, thus accruing only to the owners thereof who, after all, pay the assessment.

Some rules:

- An exemption from taxation does not include exemption from a special assessment.
- The power to tax carries with it the power to levy a special assessment.

Toll and Tax

1. Toll is a sum of money for the use of something. It is consideration which is paid for the use of a road, bridge, or the like, of a public nature. Taxes, on the other hand, are enforced proportional contributions from persons and property levied by the State by virtue of its sovereignty for the support of the government and all public needs.
2. Toll is a demand of proprietorship, while tax is a demand of sovereignty.
3. Toll is paid for the use of another's property; tax is paid for the support of government.
4. The amount paid as toll depends on the cost of construction or maintenance of the public improvement used; while there is no limit on the amount of tax that can be collected as long as it is not ***excessive, whimsical, or confiscatory.***
5. Toll may be imposed by the government or by private individuals or entities; tax may be imposed only by the government.

Tax and Penalty

1. Penalty is any sanction imposed as a punishment for violation of law or for acts deemed injurious; taxes are enforced proportional contributions from persons and property levied by the State by virtue of its sovereignty for the support of the government and all public needs.
2. Penalty is designed to regulate conduct; taxes are generally intended to generate revenue.
3. Penalty may be imposed by the government or by private individuals or entities; taxes only by the government.

Debt and Tax

1. A debt is generally based on contract, express or implied, while a tax is based on laws.
2. A debt is assignable, while a tax generally cannot be assigned.
3. A debt may be paid in kind, while a tax is generally paid in money.
4. A debt may be the subject of set-off or compensation, while a tax generally cannot.
5. A person cannot be imprisoned for non-payment of tax, except poll tax.
6. A debt is governed by the ordinary periods of prescription, while a tax is governed by the special prescriptive periods provided for in the NIRC.
7. A debt draws interest when it is so stipulated or where there is default, while a tax does not draw interest except only when delinquent.

SURVEY OF PHILIPPINE TAXES

A. Internal Revenue taxes imposed under the NIRC
  a. Income tax
  b. Transfer taxes
  - Estate tax
  - Donor's tax

  3. Percentage taxes
    a. Value Added Tax
    b. Other percentage taxes

  4. Excise taxes
  5. Documentary stamp tax

B. Local/Municipal Taxes
C. Tariff and Customs duties
D. Taxes/Tax incentives under special laws

CLASSIFICATION OF TAXES

As to subject matter or object

1. **Personal, poll or capitation tax -** Tax of a fixed amount imposed on persons residing within a specified territory, whether citizens or not, without regard to their property or the occupation or business in which they may be engaged. e.g. Community tax.

2. **Property** Tax imposed on property, real or personal, in proportion to its value or in accordance with some other reasonable method of apportionment.

3. **Excise tax -** A charge imposed upon the performance of an act, the enjoyment of a privilege, or the engagement in an occupation.

As to purpose

1. **General/Fiscal/Revenue tax-** A general/fiscal/revenue tax is that imposed for the purpose of raising public funds for the service of the government.

2. **Special/regulatory tax -** A special/regulatory tax is primarily imposed for the regulation of useful or non-useful occupation or enterprises or for the regulation or protection of industries imbued with public interest, and secondarily for the purpose of raising public funds.

As to who bears the burden

1. **Direct tax -** A direct tax is demanded from the person who also shoulders the burden of the tax. It is a tax which the taxpayer is directly or primarily liable and which he or she cannot shift to another.

2. **Indirect tax -** An indirect tax is demanded from a person in the expectation and intention that he or she shall indemnify himself or herself at the expense of another, falling finally upon the ultimate purchaser or consumer. A tax which the taxpayer can shift to another.

As to scope of the tax

1. **National tax -** That tax imposed by the national government.
2. **Local tax -** A local tax is imposed by municipal corporations or local government units (LGU's).

As to the determination if amount

1. **Specific tax -** A specific tax is a tax of fixed amount, imposed by the head or number or by some other standard of weight or measurement. It requires no assessment other than the listing or classification of the objects to be taxed.

2. **Ad valorem tax -** As ad valorem tax is a tax of fixed proportion of the value of the property with respect to which the tax is assessed. It requires the intervention of assessors or appraisers to estimate the value of such property before the amount due from each taxpayer can be determined.

As to graduation or rate

1. **Proportional tax -** Tax based on a fixed percentage of the amount of the property receipts or other basis to be taxed. E.g. Real estate tax.

2. **Progressive or graduated tax -** The tax rate of which increases as the tax base or bracket increases. e.g. Income tax

   - **Digressive tax rate:** progressive rate stops at a certain point. Progression halts at a particular stage.

   ✘ Not to be confused with Progressive system of taxation, wherein the number of indirect taxes outnumber the direct taxes.

3. **Regressive tax -** Tax the rate of which decreases as the tax base or bracket increases. There is no such tax in the Philippines.

NATURE AND LIMITATIONS OF THE POWER OF TAXATION

Nature of characteristics of the State's power to tax

1. The power of taxation is an incident of sovereignty as it is *inherent* in the State, belonging as a matter of right to every independent government. It does need constitutional conferment. Constitutional provisions do not give rise to the power to tax but merely impose limitations on what would otherwise be an invincible power. No attribute of sovereignty is more pervading, and at no point does the power of government affect more constantly and intimately all the relations of life than through the exactions made under it, *[Churchill and Tait v. Concepcion, 34 Phil 969].*

2. The power to tax is inherent in the State, and the State is free to select the object of taxation, *such power being exclusively vested in the legislature, EXCEPT* where the Constitution provides otherwise, *[Art. VI, Sec, 28 (2); Art. X, Sec. 5].*

   Art. VI, Sec. 28. par. 2.- The Congress may by law authorize the President to fix within specified limits, and subject to such limitations and restrictions as it may impose, tariff rates, import and export quotas, tonnage and wharfage dues, and other duties or imposts within the framework of the national development program of the Government.

   Art. X, Sec. 5- Each local government unit shall have the power to create its own sources of revenues and to levy taxes, fees, and charges subject to such guidelines and limitations as the Congress may provide, consistent with the basic policy of local autonomy. Such taxes, fees, and charges shall accrue exclusively to the local governments.

3. It is subject to *Constitutional and inherent limitations*; hence, it is not an absolute power that can be exercised by the legislature anyway it pleases.

4. **Power to tax is exclusively legislative in nature -** The power to tax is peculiarly and exclusively legislative and cannot be exercised by the executive or judicial branches of the government. Hence, only Congress can impose taxes.

Power to tax includes the power to destroy - Chief Justice Marshall declared that the power to tax includes the power to destroy. Therefore, it should be exercised with caution to minimize injury to the proprietary rights of the taxpayer. It must be exercised fairly, equally and uniformly, lest the tax collector kills the "hen that lays the golden egg". An in order to maintain the general public's trust and confidence in the government, this power must be used justly and not treacherously. [Chief Justice Marshall in the case *McCulloch v. Maryland, reiterated in Roxas v. CTA 23 SCRA 276].*

In the case *Panhandle Oil Company v. Mississipi,* Justice Holmes seemingly contradicted the *Marshallian* view by declaring that "*the power to tax is not the power to destroy while this court sits."*

Domondon's reconciliation of Marshall and Holmes

- The imposition of a valid tax measure could not be judicially restrained merely because it would prejudice the taxpayer's property.
- An illegal tax could be judicially declared invalid and should not work to prejudice a taxpayer's property.
- Marshall's view refers to a valid law, while Holmes' view refers to an invalid law.

Matters within the competence of the legislature [Scope of legislative power to tax]

1. The subject to be taxed.
2. The purpose (object of taxation) of the tax (should always be for a public purpose).
3. The amount or rate of tax.
4. The manner, means, and agencies of collection of the tax.

POWER TO TAX IS EXCLUSIVELY LEGISLATIVE IN NATURE

As such, the legislature has the power as to-

1. Discretion as to subject of taxation - The legislature has unlimited scope as to the persons, property or occupation to be taxed, where there are no constitutional restrictions, provided the property is within the territorial jurisdiction of the taxing state, ***[Cooley]***

CIR v. Santos, 277 SCRA 617 [1997]- The Supreme Court held that it is within the province of the legislature whether to tax jewelry or not. With the legislature, lies primarily the discretion to determine the nature (kind), object (purpose), extent (rate), coverage (subjects), and situs (place), of taxation.

It is inherent in the power to tax that the State be free to select the subjects of taxation, and it has been repeatedly held that "*inequalities which result from a singling out of one particular class for taxation, or exemption, infringe no Constitutional limitation."*

Benjamin Gomez v. Enrico Palomar,[L-23645, Oct. 29, 1968, 25 SCRA 827] - Petitioner questions the constitutionality of the statute, claiming that RA 1635, otherwise known as the Anti-TB Stamp Law, is violative of the equal protection clause of the Constitution because it constitutes mail users into a class for the purpose of the tax while leaving untaxed the rest of the population and that even among postal patrons the statute discriminatorily grants exemptions.

It is settled that the legislature has the inherent power to select the subject of taxation and to grant exemptions. The classification of mail users is based on the ability to pay, the enjoyment of a privilege and on administrative convenience. Tax exemptions have never been thought of as raising issues under the equal protection clause.

Silvestre Punsalan v.The Mun. Board of the City of Manila [95 Phil 46] - Plaintiffs sought the annulment of Ordinance No. 3398 of the City of Manila which imposes a municipal occupation tax on persons exercising various professions in the city and penalizes non-payment of the tax, enacted pursuant to Sec. 18 of the Revised Charter of the City of Manila, which empowers the Mun. Board to impose a municipal occupation tax, not to exceed P50 per annum, on persons engaged in various professions.

Plaintiff's complaint is that while the law has authorized the City of Manila to impose the said tax, it has withheld that authority from other chartered cities, not to mention municipalities.

The SC held, that it is not for the courts to judge what particular cities or municipalities should be empowered to impose occupation taxes in addition to those imposed by the National Government. That matter is peculiarly within the domain of the political department and the courts would do well not to encroach upon it.

2. Discretion as to purposes for which taxes shall be levied - The sole arbiter of the purposes for which taxes shall be levied is the legislature, provided the purposes are public. The courts may review the levy of the tax to determine whether it is for a public purpose, but once that is determined, the courts can make no other inquiry as to the purpose of the tax, as it affects the power to impose it, *[Cooley]*

Walter Lutz v. Antonio Araneta, [L-7859, Dec. 22, 1955, 98 Phil 148] - Plaintiff Lutz assailed the constitutionality of Secs. 2 and 3, CA 567, which provided for an increase of the existing tax on the manufacture of sugar, alleging such tax as unconstitutional and void for not being levied for a public purpose but for the aid and support of the sugar industry exclusively.

The SC held that as the protection and promotion of the sugar industry is a matter of public concern, *the legislature may determine within reasonable bounds what is necessary for its protection and expedient for its promotion. Here, the* *legislative discretion must be allowed full play, subject only to the test of reasonableness;* and it is not contended that the means provided in Sec. 6 of CA 567, bear no relation to the objective pursued or are oppressive in character. If objective and methods alike are constitutionally valid, no reason is seen why the state may not levy taxes to raise funds for their prosecution and attainment. Taxation may be made the implement of the State's Police Power.

Congress passed a law replacing BIR to Internal Revenue Management Authority [IRMA]. IRMA would accredit private citizens to be the collectors of taxes. These citizens will remit to IRMA their collections and failure to do so would be a ground to revoke their accreditations. Is the law valid?

No, the collection of a tax is a governmental function and is lodged exclusively to Congress. However, Congress may not delegate the taxing power but the administration of tax measures. When it created IRMA the administration of the tax measure was delegated to it and further delegation of such delegated power would be violative of the principle of *potestas delegare non delegate potest*. The accreditation of private individuals as collectors would be delegation of power which was delegated to IRMA. Besides, there is no assurance that the private individuals would remit the collected taxes, hence jeopardize the existence of the State, since taxes are its lifeblood.

Congress divided the Philippines into a several revenue regions wherein each region will have an IRMA which will exclusively and solely levy and collect taxes. Is the tax measure valid?

The tax measure is invalid. ***Per the Section 5, Article X of the Constitution***- *"each local government unit shall have the power to create its own sources of revenues and to levy taxes, fees, and charges subject to such guidelines and limitations as the Congress may provide, consistent with the basic policy of local autonomy. Such taxes, fees, and charges shall accrue exclusively to the local governments."* Thus, making IRMA as the sole authority to levy and collect tax will be violative of this Constitutional mandate since it would deprive local government to levy and collect taxes for their revenues.

INHERENT LIMITATIONS OF THE POWER OF TAXATION

INHERENT LIMITATIONS

1. Purpose must be public in nature.
2. Prohibition against delegation of the taxing power.
3. Exemption of government entities, agencies, and instrumentalities.
4. International comity.
5. Limitations of territorial jurisdiction

PUBLIC PURPOSE OF TAXATION - This is one of the inherent limitations on the power to tax and is synonymous to "governmental purpose." A tax must always be imposed for a public purpose, otherwise, it will be declared as invalid.

The term "public purpose" has no fixed connotation. The essential point is that the purpose of the tax affects the inhabitants as a community and not merely as inhabitants.

It has been said that the best test of rightful taxation is that the proceeds of the tax must be used:

a. For the support of the government.
b. For some of the recognized objects of the government; or
c. To promote the welfare of the community.

What if the levy did not specify the purpose, does the tax comply with the requirement of public purpose? Yes, it complies with public purpose since the taxes collected becomes part of the purpose and as such cannot be used for a private purpose.

Remedy if taxes collected was not used for public purpose- taxpayer's suit.

Public vs. Private interest- In *Pascual v. Sec. of Public Works 110 SCRA Phil 331*, the SC held that the appropriation for construction of feeder roads on land belonging to a private person is not valid, and donation to the government of the said land made over 5 months after the approval and effectivity of the Act for the purpose of giving semblance of legality to the appropriation does not cure the basic defect. Incidental advantage to the public or to the State, which results from the promotion of private enterprises, does not justify the use of public funds.

Effect of incidental benefit to private interest- The purposes to be accomplished by taxation need not be exclusively public. Although, private individuals are directly benefited, the tax would still be valid provided such benefit is only incidental.

The test is not as to who receives the money, but the character of the purpose for which it is expended; not the immediate result of the expenditure, but rather the ultimate results.

The appropriation of public money to construct a road on private land is not a public purpose. **[*Pascual v. Secretary of Public Works. 110 Phil. 331*].**

POWER TO TAX CANNOT BE DELEGATED - The power of taxation, being purely legislative cannot be delegated by the Congress. This limitation arises from the doctrine of separation of powers among the three branches of government.

Exception to the non-delegation rule

1. Delegation to the President
2. Delegation to local government units
3. Delegation to administrative agencies

Delegation to the President- Congress may authorize, by law, the President to fix, within specified limits and subject to such limitations and restrictions as it may impose:

1. Tariff rates;
2. Import and export quotas;
3. Tonnage and wharfage dues; and
4. Other duties or imposts within the national development program of the government.

This authorization is embodied in Sec. 401 of the Tariff and Customs Code which is also called the "*flexible tariff clause*"

Flexible tariff clause- In the interest of national economy, general welfare and/or national security, the President, upon recommendation of the National Economic and Development Authority, is empowered:

1. To increase, reduce or remove existing protective rates of import duty, provided that the increase should not be higher than 100% ad valorem.
2. To establish import quota or to ban imports of any commodity; and
3. To impose additional duty on all imports not exceeding 10% ad valorem.

Delegation to Local Government Units - The power to tax is primarily vested in the Congress, however, in our jurisdiction, it may be exercised by local legislative bodies, no longer merely by virtue of a valid delegation but pursuant to direct authority conferred by Section 5, Article X of the 1987 Constitution, subject to guidelines and limitations which Congress may provide which must be consistent with the basic policy of local autonomy, *[MCIAA v. Marcos, 261 SCRA 667]*.

However, the power of local government units to impose taxes and fees is always subject to the limitations which the Congress may provide, the former having no inherent power to tax. [*Basco v. PAGCOR*].

Municipal corporations are mere creations of Congress which has the power to create and abolish municipal corporations. Congress therefore, has the power of control over local government units. If Congress can grant to a municipal corporation the power to tax certain matters, it can also provide for exemptions or even to take back the power.

Delegation to Administrative Agencies - With the growing complexities of modern life, and the many technical fields of government functions, as in matters pertaining to tax exemptions, delegation of legislative powers has become the rule and non-delegation the exception. The legislature may not have the competence, let alone the interest and the time, to provide direct and efficacious solutions to many problems attendant upon present day undertakings. The legislature could not be expected to state all the detailed situations wherein the tax exemption privilege would be restored. The task may be assigned to an administrative body like the Fiscal Incentives Review Board (FIRB). [*Maceda v. Macaraig, 196 SCRA 771].*

For delegation to be constitutionally valid, the law must be complete in itself and must set forth sufficient standards.

Certain aspects of the taxing process that are not really legislative in nature are vested in administrative agencies. In these cases, there really is no delegation, to wit:

1. Power to and value property;
2. Power to assess and collect taxes;
3. Power to perform details of computation, appraisal, or adjustment; among others.

Congress passed a law revoking the power of the President to fixed tariff rates and wharfage dues. Is the law valid? Yes, the law is valid. The Constitution only allows the delegation of the power to fixed tariff and wharfage dues and does not require that the same must be delegated to the President. It is a principle that delegated powers can be revoked. The President's power to fixed tariff rates and wharfage dues is delegated powers which can be revoked by the delegating authority, which is Congress.

EXEMPTION OF GOVERNMENTAL ENTITIES

Can the state tax itself? Yes, there is no prohibition under the law, but it is not wise for the state to do it, since it will be taxing itself to raise money for itself. Moreover, immunity from tax is necessary in order that the governmental functions will not be impeded.

When can the state be liable for taxes? The state may pay taxes under a specific and definite provision of law, e.g. the tariff and customs law on custom duties on imported goods, but if the act is purely governmental function then it may apply for exemption.

Property Owned by the State - Tax exemption of property owned by the Republic of the Philippines refers to property owned by the government and its agencies which do not have separate and distinct personalities. "The government does not part with its title by reserving them, but simply gives notice to the world that it desires them for a certain purpose." As its title remains with the Republic, the reserved land is clearly covered by tax exemption.

However, the exemption does not extend to improvements on public land. Consequently, the warehouse constructed on the reserved land by NDC should properly be assessed real estate tax, as such improvement does not appear to belong to the public, *[NDC v. Cebu City, 215 SCRA 382]*.

Which Governmental Entities are Exempt from Tax?

1. Government Service Insurance System (GSIS)
2. Social Security System (SSS)
3. Philippine Health Insurance Corporation (PHIC, PhilHealth)
4. Philippine Charity Sweepstakes Office (PCSO)
5. Philippine Amusement and Gaming Corporation (PAGCOR)

Congress passed a law taxing the gross receipts of every Local Government Units. Is the tax measure valid? The tax measure is invalid. The Constitution provides that taxes levied by LGU's shall exclusively accrue to their benefits. Thus, a tax measure imposing taxes on gross receipts of every LGU violates this constitutional mandate, since that tax base is gross receipts where revenues from taxes are included as taxable. In this case the state is taking part of the pie which, as the constitution mandates, accrue exclusively to LGU's

INTERNATIONAL COMITY - Courteous, friendly agreement and interaction between States.

Under International Law, property of a foreign State may not be taxed by another State.

Reasons for Exemption

- Sovereign equality of States.
- When one State enters the territory of another State, there is an implied understanding that the former does not intend to denigrate by placing itself under the jurisdiction of the other State.
- Immunity from suit of a State.

LIMITATION OF TERRITORIAL JURISDICTION

- Tax laws cannot operate beyond a state's territorial limits.
- Property outside one's jurisdiction does not receive any protection from the State.
- This must be correlated with situs of taxation. Thus:

Real property- located outside the Philippines cannot be taxed by the Philippine Government

Tax on persons- situs is residence of the taxpayer

Tax on exercise of rights- situs is either the citizenship, place where the right was exercise, or residence of the taxpayer.

Note:

1. **Withholding Taxes-** withholding taxes are always subject to the principle of territoriality. Why? Because withholding tax require the payor to withhold the tax and remit it to the Philippine government. If the withholding agent was remiss in his obligation, then he will be made personally liable. In this case the Philippine government cannot require the payor to withhold the tax since the former is outside the territorial jurisdiction of the Philippines.

2. **Jurisdiction of the Philippine government to impose taxes -** Where shares of stock left by a non-resident alien decedent with a corporation in the Philippines, the SC held that the actual situs of the shares of stock is in the Philippines. The owner, residing in California, had extended here her activities with respect to her intangibles so as to avail herself of the protection and benefit of the Philippine laws. Accordingly the Philippine government had the jurisdiction to tax, ***[Wells Fargo Bank v. Collector, 70 Phil 235]***.

CONSTITUTIONAL LIMITATION ON THE POWER TO TAX

CONSTITUTIONAL LIMITATIONS

1. Due process of law;
2. Equal protection of laws;
3. Rule of uniformity and equity in taxation;
4. Prohibition against imprisonment for non-payment of poll tax;
5. Prohibition against impairment of obligations and contracts;
6. Prohibition against infringement of religious freedom;
7. Prohibition against appropriation of proceeds of taxation for the use, benefit, or support of any church;
8. Prohibition against taxation of religious, charitable, and educational entities;
9. Prohibition against taxation of non-stock, non-profit educational institutions;
10. Others
    - **a)** Grant of tax exemption
    - **b)** Veto of appropriation, revenue, tariff bills by the President
    - **c)** Non-impairment of the SC jurisdiction
    - **d)** Revenue bills shall originate exclusively from the House of Representatives
    - **e)** Infringement of press freedom
    - **f)** Grant of franchise

DUE PROCESS OF LAW - The due process clause may be invoked where a taxing statute is so arbitrary that it finds no support in the Constitution. Absent such a showing, however, the presumption must prevail *[Sison vs. Ancheta].*

Substantive due process- There must be a valid law. How do you know that a law is valid? It is not unconscionable and unjust as to amount to confiscation of property not be arbitrary as to find no support in the Constitution.

Procedural due process- opportunity to be heard. Notice and hearing.

Thus in Sison vs. Ancheta, 60% tax rate was declared by the Supreme Court to be valid. Why? Because a taxpayer is entitled to allowable deductions, so it is also proper to impose a higher rate of tax.

When does the power of taxation impinge the due process clause? The due process clause may be invoked where a taxing statute is so arbitrary that it finds no support in the Constitution, as where it can be shown to amount to a confiscation of property, ***[Reyes v. Almanzor, 196 SCRA 322]***.

Is double taxation confiscatory? No, unless it is direct duplicate taxation.

EQUAL PROTECTION OF LAWS - All persons subject to legislation shall be treated alike under similar circumstances and conditions both in privilege conferred and liabilities imposed.

The doctrine does not require that persons or properties different in fact be treated in law as though they were the same. What it prohibits is class legislation which discriminates against some and favors others.

As long as there are rational or reasonable grounds for so doing, Congress may group persons or properties to be taxed and it is sufficient if all members of the same class are subject to the same rate and the tax is administered impartially upon them.

Is classification allowed? The taxing power has the authority to make reasonable and natural classification for purposes of taxation, but the government's act must not be prompted by spirit of hostility, or at the very least discrimination that finds no support in reason. It suffices then that the laws operate equally and uniformly on all persons under similar circumstances or that all persons must be treated in the same manner, the conditions not being different both in privileges conferred and liabilities imposed, *[Sison v. Ancheta, 130 SCRA 654]*.

Requisites of a valid classification

1. It must be based on substantial distinctions which make real differences.
2. The classification must be germane to the purpose of the law.
3. The classification must not be limited to existing conditions only but must also apply to future conditions substantially identical to those of the present.
4. The classification must apply equally to all members of the same class. [*Tiu v. CA, 301 SCRA 278 (1999)]*

Tiu v. CA- The Constitutional right to equal protection of the law is not violated by an executive order, issued pursuant to law, granting tax and duty incentives only to businesses within the "*secured area*" of the Subic Special Economic Zone and denying them to those who live within the Zone but outside such "*fenced in"* territory. The Constitution does not require absolute equality among residents. It is enough that all persons under like circumstances or conditions are given the same privileges and required to follow the same obligations. In short, a classification based on valid and reasonable standards does not violate the equal protection clause.

We find real and substantial distinctions between the circumstances obtaining inside and those outside the Subic Naval Base, thereby justifying a valid and reasonable classification.

Ormoc Sugar Company v. Treasurer of Ormoc City, 22 SCRA 603- The SC held the ordinance unconstitutional for taxing only sugar produced and exported by the Ormoc Sugar Co., Inc. The classification to be reasonable should be in terms applicable to future conditions as well. The taxing ordinance should not be singular and exclusive as to exclude any substantially established sugar central of the same class as plaintiff, from the coverage of the tax.

A law withdrawing the exemption granted to the press was challenged as discriminatory for giving broadcast media favored treatment.-The SC held that it is not discriminatory. If the press is now required to pay VAT, it is not because it is being singled out, but only because of the removal of the exemption previously granted by law. Further, the press is taxed on its transactions involving printing and publication, which are different from the transactions of broadcast media, there is a reasonable basis for the classification, *[Tolentino v. Sec. of Finance 235 SCRA 630]*

UNIFORMITY AND EQUITY IN TAXATION - Sec. 28 c, Art. VI of the Constitution provides that "*the rule of taxation shall be uniform and equitable*".

The concept of uniformity in taxation implies that all taxable articles or properties of the same class shall be taxed at the same rate. It requires the uniform application and operation, without discrimination, of the tax in every place where the subject of the tax is found. It does not, however, require absolute identity or equality under all circumstances, but subject to reasonable classification.

The concept of equity in taxation requires that the apportionment of the tax burden be, more or less, just in the light of the taxpayer's ability to shoulder the tax burden and, if warranted, on the basis of the benefits received from the government. Its cornerstone is the taxpayer's ability to pay.

PROHIBITION AGAINST IMPRISONMENT FOR NON-PAYMENT OF TAX - No person shall be imposed for debt or non-payment of poll tax. [Sec. 20, Art. III, Constitution]

The non-imprisonment rule applies to non-payment of poll tax which is punishable only by a surcharge, but not to other violations like falsification of community tax certificate and non-payment of other taxes.

Poll tax- Poll tax is a tax of fixed amount imposed on residents within a specific territory regardless of citizenship, business or profession. e.g. community tax

PROHIBITION AGAINST IMPAIRMENT OF OBLIGATIONS AND CONTRACTS

- No law impairing the obligation of contracts shall be passed. [Sec. 10, Art. III, 1987 Constitution]
- The obligation of a contract is impaired when its terms or conditions are changed by law or by party without the consent of the other, thereby weakening the position or rights of the latter.
- An example of impairment by law is when a later taxing statute revokes a tax exemption based on a contract. But this only applies when the tax exemption has been granted for a valid consideration **and not only a unilateral tax exemption.**

- A later statute may revoke exemption from taxation provided for in a franchise because the Constitution provides that a franchise is subject to amendment, alteration or repeal.

Note: in determining impairment of contracts, determine whether the government is shedding of its sovereign power or asserting a sovereign authority. Check if these elements are present:

1. There is a contract between the government and the taxpayer where the government sheds off its sovereign character and steps down to the level of taxpayer;
2. The government enter into contract;
3. One of the provisions in the contract is the grant of tax exemption to the other contracting party.

Bar Question [1997] - X Corporation was the recipient in 1990 of two tax exemptions both from Congress, one law exempting the company's bond issues from taxes and the other exempting the company from taxes in the operation of its public utilities. The two laws extending the tax exemptions were revoked by Congress before their expiry date. Were the revocations constitutional?

Suggested Answer: Yes. The exempting statutes are both granted unilaterally by Congress in the exercise of taxing powers. Since taxation is the rule and tax exemption is the exception, any tax exemption unilaterally granted can be withdrawn at the pleasure of the taxing authority without violating the Constitution.

Neither of the tax exemptions were issued by the taxing authority in a contract lawfully entered by it so that their revocation would not constitute an impairment of the obligations of contracts.

Bar Question [2004] - A law was passed granting tax exemption to certain industries and investments for a period of 5 years. But 3 years later, the law was repealed. With the repeal, the exemptions were considered revoked by the BIR, which assessed the investing companies for unpaid taxes effective on the date of the repeal of the law.

NPC and KTR companies questioned the assessments on the ground that, having made their investments in full reliance with the period of exemption granted by law, its repeal violated their constitutional right against the impairment of the obligations and contracts. Is the contention of the companies tenable or not? Reason

Suggested Answer: The contention is not tenable. The exemption granted is in the nature of a unilateral exemption. Since the exemption given is spontaneous on the part of the legislature and no service or duty or other remunerative conditions have been imposed on the taxpayers receiving the exemption, it may be revoked at will by the legislature. What constitutes an impairment of the obligation of contract is the revocation of an exemption which is founded on a valuable consideration because it takes the form and essence of a contract.

PROHIBITION AGAINST INFRINGEMENT OF RELIGIOUS FREEDOM

- No law shall be made respecting an establishment of religion, or prohibiting the free exercises thereof.

- The free exercise and enjoyment of religious profession and worship, without discrimination or preference, shall forever be allowed. No religious test shall be required for the exercise of civil or political rights. [Sec. 5, Art. III, 1987 Constitution].

- The payment of license fees for the distribution and sale of bibles suppresses the constitutional right of free exercise of religion. [*American Bible Society v. Manila, 101 Phil. 386]*. **If a tax law becomes a prior restraint to the exercise of religion then such tax law is unconstitutional.**

PROHIBITION AGAINST APPROPRIATION OF PROCEEDS OF TAXATION FOR THE USE, BENEFIT, OR SUPPORT OF ANY CHURCH

Section 29, Art. VI, 1987 Constitution

1. No money shall be paid out of the Treasury except in pursuance of an appropriation made by law.
2. No public money or property shall be appropriated, applied, paid, or employed directly or indirectly, for the use, benefit, or support of any church, denomination, sectarian institution or system of religion, or of any priest, preacher, minister or other religious teacher, or dignitary as such except when such priest, preacher, minister or dignitary is assigned to the armed forces, or to any penal institution, or government orphanage or leprosarium.
3. All money collected on any tax levied for a special purpose shall be treated as a special fund and paid out for such purpose only. If the purpose for which a special fund was created has been fulfilled or abandoned, the balance, if any, shall be transferred to the general funds of the government.

PROHIBITION AGAINST TAXATION OF REAL PROPERTY ACTUALLY, DIRECTLY, AND EXCLUSIVELY USED FOR RELIGIOUS, CHARITABLE, AND EDUCATIONAL PURPOSE - Charitable institutions, churches and parsonages or convents appurtenant thereto, mosques, non-profit cemeteries, and all lands, buildings, and improvements, actually, directly and exclusively used for religious, charitable, or educational purposes shall be exempt from taxation. **[Sec. 28, Art. VI, 1987 Constitution].**

This is an exemption from real property tax only. The basis of exemption is actual, direct, and exclusive used of the property for religious, educational, and charitable purposes, and not ownership of the property. Corollarily, ***to be exempt from realty taxation, there must be proof of actual, direct and exclusive use of lands, buildings and improvements for religious or charitable purposes***, *[Province of Abra v. Hernando 107 SCRA 104].*

Ownership is immaterial; it is the used of the property that determines exemption from tax. Therefore, the exemption attaches to the property as long as it is actually, directly and exclusively used for religious, educational and charitable purposes.

Example: A church rented a lot from a private person. The lot was used for spiritual rituals of the members? Is the land subject to tax? NO, since it is actually, directly and exclusively used for religious purposes.

What if it is the church that leases a lot to private individual, is the land subject to tax? YES! Since it is not actually, directly, and exclusively used for religious purposes.

Note: Instructive in this topic is the case of *Lung Center of the Philippines vs. Quezon City*, which abandons the ruling in *Abra Valley College vs. Aquino*, *Bishop of Nueva Segovia* and *Herrera* case, which enunciated that properties incidentally used for religious, educational, and charitable purposes are exempt from real property tax. *Incidental exemption is not anymore allowed.*

LUNG CENTER OF THE PHILIPPINES VS. QUEZON CITY

G.R. No. 144104. June 29, 2004

Facts: The petitioner Lung Center of the Philippines is a non-stock and non-profit entity established by virtue of Presidential Decree No. 1823. It is the registered owner of a parcel of land, located at Quezon Avenue corner Elliptical Road, Central District, Quezon City. Erected in the middle of the aforesaid lot is a hospital known as the Lung Center of the Philippines. A big space at the ground floor is being leased to private parties, for canteen and small store spaces, and to medical or professional practitioners who use the same as their private clinics for their patients whom they charge for their professional services. Almost one-half of the entire area on the left side of the building along Quezon Avenue is vacant and idle, while a big portion on the right side, at the corner of Quezon Avenue and Elliptical Road, is being leased for commercial purposes to a private enterprise known as the Elliptical Orchids and Garden Center.

The petitioner accepts paying and non-paying patients. It also renders medical services to out-patients, both paying and non-paying. Aside from its income from paying patients, the petitioner receives annual subsidies from the government

Petitioner was assessed by the local government of Quezon City for real property tax concerning said lot. Petitioner protested said assessment claiming that it is exempt. However, petitioner's claim for tax exemption was denied by both the City assessor and Board of Assessment Appeals. Hence this petition.

Issue:

a. Whether the petitioner is a charitable institution within the context of Presidential Decree No. 1823 and the 1973 and 1987 Constitutions and Section 234(b) of Republic Act No. 7160; and

b. Whether the real properties of the petitioner are exempt from real property taxes.

Ruling: As to the first issue, the Court held that petitioner is a charitable institution within the context of the 1973 and 1987 Constitutions.

Explained the Court, to determine whether an enterprise is a charitable institution/entity or not, the elements which should be considered include the *statute creating the enterprise*, *its corporate purposes, its constitution and by-laws, the methods of administration, the nature of the actual work performed, the character of the services rendered, the indefiniteness of the beneficiaries, and the use and occupation of the properties.*

The petitioner met the foregoing requirements, hence a charitable entity. Under P.D. No. 1823, the petitioner is a non-profit and non-stock corporation which is to be administered by the Office of the President of the Philippines with the Ministry of Health and the Ministry of Human Settlements. It was organized for the welfare and benefit of the Filipino people principally to help combat the high incidence of lung and pulmonary diseases in the Philippines.

Moreover, as to the contention that petitioner is not a charitable institution since it admits paying patients and receives donations, the Court said: "as a general principle, a charitable institution does not lose its character as such and its exemption from taxes simply because it derives income from paying patients, whether out-patient, or confined in the hospital, or receives subsidies from the government, so long as the money received is devoted or used altogether to the charitable object which it is intended to achieve; and no money inures to the private benefit of the persons managing or operating the institution."

In this case, the petitioner adduced substantial evidence that it spent its income, including the subsidies from the government for 1991 and 1992 for its patients and for the operation of the hospital. It even incurred a net loss in 1991 and 1992 from its operations.

As to the second issue, the Court held that those portions of petitioner's real property that are leased to private entities are not exempt from real property taxes as these are not actually, directly and exclusively used for charitable purposes.

Petitioner's argument that its property is exempt from real property tax per its charter does not hold water. Section 2 of its charter provides that- "being a non-profit, non-stock corporation organized primarily to help combat the high incidence of lung and pulmonary diseases in the Philippines, all donations, contributions, endowments and equipment and supplies to be imported by authorized entities or persons and by the Board of Trustees of the Lung Center of the Philippines, Inc., for the actual use and benefit of the Lung Center, *shall be exempt from income and gift taxes, the same further deductible in full for the purpose of determining the maximum deductible amount under Section 30, paragraph (h), of the National Internal Revenue Code, as amended. The Lung Center of the Philippines shall be exempt from the payment of taxes, charges and fees imposed by the Government or any political subdivision or instrumentality thereof with respect to equipment purchases made by, or for the Lung Center.*

It is plain as day that under the decree, *the petitioner does not enjoy any property tax exemption privileges for its real properties as well as the building constructed thereon.* If the intentions were otherwise, the same should have been among the enumeration of tax exempt privileges under Section 2.

Corollarily, petitioner's claim that it is exempt from real property tax per Section 28, Art. XIV of the Philippine Constitution is not correct.

Under the 1973 and 1987 Constitutions and Rep. Act No. 7160 [LGC] in order to be entitled to the exemption, the petitioner is burdened to prove, by clear and unequivocal proof, that (a) it is a charitable institution; and (b) its real properties are **ACTUALLY**, **DIRECTLY** and **EXCLUSIVELY** used for charitable purposes.

"Exclusive" is defined as possessed and enjoyed to the exclusion of others; debarred from participation or enjoyment; and "exclusively" is defined, "in a manner to exclude; as enjoying a privilege exclusively." If real property is used for one or more commercial purposes, it is not exclusively used for the exempted purposes but is subject to taxation. The words "dominant use" or "principal use" cannot be substituted for the words "used exclusively" without doing violence to the Constitutions and the law. **Solely is synonymous with exclusively.**

Therefore, what is meant by actual, direct and exclusive use of the property for charitable purposes is the direct and immediate and actual application of the property itself to the purposes for which the charitable institution is organized. It is not the use of the income from the real property that is determinative of whether the property is used for tax-exempt purposes.

In this case the petitioner failed to discharge its burden to prove that the entirety of its real property is actually, directly and exclusively used for charitable purposes. While portions of the hospital are used for the treatment of patients and the dispensation of medical services to them, whether paying or non-paying, other portions thereof are being leased to private individuals for their clinics and a canteen. Further, a portion of the land is being leased to a private individual for her business enterprise.

Accordingly, held the Court, the portions of the land leased to private entities as well as those parts of the hospital leased to private individuals are not exempt from such taxes. On the other hand, the portions of the land occupied by the hospital and portions of the hospital used for its patients, whether paying or non-paying, are exempt from real property taxes.

Hypothetical Question: *what if a city or municipality applies the ruling above, what could be the best defense if your client is an educational institution? – inases ng city ang mga playgrounds ng eskwelahan.*

Of course do not use the theory of incidental exemption. You need to repackage it, ergo [1] argue that those areas [play grounds] are not only incidental but NECESSARY for the existence of the school. Because, holistic education necessitates a space where the students can freely move so as to express themselves well, etc… [2] To be considered as an educational institution, a school need not teach in every square inch of its perimeter.

RELATIVE TO INCOME TAX - ***Is there a constitutional exemption of religious institution from paying income taxes?*** None, the grant of exemption from payment of income tax is statutory in nature, specifically, Section 30 of the NIRC.

Section 30, NIRC. Exemptions from Tax on Corporations. -The following organizations shall not be taxed under this Title in respect to income received by them as such:

a. Labor, agricultural or horticultural organization not organized principally for profit;

b. Mutual savings bank not having a capital stock represented by shares, and cooperative bank without capital stock organized and operated for mutual purposes and without profit;

c. A beneficiary society, order or association, operating for the exclusive benefit of the members such as a fraternal organization operating under the lodge system, or mutual aid association or a non-stock corporation organized by employees providing for the payment of life, sickness, accident, or other benefits exclusively to the members of such society, order, or association, or non-stock corporation or their dependents;

d. Cemetery company owned and operated exclusively for the benefit of its members;

e. ***Non-stock corporation or association organized and operated exclusively for religious, charitable, scientific, athletic, or cultural purposes, or for the rehabilitation of veterans,***

no part of its net income or asset shall belong to or inures to the benefit of any member, organizer, officer or any specific person;

- **f.** Business league chamber of commerce, or board of trade, not organized for profit and no part of the net income of which inures to the benefit of any private stock-holder, or individual;
- **g.** Civic league or organization not organized for profit but operated exclusively for the promotion of social welfare;
- **h.** A non-stock and non-profit educational institution;
- **i.** Government educational institution;
- **j.** Farmers' or other mutual typhoon or fire insurance company, mutual ditch or irrigation company, mutual or cooperative telephone company, or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting its expenses; and
- **k.** Farmers', fruit growers', or like association organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses on the basis of the quantity of produce finished by them;

Notwithstanding the provisions in the preceding paragraphs, the income of whatever kind and character of the foregoing organizations from ***any of their properties, real or personal, or from any of their activities conducted for profit regardless of the disposition made of such income***, shall be subject to tax imposed under this Code.

Caveat: per the last paragraph of Section 30, not all income of the foregoing institutions are exempt from tax, because income of whatever kind and character from any of their properties, real or personal, or from any of their activities conducted for profits regardless of the disposition made of such income is taxable.

Ergo, *is the income of Porta Vaga Mall [owned by the Diocese of Baguio] subject to income tax*? Yes, because… refer to last paragraph of Section 30, NIRC *supra*!

Bar Question [2000, 2006]- Sec. 28, Art. VI, 1987 Constitution provides that charitable institutions, churches and parsonages or convents appurtenant thereto, mosques, non-profit cemeteries, and all lands, buildings, and improvements, actually, directly and exclusively used for religious, charitable, or educational purposes shall be exempt from taxation.

- **a.** To what kind of tax does this exemption apply?
- **b.** Is proof of actual use necessary for tax exemption purposes under the Constitution?

Suggested Answers:

- **a.** The exemption applies only to property taxes. What is exempted is not the institution itself but the lands, buildings and improvements actually, directly and exclusively used for religious, charitable, and educational purposes.

- **b.** Yes, because tax exemptions are strictly construed against the taxpayer. There must be evidence to show that the taxpayer has complied with the requirements for exemption. Furthermore, real property taxation is based on use and not on ownership; hence, the same rule must also be applied for real property tax exemptions.

PROHIBITION AGAINST TAXATION OF THE REVENUES AND ASSETS OF NON-STOCK, NON-PROFIT EDUCATIONAL INSTITUTIONS - All revenues and assets of non-stock, non-profit educational institutions used actually, directly, and exclusively for educational purposes shall be exempt from taxes and duties. Upon the dissolution or cessation of the corporate existence of such institutions, their assets shall be disposed of in the manner provided by law. **[Sec. 4, Art. XIV, 1987 Constitution].**

This exemption from corporate income tax is embodied in Sec. 30 of the NIRC which includes non-stock, non-profit educational institutions.

The source of the income is immaterial as long as it is actually, directly, and exclusively used for educational purposes.

And be noted that- generation of an income does not determine the non-profit character of a school. Note further that the exemption extends not only to income tax but also duties.

Department of Finance Order 145-85 - Non-stock, non-profit educational institutions are exempt from taxes on all their revenues and assets used actually, directly and exclusively for educational purposes.

However, they shall be subject to internal revenue tax on income from trade, business or other activity, the conduct of which is not related to the exercise or performance by such educational institutions of its educational purposes or functions.

Example: Tuition fees. Half was spent for educational purposes. The other half remained in the school's treasury. Is the latter subject to tax? No! Not because of the constitutional provision but pursuant to Section 30(h) of NIRC. Besides there is a consistency of the collection of revenue and the purpose of the school. Tuition fees are necessary for the school's existence.

Interest income shall be exempt only when used directly and exclusively for educational purposes. To substantiate this claim, the institution must submit annual information return and duly audited financial statement. A certification of actual utilization and the Board resolution or the proposed project to be funded out of the money deposited in banks shall also be submitted.

What if the canteen is operated by third persons and not the school, is the income subject to tax? Notwithstanding the last paragraph of Section 30 of NIRC and the above order, revenue derive from canteen concessionaires is still exempt from tax as long as it is actually, directly, and exclusively used for educational purposes per the provision of the constitution- *"**all revenues and assets** of non-stock, non-profit educational institutions used actually, directly, and exclusively for educational purposes shall be exempt from **taxes and duties**."* The burden of proof lies with the taxpayer, since taxation is the rule, and exemption is the exception.

Department of Finance Order 137-87- An educational institution means a non-stock, non-profit corporation or association duly registered under Philippine law, and operated exclusively for educational purposes, maintained and administered by a private individual or group offering formal education, and with an issued permit to operate by the DECS.

Revenues derived from and assets used in the operation of cafeteria/canteens, dormitories, and bookstores are exempt from taxation provided they are owned and operated by the educational institution as ancillary activities and the same are located within the school premises.

What is an educational institution? Instructive of this query is the case of *CIR v. CA, 298 SCRA 83 [1998].*

The Young Men's Christian Association of the Philippines, Inc. (YMCA), was established as *"welfare, educational and charitable non-profit corporation."* It conducts various programs and activities that are beneficial to the public, especially the young people, pursuant to its religious, educational and charitable objectives.

In this case, the SC held that the income derived by YMCA from leasing out a portion of its premises to small shop owners, like restaurants and canteen operators, and from parking fees collected form non-members are taxable income.

First, the constitutional tax exemptions granted to non-stock, non-profit educational institutions do not find application because YMCA is not an educational institution. The term "*educational institutions*" or "*Institute of learning*" has acquired a well-known and technical meaning. Under the Education Act of 1982, such term refers to schools. The school system is synonymous with formal education, which "*refers to the hierarchically structured chronologically graded learning's organized and provided by the formal school system and for which certification is required in order for the learner to progress through the grades or move to the higher levels."* A perusal of the articles of incorporation of the YMCA does not show that it established such a system.

Second, even if it be exempt under Sec. 30, of the NIRC as a non – profit, non – stock educational corporation, the income from the rent of its premises and parking fees are not covered by the exemption, according to the last paragraph of the same section. Sec. 30 provides that income of whatever kind and character from any of its properties, real or personal, or from any of its activities for profit are not exempt from income tax.

Finally, **Sec. 28, Art. VI of the Constitution** does not apply as it extends exemption only from real and property taxes- not from income taxes.

Bar Question [2000] Sec. 4, Art. XIV, 1987 Constitution provides- all revenues and assets of non-stock, non-profit educational institutions used actually, directly, and exclusively for educational purposes shall be exempt from taxes and duties. Are the income derived from dormitories, canteens, and bookstores as well as interest income on bank deposits and yields from deposit substitutes automatically exempt from taxation? Explain.

Suggested Answer: No. The interest income on bank deposits and yields from deposit substitutes are not automatically exempt from taxation. There must be a showing that the incomes are included in the school's annual information return and duly audited financial statements, together with-

a. Certifications from depositary banks as to the amount of interest income earned from passive investments not subject to the 20% final withholding tax; and

b. Certification of actual, direct, and exclusive utilization of said income for educational purposes; board resolution on proposed project to be funded out of the money deposited in banks or placed in money market placements, which must be used actually, directly, and exclusively for educational purposes.

The income derived from dormitories, canteens and bookstores are not also automatically exempt from taxation. There is still the requirement for evidence to show actual, direct, and exclusive use for educational purposes. It is to be noted that the 1987 Constitution does not distinguish with respect to the source or origin of the income. The distinction is with respect to the use of which should be actual, direct, and exclusive for educational purposes.

Consequently, the provisions of Section 30 of the NIRC of 1997, that a non-stock and non-profit educational institution is exempt from taxation only in respect to income received by them as such could not affect the constitutional tax exemption. Where the constitution does not distinguish with respect to the source or origin, the tax code should not make distinctions.

TAXATION OF PROPRIETARY EDUCATIONAL INSTITUTIONS - Proprietary educational institutions, including those cooperatively owned, may likewise be entitled to such exemptions subject to the limitations provided by law including restrictions on dividends and provisions for investment, [Sec. 4(3), Art. XIV, Constitution].

Thus, the source of the income must be determined first, applying the pre-dominant test. If the revenue is derived from sources congruent to the purpose of the school, the revenue shall be taxed at a preferential arte of 10% per Section 27(B) of the NIRC- *"proprietary educational institutions and hospitals which are non-profit shall pay a tax of 10% on their taxable income except for passive income which is subject to different tax rates."*

However, if the revenues were derived from sources that are inconsistent with the purpose of the educational institution then the tax rate will be 30%- the school losses its educational character, and is treated as an ordinary corporation.

DONATIONS TO CHARITABLE, RELIGIOUS INSTITUTIONS, AND EDUCATIONAL INSTITUTIONS- ***Section 101 of the NIRC provides***- the following gifts shall exempt from donor's tax:

(3) Gifts in favor of an educational and/or charitable, religious, cultural or social welfare corporation, institution, accredited nongovernment organization, trust or philanthropic organization or research institution or organization*: Provided, however, that not more than thirty percent (30%) of said gifts shall be used by such donee for administration purposes.*

For the purpose of the exemption, a 'non-profit educational and/or charitable corporation, institution, accredited nongovernment organization, trust or philanthropic organization and/or research institution or organization' is a school, college or university and/or charitable corporation, accredited nongovernment organization, trust or philanthropic organization and/or research institution or organization, incorporated as a nonstock entity, paying no dividends, governed by trustees who receive no compensation, and devoting all its income, whether students' fees or gifts, donation, subsidies or other forms of philanthropy, to the accomplishment and promotion of the purposes enumerated in its Articles of Incorporation.

Congress passed a law taxing all donations given to non- profit educational institutions. Is the law valid?

The answer would depend on the nature of the imposition of tax-

If the imposition is absolute then it is invalid being contrary to the Constitution. The law is invalid since the Constitution provides that - *all revenues and assets of non-stock, non-profit educational institutions used actually, directly, and exclusively for educational purposes shall be exempt from taxes and duties*. Thus to impose taxes on donations, which becomes part of the institution's revenues which are actually, directly and exclusively used for educational purpose will violate this constitutional mandate.

Further, **Article XIV, Section 4 (4)** - subject to conditions prescribed by law, all grants endowments, donations, or contributions used actually, directly, and exclusively for educational purposes shall exempt from tax.

Thus, the tax measure is valid if it imposes certain limits or amounts of taxable donation and not absolutely imposed taxes on all donations, pursuant to the phrase 'subject to the conditions prescribed by law.'

OTHER CONSTITUTIONAL LIMITATIONS

1. **GRANT OF EXEMPTION**
   - No law granting any tax exemption shall be passed without the concurrence of a majority of all Members of Congress, [Sec. 28(4), Art. VI, Constitution].
   - Grant of exemption must be pursuant to a law and not any executive order.
   - Revocation of tax exemption is just like passing an ordinary law; it does not need higher voting requirement.

2. **VETO OF APPROPRIATION, REVENUE, OR TARIFF BILLS BY THE PRESIDENT**
   - The President shall have the power to veto any particular item or items in an appropriation, revenue, or tariff bill, but the veto shall not affect the item or items to which he does not object, [Sec. 27(2), Art. VI, Constitution].
   - An item in a bill refers to particulars, details, the distinct and severable parts of a bill. In budgetary legislation, an item is an invalid sum of money dedicated to a stated purpose, [Gonzales v. Macaraig 191 SCRA 452]
   - Determination of facts is a valid delegation to the President.

3. **NON-IMPAIRMENT OF THE JURISDICTION OF THE SC**
   - Congress cannot take away from the SC the power given to it by the Constitution as the final arbiter of tax cases.
   - The SC shall have the following powers:
     - **a.** Review, revise, reverse, modify, or affirm on appeal or certiorari, as the law or the Rules of Court may provide, final judgments and orders of lower courts in:
     - **b.** All cases involving the legality of any tax, impost, assessment, or toll, or any penalty imposed in relation thereto, [Sec. 5(2) (B), Art. VIII, Constitution].

4. **REVENUE BILLS SHALL ORIGINATE EXCLUSIVELY FROM THE HOUSE OF REPRESENTATIVES**
   - All appropriation, revenue or tariff bills, bills authorizing an increase of the public debt, bill of local application, and private bills shall originate exclusively in the House of Representatives, but the Senate may propose or concur with amendments, **[Sec. 24, Art. VI, Constitution].**

   - **Rationale:** to comply with the principle of taxation with representation, because district representatives are the representatives of the people and they knew whether the people can still handle additional burden of tax.

   - The Constitution simply means that the initiative for the filing of bills must come from the House of Representatives, on the theory that, elected as they are from the districts, the members of the House can be expected to be more sensitive to the local needs and problems. It is not the law –

But the revenue bill – which is required by the Constitution to originate exclusively in the House of Representatives, because a bill originating in the House may undergo such extensive changes in the Senate that the result may be a rewriting of the whole, and a distinct bill may be produced, ***[Tolentino v. Sec. of Finance].***

- The Constitution does not also prohibit the filing in the Senate of a substitute bill in anticipation of its receipt of the bill from the House, as long as action by the Senate is withheld until of a said bill, ***[Tolentino v. Sec. of Finance]***

Bar Question [1997] - The House of Representatives introduced House Bill 700, which was envisioned to levy tax on various transactions. After the bill was approved by the House, the bill was sent to the Senate as so required by the Constitution. In the upper House instead of a deliberation on the House Bill, the Senate introduced Senate Bill No. 800 which was its own version of the same tax. The Senate deliberated on this Senate Bill and approved the same. The House Bill and Senate Bill were then consolidated in the Bicameral Committee. Eventually the consolidated bill was approved and sent to the President who signed the same. The private sectors affected by the new law questioned the validity of the enactment on the ground that the Constitutional provisions requiring that all revenue bills should originate from the House of Representatives had been violated. Resolve the issue.

Suggested Answer: there is no violation of the constitutional requirement that all revenue bills should originate from the House of Representatives. What is prohibited is for the Senate to enact revenue measures on its own without a bill originating from the house. But once the revenue bill was passed by the House an sent to the Senate, the latter can pass its own version on the same subject matter consonant with the latter's power to propose or concur with amendments. This follows from the co-equality of the two chambers of Congress.

5. **INFRINGEMENT OF PRESS FREEDOM-** This limitation does not mean that the press is exempt from taxation. Taxation constitutes an infringement of press freedom when it operates as a prior restraint to the exercise of this constitutional right. When the tax is imposed on the receipts or the income of the press it is a valid exercise of the sovereign prerogative.

6. **GRANT OF FRANCHISE-** Tax exemptions included in the grant of a franchise may be revoked by another law as it is specifically provided in the Constitution that the grant of any franchise is always subject to amendment, alteration, or repeal by the Congress when the common good so requires.

What if there is a violation of these inherent limitations, can you go to court to question the same? *Yes*! However not on the ground that there was a violation of the inherent limitations, but on the ground that the tax law is confiscatory, oppressive and whimsical and is violative of the due process clause of the constitution.

What if you cannot find a provision that will support your claim that the tax law is oppressive, confiscatory, and whimsical, what will you do? [1] Save money to pay the tax [2] find ways to evade taxation. ☺☺

MEANS OF AVOIDING OR MINIMIZING THE BURDEN OF TAXATION

There are two ways of minimizing the burden of taxation namely – [1] tax evasion, illegal and [2] tax avoidance, legal.

TAX EVASION- Tax evasion is the use by the taxpayer of illegal or fraudulent means to defeat or lessen the payment of a tax. It is also known as "tax dodging." It is punishable by law.

Tax evasion is a term that connotes fraud through the use of pretense or forbidden devices to lessen or defeat taxes, [*Yutivo v. CTA 1 SCRA 160*].

Elements of tax evasion- Tax evasion connotes the integration of three factors:

1. The end to be achieved. Example: the payment of less than that known by the taxpayer to be legally due, or in paying no tax when such is due.
2. An accompanying state of mind described as being "evil, in bad faith, wilful, or deliberate and not accidental."
3. A course of action (or failure of action) which is unlawful.

Evidence to prove evasion - Since fraud is a state of mind, it need not be proved by direct evidence but may be proved from the circumstances of the case.

In the case of *Republic v. Gonzales, 13 SCRA 633,* the Supreme Court affirmed the assessment of a deficiency tax against Gonzales, a private concessionaire engaged in the manufacture of furniture inside the Clark Air Base, for under-declaration of his income. SC held that the failure of the taxpayer to declare for taxation purposes his true and actual income derived from his business for two consecutive years is an indication of his fraudulent intent to cheat the government of taxes due to it.

Examples of tax evasion- illegal, only if you're caught☺

1. Deliberate failure to report a taxable income or property; deliberately reduction of income that has been received.
2. Creating two separate book of accounts
3. Underdeclaration of value of the sale- usually the selling price is higher than the zonal value of the land. Since the basis for taxation is the zonal value, in the deed of sale the amount to be placed therein is the zonal value and not the selling price, to minimize

paying huge taxes. The lesser the price the lesser the tax liability.

4. If you're a lawyer- un bigyan mo lang ng official receipt ay un mga notarized documents (mga 200-500 pesos lang), pero pag may natanggap kang kaso at ang initial payment ay 50k, acknowledgment lang ibigay mo huwag OR. ☺☺

TAX AVOIDANCE - Tax avoidance is the exploitation by the taxpayer of legally permissible alternative tax rates or methods of assessing taxable property or income in order to avoid or reduce tax liability. It is politely called, "tax minimization" and is not punishable by law.

In the case of ***Delphers Traders Corp. v. IAC, 157 SCRA 349,*** the Supreme Court upheld the estate planning scheme resorted to by the Pacheco family in converting their property to shares of stock in a corporation which they themselves owned and controlled. By virtue of the deed of exchange, the Pacheco co-owners saved on inheritance taxes. The Supreme Court said the records do not point to anything wrong and objectionable about this estate planning scheme resorted to. The legal right of the taxpayer to decrease the amount of what otherwise could be his taxes or altogether avoid them by means which the law permits cannot be doubted.

Valid escape from taxation

1. Maximize allowable deductions
2. Relocate business- municipalities impose lower real property tax than cities.
3. Convert business into corporation- ceiling tax is 30%.
4. ***Spreading the value of donation.*** Suppose that a parent wants to donate his lot worth 500k to his child. What shall he do to avoid paying donor's tax? The parent can donate portion of the land with a value of 100k, since this is exempt from taxation. The parent can do this every year until he donates the entire lot to his child.

SHIFTING

- Shifting is the transfer of the **burden of a tax** by the original payer or the one on whom the tax was assessed or imposed to someone else.

- It should be borne in mind that what is transferred is not the payment of the tax but the burden of the tax.

- Only **indirect taxes** may be shifted (e.g. VAT); direct taxes (e.g. Income tax) cannot be shifted.

Ways of shifting the tax burden

1. **Forward shifting-** When the burden of the tax is transferred from a factor of production through factors of distribution until it finally settles on the ultimate purchase or consumer.

   Example: Manufacturer or producer may shift tax assessed to wholesaler, who in turn shifts it to retailer, who also shifts it to the final purchaser or consumer.

2. **Backward shifting-** When the burden of the tax is transferred from the consumer or purchaser through the factors of distribution to the factor of production.

   Example: Consumer or purchaser may shift tax imposed on him to retailer by purchasing only after the price is reduced, and from the latter to the wholesaler, and finally to the manufacturer or producer.

3. **Onward shifting-** When the tax is shifted two or more times either forward or backward. Thus, a transfer from the seller to the purchaser involves one shift; from the producer to the wholesaler, then to retailer, we have two shifts; and if the tax is transferred again to the purchaser by the retailer, we have three shifts in all.

Impact and incidence of taxation

- **Impact of taxation** is the point on which a tax is originally imposed. In so far as the law is concerned, the taxpayer is the person who must pay the tax to the government. He is also termed as the statutory taxpayer – the one on whom the tax is formally assessed. He is the subject of taxation.

- **Incidence of taxation** is that point on which the tax burden finally rests or settles down. It takes place when shifting has been effected from the statutory taxpayer to another.

Statutory taxpayer

- The statutory taxpayer is the person required by law to pay the tax or the one on whom the tax is formally assessed. In short, he or she is the subject of the tax.

- In direct taxes, the statutory taxpayer is the one who shoulders the burden of the tax while in indirect taxes, the statutory taxpayer is the one who pays the tax to the government but the burden can be passed to another person or entity.

Relationship between impact, shifting, and incidence of tax

- The impact is the initial phenomenon, the shifting is the intermediate process, and the incidence is the result. Thus, the impact in a sales tax (e.g. VAT) is on the seller (manufacturer) who shifts the burden to the customer who finally bears the incidence of the tax.

- Impact is the imposition of the tax; shifting is the transfer of the tax; while incidence is the setting or coming to rest of the tax.

Congress passed a law prohibiting the shifting of the burden of indirect tax. Is the law valid? Yes, since it is a principle that the taxing power of Congress is plenary. Corollarily, Congress has the power to determine the impact of taxation. Ergo, when Congreves decided that the burden of an indirect tax should not be shifted then it is valid exercise of such power.

TAX EXEMPTION

- It is the grant of immunity to particular persons or corporations of a particular class from a tax which persons and corporations generally within the same state or taxing district are obliged to pay. It is an immunity or privilege; it is freedom from a financial charge or burden to which others are subjected.

- Exemption is allowed only if there is a clear provision therefore.

- It is not necessarily discriminatory as long as there is a reasonable foundation or rational basis.

Rationale for granting tax exemptions

- Its avowed purpose is some public benefit or interest which the law-making body considers sufficient to offset the monetary loss entailed in the grant of the exemption.

- The theory behind the grant of tax exemptions is that such act will benefit the body of the people. It is not based on the idea of lessening the burden of the individual owners of property.

Grounds for granting tax exemptions

1. May be based on contract. In such a case, the public which is represented by the government is supposed to receive a full equivalent therefore, i.e. charter of a corporation.

2. May be based on some ground of public policy, i.e., to encourage new industries or to foster charitable institutions. Here, the government need not receive any consideration in return for the tax exemption.

3. May be based on grounds of reciprocity or to lessen the rigors of international double or multiple taxation.

Note: Equity is not a ground for tax exemption. Exemption is allowed only if there is a clear provision of law therefor.

Nature of tax exemption

a) It is a mere personal privilege of the grantee.
b) It is generally revocable by the government unless the exemption is founded on a contract which is protected from impairment.
c) It implies a waiver on the part of the government of its right to collect what otherwise would be due to it, and so is prejudicial thereto.
d) It is not necessarily discriminatory so long as the exemption has a reasonable foundation or rational basis.

Kinds of tax exemption according to manner of creation

1. **Express or affirmative exemption.**
   - When certain persons, property or transactions are, by express provision, exempted from all or certain taxes, either entirely or in part.

2. **Implied exemption or exemption by omission.**
   - When a tax is levied on certain classes of persons, properties or transactions without mentioning the other classes.
   - Every tax statute makes exemptions because of omissions.

Kinds of tax exemptions according to scope or extent

1. **Total-** When certain persons, property or transactions are exempted, expressly or impliedly, from all taxes.

2. **Partial-** When certain persons, property or transactions are exempted, expressly or impliedly, from certain taxes, either entirely or in part.

Does the provision in a statute granting exemption from all taxes include indirect taxes? No. As a **general rule**, indirect taxes are not included in the grant of such exemption unless it is expressly stated.

Nature or power to grant tax exemptions

1. **National government-** The power to grant tax exemptions is an attribute of sovereignty for the power to prescribe who or what persons or property shall be taxed implies the power to prescribe who or what persons or property shall be taxed implies the power to prescribe who or what persons or property shall not be taxed.

2. **Local governments-** Municipal corporations are clothed with no inherent power to tax or to grant tax exemptions. But the moment the power to impose a particular tax is granted, they also have the power to grant exemptions therefrom unless forbidden by some provision of the Constitution or the law.

   The legislature may delegate its power to grant tax exemptions to the same extent that it may exercise the power to exempt.

Basco v. PAGCOR [196 SCRA 52] - The power to tax of municipal corporations must always yield to a legislative act of Congress which is superior, having been passed by the State itself. Municipal corporations are mere creatures of Congress which has the power to create and abolish municipal corporations due to its general legislative powers. If Congress can grant the power to tax, it can also provide for exemptions or even take back the power.

Chavez v. PCGG [GR No. 130716, Dec. 6, 1998] - In a compromise agreement between the Philippine Government, represented by the PCGG, and the Marcos heirs, the PCGG granted tax exemptions to the assets which will be apportioned to the Marcos heirs. The Supreme Court ruled that the PCGG has absolutely no power to grant tax exemptions, even under the cover of its authority to compromise ill-gotten wealth cases. The grant of tax exemptions is the exclusive prerogative of Congress.

In fact, the Supreme Court even stated that Congress itself cannot grant tax exemptions in the case at bar because it will violate the equal protection clause of the Constitution.

INTERPRETATION OF LAWS GRANTING TAX EXEMPTIONS

General rule

- In the construction of tax statutes, exemptions are not favored and are construed *strictissimi juris* against the taxpayer. The fundamental theory is that all taxable property should bear its share in the cost and expense of the government.

- Taxation is the rule and exemption is the exception.

- He who claims exemption must be able to justify his claim or right thereto by a grant express in terms *"too plain to be mistaken and too categorical to be misinterpreted."* If not expressly mentioned in the law, it must be at least within its purview by clear legislative intent.

Exceptions

1. When the law itself expressly provides for a liberal construction thereof.

2. In cases of exemptions granted to religious, charitable and educational institutions or to the government or its agencies or to public property because the general rule is that they are exempted from tax.

Strict interpretation does not apply to the government and its agencies - Petitioner cannot invoke the rule of *strictissimi juris* with respect to the interpretation of statutes granting tax exemptions to the NPC. The rule on strict interpretation does not apply in the case of exemptions in favour of a political subdivision or instrumentality of the government, ***[Maceda v. Macaraig]***.

Davao Gulf v. Commissioner, [293 SCRA 76(1998)] - A tax cannot be imposed unless it is supported by the clear and express language of a statute; on the other hand, once the tax is unquestionably imposed, "a claim of exemption from tax payments must be clearly shown and based on language in the law too plain to be mistaken." Since the partial refund authorized under Sec. 5, RA 1435, is in the nature of a tax exemption, it must be construed *strictissimi juris* against the grantee. Hence, petitioner's claim for refund based on specific taxes it actually paid must expressly be granted in a statute stated in a language too clear to be mistaken.

TAX REMISSION OR TAX CONDONATION - The word "remit" means to desist or refrain from exacting, inflicting or enforcing something as well as to restore what has already been taken. The remission of taxes due and payable to the exclusion of taxes already collected does not constitute unfair discrimination. Such a set of taxes is a class by itself and the law would be open to attack as class legislation only if all taxpayers belonging to one class were not treated alike, ***[Juan Luna Subdivision v. Sarmiento, 91 Phil 370]***

The condonation of a tax liability is equivalent to and is in the nature of a tax exemption. Thus, it should be sustained only when expressly provided in the law. ***[Surigao Consolidated Mining v. Commissioner of Internal Revenue, 9 SCRA 728].***

TAX AMNESTY - Tax amnesty, being a general pardon or intentional overlooking by the State of its authority to impose penalties on persons otherwise guilty of evasion or violation of a revenue or tax law, partakes of an absolute forgiveness or waiver by the government from its right to collect what otherwise would be due it and, in this sense, prejudicial to itself. It is granted particularly to tax evaders who wish to relent and are willing to reform, thus giving them a chance to do so and thereby become a part of the new society with a clean slate, ***[Republic v. IAC, 196 SCRA 335].***

Like tax exemption, tax amnesty is never favored nor presumed in law. It is granted by statute. The terms of the amnesty must also be construed against the taxpayer and liberally in favour of the government.

SET-OFF OR COMPENSATION IN TAXATION

General rule: A tax delinquency cannot be extinguished by legal compensation. This is so because the government and the person assessed with the tax are not mutually creditors and debtors. Neither is a tax obligation an ordinary debt. Moreover, the collection of a tax cannot await the results of a lawsuit against the government. Finally, taxes are not in the nature of contracts but grow out of the duty to, and are positive acts of the government to the making and enforcing of which the personal consent of the taxpayer is not required ***[Francia v. IAC, 162 SCRA 622].***

Instructive is the case of ***Philex Mining Corp. v. CIR, 294 SCRA 687 [1998]*** wherein-

- Philex Mining Corp. wants to set-off its claims for VAT input credit/refund for the excise taxes due from it. The Supreme Court disallowed such set-off or compensation.

- Taxes cannot be subject to compensation for the simple reason that the government and the taxpayer are not creditors and debtors of each other. There is a material distinction between a tax and a debt. Debts are due to the government in its corporate capacity, while taxes are due to the government in its sovereign capacity.

Exception: Set-off was allowed- The Supreme Court allowed set-off in the case of ***Domingo v. Garlitos [8 SCRA 443]*** *[in re: claim for payment of unpaid services of a government employee vis-à-vis the estate tax from his estate].* The fact that the court having jurisdiction of the estate had found that the claim of the estate against the government has been appropriated for the purpose by a corresponding law shows that both the claim of the government for inheritance taxes and the claim of the intestate for services rendered have already became overdue and demandable as well as fully liquidated. Compensation therefore takes place by operation of law.

Requisites of Compensation in taxation [Domingo v.Garlitos]

1. That the tax assessed and the claim against the government be fully liquidated.
2. That the tax assessed and the claim against the government is due and demandable, and
3. That the government had already appropriated funds for the payment of the claim.

What then is the remedy if there was an overpayment of tax? File a claim for refund or claim it as a tax credit.

SOURCES, APPLICATION, INTERPRETATION AND ADMINISTRATION OF TAX LAWS

Sources of tax laws

1. Constitution
2. National Internal Revenue Code
3. Tariff and Customs Code
4. Local Government Code (Book II)
5. Local tax ordinances/ City or Municipal tax codes
6. Tax treaties and international agreements
7. Special laws
8. Decisions of the Supreme Court and the Court of Tax Appeals
9. Revenue rules and regulations and administrative rulings and opinions

TAX TREATY - A tax treaty is one of the sources of our law on taxation. The Philippine government usually enters into tax treaties in order to avoid or minimize the effects of double taxation. A treaty has the force and effect of law.

REVENUE RULES AND REGULATIONS AND ADMINISTRATIVE RULINGS AND OPINIONS

Authority to promulgate rules and regulations, and rulings and opinions

- The Secretary of Finance, upon recommendation of the Commissioner of Internal Revenue, shall promulgate needful rules and regulations for the effective enforcement of the provisions of the NIRC.

- This is without prejudice to the power of the Commissioner of Internal Revenue to make rulings or opinions in connection with the implementation of the provisions of the Internal Revenue laws, including rulings on the classification of articles for sales tax and similar purposes.

Purpose of rules and regulations

1. To properly enforce and execute the laws.
2. To clarify and explain the law
3. To carry into effect the law's general provisions by providing details of administration and procedure.

Requisites for validity of rules and regulations

1) They must not be contrary to law and the Constitution.
2) They must be published in the Official Gazette or a newspaper of general circulation.

Commissioner v. CA, [240 SCRA 368] - The authority of the Minister of Finance, in conjunction with the Commissioner of Internal Revenue, to promulgate rules and regulations for the effective enforcement of internal revenue rules cannot be controverted. Neither can it be disputed that such rules and regulations, as well as administrative opinions and rulings, ordinarily should deserve weight and respect by the courts. Much more fundamental than either of the above, however, is that all such issuances must not override, but must remain consistent with, the law they seek to apply and implement. Administrative rules and regulations are intended to carry out, neither to supplant nor to modify, the law.

La Suerte v. CTA [134 SCRA 29] - When an administrative agency renders an opinion by means of a circular or memorandum, it merely interprets existing laws and no publication is necessary for its validity. Construction by an executive branch of the government of a particular law, although not binding upon the courts, must be given weight as the construction came from the branch of the government which is called upon to implement the law.

EFFECTIVITY OF REVENUE RULES AND REGULATIONS - Revenue Memorandum Circular 20-86 was issued to govern the drafting, issuance, and implementation of revenue tax issuances, including:

1) Revenue Regulations;
2) Revenue Audit Memorandum Orders; and
3) Revenue Memorandum Circulars and Revenue Memorandum Orders.

Except when the law otherwise expressly provides, the aforesaid revenue tax issuances shall not begin to be operative until after due notice thereof may be fairly assumed.

Due notice of the said issuances may be fairly presumed only after the following procedures have been taken:

1. Copies of the tax issuances have been sent through registered mail to the following business and professional organizations:
   a. Philippine Institute of Certified Public Accountants
   b. Integrated Bar of the Philippines
   c. Philippine Chamber of Commerce and Industry
   d. American Chamber of Commerce
   e. Federation of Filipino-Chinese Chamber of Commerce; and

f. Japanese Chamber of Commerce and Industry in the Philippines.

However, other persons or entities may request a copy of the said issuances.

2. The Bureau of Internal Revenue shall issue a press release covering the highlights and features of the new tax issuance in any newspaper of general circulation.

3. Effectivity date for enforcement of the new issuance shall take place thirty (30) days from the date of the issuance had been sent to the above-enumerated organizations.

BIR RULINGS - Administrative rulings, known as BIR rulings, are the less general interpretation of tax laws being issued from time to time by the Commissioner of Internal Revenue. They are usually rendered on request of taxpayers to clarify certain provisions of a tax law. These rulings may be revoked by the Secretary of Finance if the latter finds them not in accordance with law.

The Commissioner may revoke, repeal, or abrogate the acts or previous rulings of his predecessors in office because the construction of the statute by those administering it is not binding on their successors if, thereafter, such successors are satisfied that a different construction of the law should be given.

Rulings in the form of opinions are also given by the Secretary of Justice who is the Chief Legal Officer of the Government.

Section 246- Non-Retroactivity of Rulings- Any revocation, modification or reversal of any of the rules and regulations promulgated in accordance with the preceding sections or any other rulings or circulars promulgated by the Commissioner shall not be given retroactive application if the revocation, modification, or reversal will be prejudicial to the taxpayers, except in following cases:

a. Where the taxpayer deliberately misstates or omits materials facts from his return or any document required of him by the BIR;
b. Where the facts subsequently gathered by the BIR are materially different from the facts on which the ruling is based; or
c. When the tax payer is in bad faith.

Note:

- A taxpayer cannot claim any right under a void ruling
- The nullity of a ruling must be declared by the court so that Article 246 will not apply.

EFFECTIVITY AND VALIDITY OF A TAX ORDINANCE - If the resolution is to be considered as a tax ordinance, it must be shown to have been enacted in accordance with the requirements of the Local Government Code. These would include the holding of a public hearing on the measure and its subsequent approval by the Secretary of Finance, in addition to the usual requisites for publication of ordinances in general *[Tuazon v. CA, 212 SCRA 739]*

INTERPRETATION AND APPLICATION OF TAX LAWS

NATURE OF INTERNAL REVENUE LAWS

1. Internal revenue laws are not political in nature.
2. Tax laws are civil and not penal in nature.

Not political in nature

- Internal revenue laws are not political in nature. They are deemed to be the laws of the occupied territory and not of the occupying enemy.

- Thus, our tax laws were in force during the Japanese occupation.

- It is well known that our internal revenue laws are not political in nature and, as such, continued in force during the period of enemy occupation and in effect were actually enforced by the occupation government. Income tax returns that were filed during that period and income tax payments made were considered valid and legal. Such tax laws are deemed to be the laws of the occupied territory and not of the occupying enemy ***[Hilado v. CIR, 100 Phil 288].***

Civil, not penal in nature

- Tax laws are civil and not penal in nature, although there are penalties provided for their violation.

- The purpose of tax laws in imposing penalties for delinquencies is to compel the timely payment of taxes or to punish evasion or neglect of duty in respect thereof.

- The war profits tax is not subject to the prohibition on *ex post facto* laws as the latter applies only to criminal or penal matters. Tax laws are civil in nature.***[Republic v. Oasan, 99 Phil 934]***

CONSTRUCTION OF TAX LAWS

1. **Rule when legislative intent is clear.**
   - Tax statutes are to receive a reasonable construction with a view to carrying out their purpose and intent.
   - It should not be construed as to permit the taxpayer to evade the payment of taxes easily.

2. **Rule when there is doubt.**
   - No person or property is subject to taxation unless within the terms or plain import of a taxing statute. In every case of doubt, tax statutes are construed strictly against the

government and liberally in favour of the taxpayer. Taxes being burdens, are not to be presumed beyond what the statute expressly and clearly declares.

3. **Provisions granting tax exemptions**
   - Such provisions are construed strictly against the taxpayer claiming tax exemption.

APPLICATION OF TAX LAWS

- **General rule:** Tax laws are ***prospective in operation*** because the nature and amount of the tax could not be foreseen and understood by the taxpayer at the time the transactions which the law seeks to tax was completed.

- **Exception:** While it is not favored, a statute may nevertheless operate retroactively provided it is expressly declared or is clearly the legislative intent. But a tax law should not be given retroactive application when it would be harsh and oppressive.

Corollary to the **Doctrine of Prospectivity** of tax laws is the principle of **No Estoppel against the Government**.

- This principle contemplates that mistake of government officials does not bind the state since taxes are the lifeblood of the state.

When to apply the Principle of Prospectivity? When revenue memorandum circulars are conformable with law as to its interpretation, both circular must apply prospectively.

When to apply the Principle of No- estoppel? When the RMC as to its interpretation of the law is not conformable with the real intent of the law. The circular is void, since thus no right arises from a void law.

Directory and mandatory provisions of tax laws

- **Directory provisions** are those designed merely for the information or direction of officers or to secure methodical and systematic modes of proceedings.

- **Mandatory provisions** are those intended for the security of the citizens or which are designed to ensure equality of taxation or certainty as to the nature and amount of each person's tax.

- The omission to follow mandatory provisions renders invalid the act or proceeding to which it relates while the omission to follow directory provisions does not involve such consequence, ***[Roxas v, Rafferty, 37 Phil 958].***

TAXPAYER'S SUIT

What is a taxpayer's suit? When is it proper? A taxpayer's suit requires illegal expenditure of taxpayer's money.

Requisites:

1. The acts questioned involve the disbursements of public funds.
2. The funds sought to be spent must appropriated by Congress and not earmarked by the President through his power of augmentation.

In ***Maceda v. Macaraig**, 197 SCRA 771,* the SC sustained the right of Sen. Maceda as a taxpayer to file a petition questioning the legality of the tax refund to NPC by way of tax credit certificates, and the use of tax certificates by oil companies to pay for their tax and duty liabilities to the BIR and Bureau of Customs.

However, in ***Gonzales v. Marcos**, 65 SCRA 624,* the SC held that the taxpayer had no legal personality to assail the validity of EO 30 creating the Cultural Center of the Philippines, as the assailed order does not involve the use of public funds. The funds came by way of donations and contributions and not by taxation

SITUS OF TAXATION

Reminder: if the question is **"may it be taxed?"-** apply the general principles of situs of taxation. However, if the question is **"is it taxed?"** apply the provision of the NIRC.

SITUS OF TAXATION IN GENERAL- Literally situs of taxation means the place of taxation. It is the state or political unit which has jurisdiction to impose a particular tax.

The purpose of setting the tax situs is to minimize the effects of double taxation.

Tax situs depends on the nature of the tax imposed by the taxing authority, such that classification must be made as to-

1. **Tax on a right**
   - Tax on a right includes **income tax**, **estate tax**, **donor's tax**, **corporate income tax**.

   - The tax situs is either the place of exercise, citizenship, or residence.

2. **Tax on property- Real or Personal**
   - Situs is where the property is located pursuant to the principle of *lex rei sitae*. This applies whether or not the owner is a resident of the place where the property is located.

   - This is so because the taxing authority has control over the property which is of a fixed and stationary character.

   - The place where the real property is located gives protection to the real property, hence the owner must support the government of that place.

Doctrine of Lex Rei Sitae- This is a principle followed in fixing the situs of taxation of a property. This means that the property is taxable in the State where it has its actual situs, specifically in the place where it is located, even though the owner resides in another jurisdiction.

With respect to property taxes, real property is subject to taxation in the State where it is located and taxable only there.*Lex rei sitae* has also been adopted for tangible personal property under Article 16 of the Civil Code. A different rule applies to intangible personal property, specifically *mobilia sequuntor personam*.

3. **Tax on persons**
   - Poll tax may be properly levied upon persons who are **inhabitants** or **residents** of the state, whether or not they are citizens.

What is the tax situs for intangible personal property?

General rule: situs is the domicile of the owner pursuant to the principle of *mobilia sequuntor personam.* This rate is based on the fact that such property does not admit of any actual location and that such property receives the protection and benefits of the law where they are located.

Exceptions:
1. When it is inconsistent with the express provisions of the statute.
2. When the property has acquired a business situs in another jurisdiction.

Mobilia Sequnntor Personam

- This latin maxim literally means that 'the property follows the person." Thus, the place where the owner is found is the situs of taxation under the rule that movables follow the person. This is generally where the owner resides.
- In taxation, this principle is applied to intangible personal property the situs of which is fixed by the domicile of the owner. The reason is that this type of property rarely admits of actual location.

Wells Fargo vs. CIR, 70 P 325 - This case involves the collection of inheritance taxes on shares of stock issued by the Benguet Consolidated Mining Corporation and owned by Lillian Eye. The shares were already subjected to inheritance taxes in California and are now being taxed by Philippine authorities.

Originally, the settled law in the United States is that intangibles have only one situs for the purpose of inheritance tax – the domicile of the decedent at the time of his death. But this rule has, of late, been relaxed. The maxim *mobilia sequuntur personam,* upon which this rule rests, has been decried as a mere fiction of law having its origin in considerations of general convenience and public policy and cannot be applied to limit or control the right of the State to tax property within its jurisdiction. It must yield to establish fact of legal ownership, actual presence and control elsewhere, and cannot be applied if to do so would result in inescapable and patent injustice.

The relaxation of the original rule rests on either of two fundamental considerations:
1. Upon the recognition of the inherent power of each government to tax persons, properties and rights within its jurisdiction and enjoying the protection of its laws; or
2. Upon the principle that as to intangibles, a single location in space is hardly possible, considering the multiple, distinct relationships which may be entered into with respect thereto.

The actual situs of the shares of stock is in the Philippines, the corporation being domiciled therein. And besides, the certificates of stock have remained in this country up to the time when the deceased died in California, and they were in the possession of the secretary of the Benguet Corporation. The secretary had the right to vote, collect dividends, among others. For all practical purposes, the secretary had legal title to the certificates of stock held in trust for Eye. Eye extended in the Philippines her activities re: her intangible personal property so as to avail herself of the protection and benefits of the Philippines laws.

CIR v. De Lara, 102 Phil 813 - The Supreme Court did not subject to estate and inheritance taxes the shares of stock issued by Philippine corporations which were left by a non-resident alien after his death. Considering that he is a resident of a foreign country, his estate is entitled to exemption from inheritance tax on the intangible personal property found in the Philippines. This exemption is granted to non-residents to reduce the burdens of multiple taxation, which otherwise would subject a decedent's intangible personal property to the inheritance tax both in his place of residence and domicile and the place where those are found.

This is, therefore, an exception to the decision of the Supreme Court in ***Wells Fargo v. CIR.*** This has since been incorporated in Sec. 104 of the NIRC.

Congress passed a law taxing the income outside of the Philippines of a non-resident alien engaged in business in the Philippines. Is the law valid? No, the law is invalid. Income tax is a tax on a right which can be levied only if the tax payer is a citizen, resident or the income was a result of the taxpayer's exercise of his right in the Philippines. In this case the income was not derived from the exercise of the taxpayer's right in the Philippines and neither is the taxpayer citizen or resident of the Philippines.

Congress passed a law imposing estate tax on properties located abroad of a Filipino decedent. Is the law valid? Yes, since estate tax is a tax on a right, hence can be levied from citizens or residence of the Philippines. In this case the decedent is a Filipino citizen; hence the exercise of the right to transfer the property in the name of another acquires tax situs in the Philippines.

THEORIES ON SITUS OF INCOME TAXATION

1. **Domicilliary theory**
   - The location where the income earner resides is the situs of taxation. This is where he is given protection, hence, he must support it.

2. **Nationality theory**
   - The country of citizenship is the situs of taxation. This is so because a citizen is given protection by his country no matter where he is found or no matter where he earns his income.

3. **Source law**
   - The country which is the source of the income or where the activity that produced the income is the situs of taxation.

Multiplicity of situs - Multiplicity of situs, or the taxation of the same income or intangible subjects in several taxing jurisdictions, arises from various factors:

1. The variance in the concept of domicile for tax purposes;
2. Multiple distinct relationships that may arise with respect to intangible personal property; or
3. He use to which the property may have been devoted all of which may receive the protection of the laws of jurisdictions other than the domicile of the owner thereto.

The remedy to avoid or reduce the consequent burden in case of multiplicity of situs is either to:

a) Provide exemptions or allowance of deduction or tax credit for foreign taxes; or
b) Enter into tax treaties with other States.

DOUBLE TAXATION

Double taxation in the strict sense and double taxation in the broad sense - In its strict sense, referred to as direct duplicate taxation, double taxation means:

1. Taxing twice;
2. by the same taxing authority;
3. within the same jurisdiction or taxing district;
4. for the same purpose;
5. in the same year or taxing period;
6. Some of the property in the territory.

In its broad sense, referred to as indirect double taxation, double taxation is taxation other than direct duplicate taxation. It extends to all cases in which there is a burden of two or more impositions.

CONSTITUTIONALITY OF DOUBLE TAXATION

- Unlike in the United States Constitution, our Constitution does not prohibit double taxation.

- However, while it is not forbidden, it is something not favored. Such taxation should, whenever possible, be avoided and prevented.

- In addition, where there is direct double taxation, there may be a violation of the constitutional precepts of equal protection and uniformity in taxation.

- The argument against double taxation may not be invoked where one tax is imposed by the State and the other is imposed by the city, it being widely recognized that there is nothing inherently obnoxious in the requirement that license fees or taxes be exacted with respect to the same occupation, calling, or activity by both the State and a political subdivision thereof. And where the statute or ordinance in question, there is no infringement of the rule on equality, **[*City of Baguio v. De Leon, 25 SCRA 938*].**

Villanueva v. City of Iloilo, 265 SCRA 538 - An ordinance imposing a municipal tax on tenement houses was challenged because the owners already pay real estate taxes and also income taxes under the NIRC. The Supreme Court held that there was no double taxation. The same tax may be imposed by the National Government as well as the local government. There is nothing inherently obnoxious in the exaction of license fees or taxes with respect to the same occupation, calling, or activity by both the State and a political subdivision thereof. Further, a license tax may be levied upon a business or occupation although the land used in connection therewith is subject to property tax.

In order to constitute double taxation in the objectionable or prohibited sense:

1. The same property must be taxed twice, when it should be taxed once.
2. Both taxes must be imposed on the same property or subject matter.
3. It should be for the same purpose.
4. By the same State, government, or taxing authority.
5. Within the same jurisdiction or taxing district.
6. During the same taxing period.
7. Of the same kind or character of tax.

At any rate, there is no unconstitutional prohibition against double taxation in the Philippines. It is something not favored but is permissible, provided that some other constitutional requirement is not thereby violated.

International juridical double taxation- Tax conventions such as the RP-US tax treaty are drafted with a view towards the elimination of international juridical double taxation, which is defined as the imposition of comparable taxes in two or more states on the same taxpayer in respect to the same subject matter and for identical periods.

Methods of eliminating double taxation - To eliminate double taxation, a tax treaty resorts to several methods. First, it sets out the respective rights to tax of the state of source or situs and of the state of residence with regard to certain classes of income or capital. In some cases, an exclusive right to tax is conferred on one of the contracting states; however, for other items of income or capital, both states are given the right to tax, although the amount of tax that may be imposed by the state of source is limited.

The second method for the elimination of double taxation applies whenever the state of source is given a full or limited right to tax together with the state of residence. In this case, the treaties make it incumbent upon the state of residence to allow relief on order to avoid double taxation.

There are two methods of relief

1. In the exemption method, the income or capital which is taxable at the state of source or situs is exempted at the state of residence, although in some instances it may be taken into account in determining the rate of tax applicable to the taxpayer's remaining income or capital.

2. In the credit method, although the income or capital which is taxed in the state of source is still taxable in the state of residence, the tax paid in the former is credited against the tax levied in the latter.

The basic difference between the two methods is that in the exemption method, the focus is on the income or capital, whereas the credit method focuses upon the tax.

SITUS OF INCOME TAXATION IN THE PHILIPPINES

1. **Interest**- residence of the debtor.

   If the obligor/ debtor is a resident of the Philippines, the interest income is treated as income from within the Philippines. It does not matter whether the loan agreement is signed in the Philippines or abroad or the loan proceeds will be used is a project inside or outside the country.

2. **Dividends-** residence of the corporation paying dividends.
   Dividends received from a **domestic corporation or from a foreign corporation** are treated as income from sources within the Philippines unless than 50% of the income of such foreign corporation for the 3 year period ending with the close of its taxable year preceding the declaration of dividends [or for such part of such period as the has been in existence] was derived from sources within the Philippines as determined under the provisions of this section; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period derived from sources within the Philippines bears to its gross income from all sources.

3. **Services**- place where the services were rendered.

4. **Sale of real property**- location of the property.

5. **Rentals and royalties**- where the property is being used.

6. **Sale of personal property**- place of transaction where ownership was transferred.

INCOME TAXATION

Reminder: If the question is **"how is it taxed?"** the answer will be either of the following-

1. Exempt
2. Subject to final tax- no need to include in the gross income
3. The income forms part of the gross income, thus it may be subject to schedular rate for individual taxpayers or subject to corporate income tax for corporate taxpayers.

Meaning of Income Taxation - Income tax has been defined as a tax on all yearly profits arising from property, profession, trade or business, or as a tax on person's income, emoluments, profits and the like.

Purposes of Income Taxation

1. To provide large amount of revenues.
2. To offset regressive sales and consumption taxes.
3. Together with estate tax, to mitigate the evils arising from the inequalities in the distribution of income and wealth, which are considered deterrents to social progress, by imposing a progressive scheme of taxation.

Requisites for the Imposition of Income Tax

1. There must be gain or profit;
2. The gain or profit is realized or received, actually or constructively;
3. It is not exempted by law or treaty from income tax.

Features of Income Tax Law

1. Income tax is a direct tax because the tax burden is borne by the income recipient upon whom the tax is

imposed. It is a tax demanded from the very person who, it is intended or desired, should pay it.

2. Income tax is a progressive tax, since the tax base increases as the tax rate increases. It is founded on the ability to pay principle and is consistent with the Constitutional provision that Congress shall evolve a progressive system of taxation.

3. The Philippines has adopted the most comprehensive system of imposing income tax by adopting the **citizenship principle,** the **residence principle,** and the **source principle**. Any one of the three principles is enough to justify the imposition of income tax on the income of a resident citizen and a domestic corporation that are tax on worldwide income. Other types of taxpayers are taxed only on their income from sources within the Philippines beginning January 1, 1998, following the territoriality principle.

4. The Philippines follows the semi-schedular or semi-global system of income taxation, although certain passive investment incomes and capital gains from sale of capital assets, namely: (a) shares of stock of domestic corporations; and (b) real property are subject to final taxes at preferential tax rates.
5. The Philippine income tax law is a law of American origin. Thus, the authoritative decision of the American official charged with enforcing the U.S. Internal Revenue Code has peculiar force and persuasive effect for the Philippines. Great weight should be given to the construction placed upon a revenue law, whose meaning is doubtful, by the department charged with its execution.

Criteria in Imposing Philippine Income Taxes

1. **Citizenship principle-** A citizen of the Philippines is subject to Philippine income tax (a) on his worldwide income from within and without the Philippines, if he resides in the Philippines, or (b) only on his income from sources within the Philippines, if he qualifies as a non-resident citizen; hence the income of a non-resident citizen from sources outside the Philippines shall be exempt from Philippine income tax.

2. **Residence principle-** a resident alien is liable to pay Philippine income tax only on his income from sources within the Philippines and is exempt from tax on income from sources outside the Philippines.

3. **Source principle-** an alien is subject to Philippine income tax because he derives income from sources within the Philippines. Thus a non-resident alien is liable to pay Philippine income tax on his income from sources within the Philippines, such as dividend, interest, rent or royalty, despite the fact that he has not set foot in the Philippines.

General Principles in Income Taxation in the Philippines

1. A citizen of the Philippines residing therein is taxable on all income derived from sources within and without the Philippines.
2. A non-resident citizen is taxable only on income derived from sources within the Philippines.
3. An individual citizen of the Philippines, who is working and deriving income from abroad as an overseas contract worker, is taxable only on income derived from sources within the Philippines. Provided that a seaman who is citizen of the Philippines and who receives compensation for services rendered abroad as member of the complement of a vessel engaged exclusively in international trade shall be treated as an overseas contract worker.
4. An alien individual, whether or not a resident of the Philippines, is taxable only on income from sources within the Philippines.
5. A domestic corporation is taxable on all income derived from sources within and without the Philippines.
6. A foreign corporation, whether engaged or not engaged in trade or business in the Philippines, is taxable only on income derived from sources within the Philippines.

Meaning of Income - Any flow of wealth other than mere return of capital.

Income refers to gains derived from capital, labor, or both labor and capital which includes gains derived from the sale or exchange of capital assets.

Income in tax laws is an amount of money coming to a person within a specified time whether as payment for services, interest or profit from investment. It means cash or its equivalent. It is gain derived and severed from capital, from labor or from both.

Income maybe defined as an amount of money coming to a person or corporation within a specified time, whether as payment for services, interest, or profit from investment ***(Conwi vs. CTA, 213 S 83)***.

Income means cash received or its equivalent. It is the amount of money coming to a person within a specified time. It is distinct from capital for, while the latter is a fund, income is a flow. As used in our laws, income is flow of wealth. The source of income is the property, activity or service that produces the income. For the source of income to be considered as coming from the Philippines, it is sufficient that income is derived from activity within the

Philippines. In BOAC's case, the sale of tickets in the Philippines is the activity that produces the income *(CIR vs. BOAC, 149 S 395)*.

Congress passed a law imposing income tax on gross receipts of businesses. Is the law valid? No, the law is invalid. The tax is a tax on capital, since the tax base is on the gross receipts [comprises of capital and income] of business establishments and not on the income. Ergo, it violates the principle that taxes should not be confiscatory, whimsical and oppressive so as not to violate the constitutional mandate that no person shall be deprive of life, liberty and property without due process of law.

CAPITAL CONTRA INCOME - Capital is the resources, while income is the gain from utilizing such resources.

The essential difference between capital and income is that capital is a fund or property existing at one distinct point in time; income is a flow of services rendered by that capital in relation to such fund through a period of time. Capital is wealth; capital is the service of wealth ***[Madrigal vs. Rafferty, 38 P 414].***

TESTS OF THE EXISTENCE OF AN INCOME

The question is when can one say that there is an income- **apply these tests in determining the existence of Income.** These tests are followed in the Philippines for purposes of determining whether income is received by the taxpayer or not during the taxable year.

1. **Severance test/ Realization test -** A capital or investment is not subject to tax, the gain or profit derived from the exchange or transaction of said capital by the taxpayer for his separate use, benefit and disposal is income subject to tax.

   The income must be severed from capital before a person can say that he has an income.

   How can one determine if there was a gain? Through these tests-

   a. **Actual realization of a gain**- taxpayer gains custody of the income.

   b. **Constructive realization of a gain-** when? Taxpayer has **control** over the income. He might not have the physical custody but he has control over the income.

   Ex: Income from bank deposits- although the taxpayer has no physical custody of the interest, he has control over the same since he can withdraw the said amount at any time during banking hours- hindi naman pwedeng basta bawiin ng bangko un kasi that is your price in investing your money in their bank! However the tax is already deducted in the interest.

Income constructively received

- Contemplates a situation where the income is credited to the account set apart for a taxpayer which may be drawn by him at any time subject to tax for the year which so credited or set apart, although not actually reduced to his possession.

- To constitute as constructive receipt, the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment of condition upon which payment is to be made.

- Thus, Limpan Investment Co. was deemed to have constructively received rental payments in 1957, when they were deposited in court due to its refusal to receive them ***[Limpan vs. CIR, 17 S 703].***

Examples of Constructive Receipt

1. Interest coupons which have matured and are payable, but have not been cashed.
2. Defaulted coupons are income for the year in which paid.
3. Partner's distributive share in the profits of a general partnership is regarded as received by the partner, although not yet distributed.

   c. **Presumptive Gain**- the law presumes a gain. This is only applicable on exceptional situations, when human experience would dictate that there is a presumptive gain sustained by the taxpayer.

   Ex: capital gains tax at the rate of 6% of the selling price or fair market value whichever is higher. In this case the law presumes that there is already a gain.

Application of Presumptive Receipt in Determining the Existence of a Gain

GENERAL PROFESSIONAL PARTNERSHIP [GPP]

GPP is not considered as a taxpayer. The taxpayers are the partners.

For purposes of determining the taxable income, apply the principle of constructive receipt since the partners have the control on how much income to be distributed and they themselves will received it.

The taxable income then is the whole of the partner's distributive share even if it is not fully given to him, but remains in the account of the partnership.

Section 26- Tax Liability of Members of General Professional Partnerships

A general professional partnership as such ***shall not be subject to the income tax*** imposed under this chapter. Persons engaging in business as partners in a general professional partnership shall be liable for income tax only in their separate and individual capacities.

For purposes of computing the distributive shares of the partners, the net income of the partnership shall be computed in the same manner as a corporation.

Each partner shall report as gross income his distributive share, actually or constructively received, in the net income of the partnership.

BUSINESS PARTNERSHIP

Although an ordinary business partnership is considered as a corporation and is thus subject to tax as such, the distributive shares of the partners is presumptively received by the partners, thus it is subject to a final tax of 10%.

Partners are considered stockholders, therefore gains distributed to them by the partnership are considered as dividends, subject to final tax of 10%.

The share of the partners is not included in the gross income since it is subject to a final tax.

Why the rule on presumptive receipt? Because the partners has the control on the profits of the partnership. It is the partners that will divide the amount of profit to be distributed and they themselves will receive it.

Section 73 [d] - "the taxable income declared by a partnership for a taxable year which is subject to tax under Section 27(A) of this Code, after deducting the corporate taxed imposed therein**, shall be deemed to have been actually or constructively received by the partners in the same taxable year and shall be taxed to them in their individual capacity, whether actually distributed or not.**"

Illustration:
A, B, C are partners. Their partnership gained 6M. They decided that they will only distribute 1M to each partner and put the 3M to the partnership's mutual fund. Will the partners be taxed based on the income that they actually received from the partnership?

No, as to the existence of taxable income of the partners, presumptive receipt of income applies [per the tax code see Section 73 (D) supra]. Thus the partners will be taxed at 2M even though they only received 1M each.

CORPORATION

Stock Dividends- cannot be considered received, either actual or presumptive receipt, by the stockholders, hence it must not be included in the taxable income of the Stockholders for that year. The stockholders have no control on the declaration of dividends so as to treat it as constructively received by them.

Cash Dividends- it is actually received by the stockholders, hence taxable on the year it was issued.

Rationale: Stock dividends issued by the corporation are **considered unrealized gain** and cannot be subjected to income tax until that gain has been realized. **Before realization, stock dividends are nothing but a representation of an interest in the corporate properties**. As capital, it is not yet subject to income tax. Capital is wealth or fund whereas income is profit or gain or the flow of wealth. The determining factor for the imposition of income tax is whether any gain or profit was derived from a transaction ***[CIR vs. CA, 301 S 152].***

Stock dividends are not an income. **It merely evidences the interest of the stockholder in the increased capital of the corporation**. An income may be defined as the amount of money coming to a person or corporation within a specified time, whether as payment for services, interest, or profit for investment. A mere advance in the value of property of a person or corporation in no sense constitutes the income specified in the revenue law. Such advance constitutes and can be treated as merely an increase of capital. **An income means cash received or its equivalent. It does not mean choses in action or unrealized increments in the value of property *[Fisher vs. Trinidad, 42 P 973].***

2. **Substantial alteration of interest test -** Income is earned when there is a substantial alteration of the interest of a taxpayer, i.e. increase in proportionate share of stockholder in a corporation.

   Income to be subject of taxation must be fully and completely realized. Where there is no separation of gain or profit, or separation of increase in value from capital, there is no income subject to tax.

Thus stock dividends are not income subject to tax on the part of the shareholder for he had the same proportionate interest in the assets of the corporation as he had before, and the stockholder was no richer and the corporation no poorer after the declaration of the dividend.

However, the pre-existing proportionate interest of the stockholder is substantially altered, the income is considered derived to the extent of the benefit received.

Moreover, if as a result of an exchange of stocks, the person received something of value which are essentially and fundamentally different from what he had before exchange, income is realized within the meaning of the revenue law.

3. **Flow of wealth test-** The essential difference between capital and income is that capital is a fund whereas income is the flow of wealth coming from such fund, capital is the tree, income is the fruit. Income is the flow of wealth other than as a mere return of capital. Hence, any proceeds from the use of capital, beyond the amount of the capital are considered as income.

4. **Tax Benefit Rule and Economic Benefit Test -** Any economic benefit to the employee that increases his networth, whatever may have been the mode by which it is effected, is taxable.

   Thus, in **stock options**, the difference between the fair market value of the shares at the time the option is exercised and the option price constitutes additional compensation income to the employee at the time of exercise, not upon the grant or vesting of the right.

5. **Claim of Right Doctrine -** If there is a receipt of a taxpayer and a third person has a claim of right over that receipt then it is not an income on the part of the taxpayer and does not form part of his taxable income, since he is obligated to return the same.

6. **Income whatever source -** All income not expressly excluded or exempted from the class of taxable ***income irrespective of the voluntary or involuntary action of the taxpayer*** in producing the income, and regardless of the source of income is taxable.

   Taxable regardless of the nature of the source, either it be from kidnapping, drug trafficking, or other illegal activities.

   Reason: if we tax only legal income, then as if the state is giving premiums or reward to illegal income, when all the more that the government should tax it.

BAR 1995- Taxable Income: Illegal Income - Mr. Lajojo is a big-time swindler. In one year he was able to earn P1 Million from his swindling activities. When the Commissioner of Internal Revenue discovered his income from swindling, the Commissioner assessed him a deficiency income tax for such income. The lawyer of Mr. Lajojo protested the assessment on the following grounds: 1) The income tax applies only to legal income, not to illegal income; 2) Mr. Lajojo's receipts from his swindling did not constitute income because he was under obligation to return the amount he had swindled, hence, his receipt from swindling was similar to a loan, which is not income, because for every peso borrowed he has a corresponding liability to pay one peso; and 3) If he has to pay the deficiency income tax assessment, there will be hardly anything left to return to the victims of the swindling. How will you rule on each of the three grounds for the protest? Explain.

SUGGESTED ANSWERS:

1) The contention that the income tax applies to legal income and not to illegal income is not correct. Section 28(a) of the Tax Code includes within the purview of gross income all Income from whatever source derived. Hence, the illegality of the income will not preclude the imposition of the income tax thereon.

2) The contention that the receipts from his swindling did not constitute income because of his obligation to return the amount swindled is likewise not correct. When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, he has received taxable income, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged to restore its equivalent **(James vs. U.S., 366 U.S. 213, 1961).** To treat the embezzled funds not as taxable income would perpetuate injustice by relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through embezzlement, while honest people pay their taxes on every conceivable type of income. *(James vs. U.S.)*

3) The deficiency income tax assessment is a direct tax imposed on the owner which is an excise on the privilege to earn an income. It will not necessarily be paid out of the same incomes that were subjected to the tax. Mr. Lajojo's liability to pay the tax is based on his having realized a taxable income from his swindling activities and will not affect his obligation to make restitution. Payment of the tax is a civil obligation imposed by law while restitution is a civil liability arising from a crime.

TAXABLE INCOME - The term taxable income means the pertinent item of gross income specified in the NIRC, less deductions and/or personal and additional exemptions, if any, authorized by such types of income by the NIRC or other special laws.

Taxable income however does not include items received which do not add to the taxpayer's net worth or does not redound to his benefit, such as amounts merely deposited or entrusted to him.

Requisites for the Taxability of an Income

1. There must be existence of a gain or profit;
2. The gain must be realized or received whether the receipt is actual, constructive, presumptive.
3. The gain must not be excluded by law or treaty from taxation.

Guide Questions in Determining Taxable Income

1. Is there gain or income?
2. Is the gain or income taxable? Is it excluded or exempt?
3. What type of income is it: income includible in the gross income, passive income, capital gains, income derived from other sources?
4. To what class does the taxpayer belong to? Individual or corporate. Citizen or not, or domestic or foreign, resident or not, engaged in trade or business or not?

Are the following considered as taxable income?

1. Found treasure- Yes, income from whatever source
2. Award of punitive damages- Yes
3. Award of damages for breach of promise or alienation of affection- Yes
4. Worthless debts subsequently collected- Yes
5. Tax refund- Generally NO, but, YES if the tax was previously allowed as a deduction and subsequently refunded or credited, as benefit accrued to the taxpayer.
6. Non-cash benefits- Yes
7. Income from illegal sources- Yes
8. Psychological benefits of work- No
9. Give away prizes- Yes
10. Scholarships/ fellowships- Yes
11. Stock dividends- No

BAR 2005- **Taxable or Non-Taxable; Income and Gains** - Explain briefly whether the following items are taxable or non-taxable: (5%)

a) Income from JUETENG;
Suggested answer: Taxable. Gross income includes "all income derived from whatever source" *(Sec. 32[A], NIRC),* which was interpreted as all income not expressly excluded or exempted from the class of taxable income, irrespective of the voluntary or involuntary action of the taxpayer in producing the income. Thus, the income may proceed from a legal or illegal source such as from jueteng. Unlawful gains, gambling winnings, etc. are subject to income tax. The tax code stands as an indifferent neutral party on the matter of where the income comes from. *[Commissioner of Internal Revenue v. Manning, G.R. No. L-28398, August 6, 1975]*

b) Gain arising from EXPROPRIATION OF PROPERTY;
Suggested answer: Taxable. Sale exchange or other disposition of property to the government of real property is taxable. It includes taking by the government through condemnation proceedings. *[Gonzales v. Court of Tax Appeals, G.R. No. L-14532, May 26, 1965]*

c) TAXES paid and subsequently refunded;
Suggested answer: Taxable only if the taxes were paid and claimed as deduction and which are subsequently refunded or credited. It shall be included as part of gross income in the year of the receipt to the extent of the income tax benefit of said deduction. *(Sec. 34[C][1], NIRC)* Not taxable if the taxes refunded were not originally claimed as deductions.

d) Recovery of BAD DEBTS previously charged off;
Suggested answer: Taxable under the TAX BENEFIT RULE. Recovery of bad debts previously allowed as deduction in the preceding years shall be included as part of the gross income in the year of recovery to the extent of the income tax benefit of said deduction. *(Sec. 34[E][1], NIRC)* This is sometimes referred as the RECAPTURE RULES.

e) Gain on the sale of a car used for personal purposes.
Suggested answer: Taxable. Since the car is used for personal purposes, it is considered as a capital asset hence the gain is considered income. *(Sec. 32[A][3] and Sec. 39[A][1], NIRC)*

BAR 1994- Condominium Corp.; Sale of Common Areas - X-land Condominium Corporation was organized by the owners of units in X-land Building in accordance with the Master Deed with Declaration of Restrictions. The X-land Building Corporation, the developer of the building, conveyed the common areas in favor of the X-land Condominium Corporation. Is the conveyance subject to any tax?

SUGGESTED ANSWER: The conveyance is not subject to any tax. The same is without consideration, and not in connection with a sale made to X-land Condominium Corporation, and the purpose of the conveyance to the latter is for the management of the common areas for the common benefit of the unit owners.

The same is not subject to income tax since no income was realized as a result of the conveyance, which was made pursuant to the Condominium Act (R.A. No. 4626, and the purpose of which was merely to vest title to the common areas in favor of the Land Condominium Corporation.

There being no monetary consideration, neither is the conveyance subject to the creditable withholding tax imposed under Revenue Regulations 1-90, as amended. The second conveyance was actually no conveyance at all because when the units were sold to the various buyers, the common areas were already part and parcel of the sale of said units pursuant to the Condominium Act. However, the Deed of Conveyance is subject to documentary stamp tax.

TREATMENT OF SPECIAL ITEMS

Forgiveness of Indebtedness

The cancellation and forgiveness of indebtedness may, dependent upon the circumstances, amount to:

1. A payment of income
2. A gift; or
3. A capital transaction

If for example, an individual performs services for a creditor who, in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his service.

If however, a creditor merely desires to benefit a debtor and without any consideration thereof cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income.

If a corporation to which a stockholder is indebted forgives the debt, the transaction has the effect of payment of dividends.

Also the sale of an ordinary asset, sold with an insufficient consideration is subject to final tax [capital gains tax of 6%].

Recovery of amounts written off- Considered as income.

PHILIPPINE INCOME TAX SYSTEM

Types of Income Tax System

1. **Schedular System-** The scheduler system is one where the income tax treatment varies and is made to depend on the kind or category of taxable income of the taxpayer.

2. **Global system-** The global system is one where the tax treatment views indifferently the tax base and generally treats in common all categories of taxable income of the taxpayer.

Approach adopted in the Philippines: Partly scheduler and partly global. The scheduler approach is used on individuals, while the global approach is used in the taxation of corporations.

Criteria in Imposing Philippine Income Taxes

1. Place where income was earned
2. Residency
3. Citizenship

What is residence for tax purposes? The 1997 Tax Code does not define residence, but the regulations provide relevant guidelines on this matter. Thus, an alien actually present in the Philippines who is not mere transient or sojourner is a resident of the Philippines for income tax purposes. A mere floating intention indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he live in the Philippines and has no definite intention as to his stay, he is a resident. One who comes to the Philippines for a definite purpose, which in its nature maybe promptly accomplished, is a transient. But if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the Philippines, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose of which he came has been consummated or abandoned [Section 5, Rev. Ruling No 2]. A resident alien loses his residence status if he actually leaves the Philippines and abandons his residency thereof without any intention of returning.

What the law requires for an alien to be considered as a resident of the Philippines is merely physical or bodily presence in a given place for a period of time, not the intention to make it permanent place of abode [Garrison vs. CA].

CLASSES OF INCOME TAXPAYERS

Basis of classification of taxpayers

1. Corporations vs. individuals
2. Nationality
3. Residence

Classes of Income Tax Payers

1. **Individuals**
   - ***a.*** *Resident citizens*
   - ***b.*** *Non-resident citizens- section 22 (e)*
   - ***c.*** *Resident aliens*
   - ***d.*** *Non-resident aliens-*
     - **i.** Engaged in trade or business in the Philippines.
     - **ii.** Not engaged in trade or business in the Philippines.

     Note: a non-resident alien individual who shall come to the Philippines and stay therein for an aggregate period of more than one hundred eighty (180) **days during any calendar year** shall be deemed a non-resident doing business in the Philippines.

   - **e.** **Special category**
     - **ii.** Minimum wage earners- tax exempt pursuant to RA 9504
     - **iii.** Employees entitled to preferential tax rate- 15% of the compensation income.
     - **iv.** Estate and trusts- treated as individual taxpayers.

2. **Corporations**
   - **a.** Domestic corporations
   - **b.** Resident foreign corporations
   - **c.** Non-resident foreign corporations

Note: for tax purposes any aggregation of persons for creating a business for profit, they are considered as a corporation.

3. **Special**
   - **a.** Proprietary educational institutions and hospitals that are non-profit
   - **b.** Insurance companies
   - **c.** General Professional Partnerships
   - **d.** Estates and Trusts- estates and trust are treated as individual taxpayers.

SOME RULES ON TAXATION OF THE VARIOUS TAXPAYERS

Who are taxed on their global income?

1. Resident citizen
2. Domestic corporation

Who are taxed only in their income from sources within the Philippines?

1. Non-resident citizen
2. Overseas contract workers
3. Alien individual, whether a resident or not of the Philippines.
4. Foreign corporation, whether engaged in trade or business in the Philippines or not.

Who are taxed only in the net Income?

1. Resident and non-resident citizens
2. Resident alien and non-resident alien engage in business in the Philippines.
3. Domestic corporation
4. Resident foreign Corporation

Who are taxed based on gross income?

1. Non-resident alien not engaged in trade or business in the Philippines.
2. Non-resident foreign Corporation.

Who is a non-resident citizen?

- The term non-resident citizen means:
  1. A citizen of the Philippines who **established to the satisfaction of the Commissioner the fact of his physical presence abroad with a definite intention to reside therein**.
  2. A citizen of the Philippines **who leaves the Philippines during the taxable year to reside abroad**, either as an immigrant or for employment on a permanent basis.
  3. A citizen of the Philippines **who works and derives income from abroad and whose employment thereat requires him to be physically present abroad most of the time during the taxable year** (those who stayed abroad for more than 183 days [based on a treaty], by reason of their work. It is not necessary that within the more than 183 days they stayed in one country).
  4. A citizen who has been previously considered as a non-resident citizen and who arrives in the Philippines at any time during the taxable year to reside permanently in the Philippines shall likewise be treated as a non-resident citizen for the taxable year in which he arrives in the Philippines with respect to his income derived from sources abroad until the date of his arrival in the Philippines.

Note: in the foregoing enumerations, the taxpayer shall submit proof to the Commissioner to show intention of leaving the Philippines to reside permanently abroad or to return to and reside in the Philippines as the case maybe.

Why the rule? Remember that taxation is the rule, exemption is the exception. If a taxpayer wants to live abroad and he did not submit proof that he will be living therein, he will be taxed on his worldwide income [lugi ang taxpayer☺]. Whereas, if the non-resident taxpayer does not submit proof of his intention to reside in the Philippines he will be taxed only on income within the Philippines [lugi ang gobyerno].

ALIENS- alien individuals are classified into resident alien and non-resident alien. Non-resident aliens are further classified into engaged or not engaged in trade or business in the Philippines. The Philippines exercises limited taxation rights over income of aliens derive from the economic activities done within the Philippines.

Note that the classification of non-resident alien engage in business or not engaged in business is the passage of time, whether or not they really engaged in trade or business or not.

Basta, if a non-resident alien stayed in the Philippines for more than 180 days, he is considered as engaged in trade or business.

Nor-resident Alien Engaged in Trade or Business in the Philippines [NRAETB]

If the aggregate period of his stay in the Philippines is more than 180 days during any calendar year, he shall be deemed a non-resident alien doing business in the Philippines.

As such, an alien engaged in trade or business in the Philippines is taxed on his income from sources within the Philippines [after deducting personal and additional exemptions, if any] at the graduated income tax rates of 5% to 32% while his passive investment incomes shall generally be subject to 20% final tax.

Bar Question [1991] - Newtex International (Phils.), Inc. is an American firm duly authorized to engage in business in the Philippines as a branch office. In its activity of acting as a buying agent for foreign, buyers of shirts and dresses abroad and performing liaison work between its home office and the Filipino garment manufacturers and exporters, Newtex does not generate any income. To finance its office expenses here, its head office abroad regularly remits to it the needed amount. To oversee its operations and manage its office here, which had been in operation for 2 years, the head office assigned 3 foreign personnel.

Are the 3 foreign personnel subject to Philippine income tax?

Suggested Answer: The 3 foreign personnel are subject to tax on the income that they received for services rendered in the Philippines. Non-resident aliens are subject to tax on income from source within the Philippines. Income is deemed derived from sources within the country when it is earned for services rendered in the Philippines.

Bar Question [2000] - Mr Cortez is a non-resident alien based in Hong Kong. During the calendar year 1999, he came to the Philippines several times and stayed in the country for an aggregated period of more than 180 days. How will Mr Cortez be taxed on his income derived from sources within the Philippines and from abroad?

Suggested Answer: Mr Cortez, being a non-resident alien individual who has stayed for an aggregate period of more than 180 days during the calendar year 1999, shall for that taxable year be deemed to be a non-resident alien doing business in the Philippines.

Considering the above, Mr Cortez shall be subject to an income tax in the same manner as a resident citizen on taxable income received from all sources within the Philippines.

Thus, he is allowed to avail of the itemized deductions including the personal and additional exemptions, but subject to the rule on reciprocity on the personal exemptions.

Non-resident Alien Not Engaged in Trade or Business in the Philippines [NRNETB]
If the aggregate period of the non-resident alien's stay in the Philippines does not exceed 180 days during any calendar year, shall be deemed a non-resident alien not doing business in the Philippines.

As such his compensation income, business or professional income, capital gain, passive investment income, and other income from sources within the Philippines is taxed at the flat rate of 25%, but capital gains from sale or exchange of shares of stocks in a domestic corporation and from real property located in the Philippines shall be subject to capital gains tax or stock transaction tax, as the case maybe.

Employees Entitled to Preferential Tax Rates
Certain alien individuals who are employed in the Philippines are entitled to the 15% preferential income tax rate on their gross compensation income from sources within the Philippines. These employees entitled to the preferential tax rate are the alien individuals employed by:

- **a.** Regional or area headquarters and regional operating headquarters of **multinational companies** in the Philippines.
- **b.** **Offshore banking units** established in the Philippines.
- **c.** Foreign service-contractor or sub-contractor engaged in **petroleum operations** in the Philippines.

It does not matter whether the alien starts to work in the Philippines at the start or end of the year. The only qualification provided for in the law relates to the entity that employs him in the Philippines. Moreover, the aggregate period of stay in the Philippines of the alien employee of the regional or area headquarters and the foreign service contractor or subcontractor will not create a permanent establishment in the Philippines for its foreign head office, even if he exceeds the 180 day rule provided for in the 1997 tax code, or the 183 day threshold prescribed in the tax treaty.

Filipino Employees of Multinational Corporations
The same tax treatment shall apply to Filipinos employed and occupying the same position as those of aliens employed by the entities mentioned above, regardless of whether or not there is an alien executive occupying the same position. Filipino employees employed by Regional Headquarters or regional Operating headquarters governed by E.O. 226, as amended by RA 8756, may choose to be taxed either at the 15% preferential tax rate on their gross income or at the graduated tax rates.

The preferential tax treatment granted to alien employees of the above entities must necessarily be extended to their Filipino counterparts' inorder to put them at par with each other. Alien employees of representatives offices of multinational companies in the Philippines who were subject to the 15% preferential tax rates on their gross income, pursuant to RR no 2-98, were deleted from the list of alien employees entitled to the reduced tax rate beginning January 1, 2002

What are Corporations for purposes of taxation? A corporation, as used in income taxation, includes partnerships, no matter how created or organized, joint stock companies, joint accounts *[cuentas en participacion]* and associations or insurance companies.

It may be-

1. Domestic corporation- those organized and incorporated under the laws of the Philippines
2. Foreign Corporation
   - **a.** Resident foreign corporation- the term applies to a foreign corporation engaged in trade or business within the Philippines.
   - **b.** Non-resident foreign corporation- this term applies to a foreign corporation not engaged in trade or business in the Philippines.

However, it does not include-

1. General Professional Partnership
2. A joint venture or consortium formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal, and other energy operations pursuant to an operating or consortium

agreement under a service contract with the government.

General Professional Partnerships - GPP are partnerships formed by persons for the sole purpose of exercising their common profession, no part of the income of which is derived from engaging in any trade or business [*Sec. 22 (b), NIRC*].

Persons engaging in business as partners in a general professional partnership shall be liable for income tax only in their separate and individual capacities [*Sec. 26, NIRC*].

For purposes of computing the distributive shares of the partners, the net income of the partnership shall be computed in the same manner as a corporation [*Sec. 26, NIRC*].

Each partner shall report the gross income of his distributive share, actually or constructively received, in the net income of the partnership [*Sec. 26, NIRC*].

Income of a GPP is deemed constructively received by the partners [Sec. 73 (d), NIRC], thus taxable in the year that it was derived.

Ordinary Business Partnership - An ordinary business partnership is considered as a corporation and is thus subject to tax as such.

Partners are considered stockholders and, therefore distributed to them by the partnership are considered as dividends subject to 10% final tax.

Joint Ventures - A joint venture is created when two corporations, while registered and operating separately, were placed under a sole management which operated the business affairs of said companies as though they constituted a single entity thereby obtaining substantial economy and profits in the operation.

Elements of joint venture- to constitute a joint venture, certain factors are essential. Thus, each party to the venture must make a contribution, not necessarily of capital, but by way of services, skill, knowledge, material or money; profits must be shared among the parties; there must be a joint proprietary interest and right of mutual control over the subject matter of the enterprise; and usually, there is single business transaction.

Non-taxable Joint Ventures- The term joint venture or consortium that is not considered as a separate taxable entity, means an unincorporated entity formed by two or more persons [individuals, partnerships, corporations] for the purpose of undertaking construction project, or engaging in petroleum and other energy operations with operating contract with the government.

Since it is not considered as a separate taxable entity, the net income or loss of the joint venture or consortium is taken up and reported by the co-venturers or consortium members in accordance with their participation in the project as set forth in their agreement.

The two elements- (1) unincorporated entity [or an entity not registered with the SEC] and (2) for the purpose of undertaking construction or energy-related project- must be present in order that the joint venture or consortium may not be considered as a separate taxable entity.

Exempt joint venture may become taxable partnership- An exempt joint venture or consortium undertaking a construction of office tower project may subsequently become subject to income tax as a separate joint venture or consortium, where after the construction period, the joint venture partners engaged in the business of leasing the building floors or portions thereof separately owned by them.

The tax exemption of the joint venture granted under the law is valid only up to the completion of the construction project and does not extend to other subsequent sale or lease of the developed condominium floors or units to customers.

Foreign joint venture or consortium that does not sell goods nor perform services in the Philippines.- A joint venture or consortium formed among non-resident foreign corporations in connection with a local project in the Philippines is not subject to Philippine income tax, where said foreign joint venture or consortium does not sell goods nor perform any service in the Philippines. This rule is anchored on the fact that foreign corporation is taxable only on income from sources within the Philippines. Accordingly, no withholding tax is required to be deducted and withheld by the Philippine payor from income payments from foreign sources made to the foreign joint venture or consortium.

Transfer of land to joint venture is similar to capital contribution; hence not taxable. - Joint venture agreements for the construction and development of real property may or not may not be treated as a separate taxable unit, depending on whether or not a separate taxable entity is established by the joint venture partners. If the parties did not form nor register a separate entity and merely agreed to pool their resources to common fund, no separate taxable unit is created. In this case, each joint venture partner has to account for his respective share in the net revenue earned from the joint venture project separate from other joint venture partners. Hence, the partners may file separate income tax returns for its net revenue for the project less its respective proportionate share in the joint venture expenses. The contribution of land to the joint venture is not a taxable event that that will give rise to a capital tax on sale or transfer of land. Such transfer is similar to a capital contribution that does not give rise to income tax.

Distribution of developed lots/units which is the end product of the joint venture is merely an act partitioning commonly owned property- not taxable - The distribution of developed lots/units is merely an act of partitioning the commonly owned property. It is nothing more than an act of terminating the co-ownership by making each partner specific owner of the identifiable lot or unit. At this stage, no taxable sum has yet been realized by the joint venture partners. That act of allocation or assigning portions of the developed lots to each member of the joint venture cannot be treated as a taxable event. The same is true despite the fact that the shares allocated to or received by the partners may not necessarily correspond to the lot area originally contributed by them to the joint venture. Hence, the titling of the land back to the joint venture partners is not subject to income tax, expanded withholding tax, and VAT.

Sale of developed floor, unit, or lot which is the end product of the joint venture is subject to income tax. - Should the corporate landowner or developer sell any of the floors or portions of the floors allocated to them to third parties, the gain that may realized by them from such sale will be subject to the regular corporate income tax and to the expanded withholding tax. This rule applies even if the sale takes place before or during the construction period.

Taxable Joint Ventures - There are two instances when a joint venture becomes a taxable entity.

First, a domestic corporation jointly owned by individuals and by two or more existing domestic corporations and/or foreign corporations that is incorporated under the laws of the Philippines, or duly registered with or licensed by the SEC is taxable corporation, even if it is engaged in the business of construction or energy related activity.

Second, if the unincorporated joint venture or consortium or unregistered partnership is engaged in any other line of business than construction or energy-related activity with operating contract with the government, the same will also be treated as a taxable corporation. The income and expenses of the taxable joint venture must be reported by it during the taxable year.

Unregistered Partnership and Co-ownership - If the activities of co-owners are **limited to the preservation of the property and the collection of income therefrom,** in which case, each co-owner is taxed individually on his distributive share in the income of the co-ownership.

If the **co-owners invest the income in business for profit**, they constitute themselves into a partnership taxable as a corporation.

What is the test to determine whether co-ownership is a taxable unregistered partnership? Find out whether the heirs have made substantial improvements on the inherited property. If so, the implication is that they will engage in business for profit (Evangelista Doctrine). If that happens, the co-ownership will be taxed as an unregistered partnership.

What are taxable unregistered partnerships? The SC in ***Evengelista vs. CIR, 102 P 140*,** held that Section 24 covered unregistered partnerships and even associations or joint accounts which have no legal personalities apart from their individual members.

Insurance pool or clearing house, composed 41 non-life insurance corporations, for the purpose of allocating and distributing the risk***[Afisco Insurance Corporation vs. CA, 302 S 1].***

Joint emergency operations of two business companies.

Leasing of 24 properties by 3 sisters to various tenants under common management for 15 years.

Leasing by father and son of lot and building to tenants under administration by a building administrator.

Domestic Corporations- The term domestic, when applied to a corporation means created or organized in the Philippines or under it laws.

Foreign Corporation- means a corporation which is not domestic.

Resident foreign corporation- is a foreign corporation engaged in trade or business within the Philippines.

Non-resident foreign corporation- foreign corporation not engaged in trade or business within the Philippines.

"Doing Business" - The term doing business implies a continuity of commercial dealings and arrangements, and contemplates, to that extent, the performance of acts or works or the exercise of some of the functions normally incident to, and in progressive prosecution of commercial gain or for the purpose of business organization. In order that a foreign corporation may be regarded as doing business within a State, there must be continuity of conduct and intention to establish a continuous business, such as the appointment of a local agent, and not one of a temporary character.

Resident Foreign Corporation - A resident foreign corporation is a foreign corporation engaged in trade and business within the Philippines. Thus the adjective resident in the term resident foreign corporation is merely used to describe a corporation organized under the laws of a foreign country, which is engaged in trade or business in the Philippines.

Philippine Branch is merely an extension of the foreign head office - A good example of a resident foreign corporation is the Philippine branch of a foreign corporation duly licensed by the SEC. the Philippine corporation, branch is merely an extension of the foreign head office, i.e. non-resident foreign corporation; hence it does not have nor issue Philippines shares of stocks, unlike that of a domestic corporation. There is only one single foreign entity. The foreign head office and the Philippine branch are one and the same entity. However, for income purposes, only the income of the Philippine branch from sources within the Philippines is subject to income tax, and the income of the Philippine branch as well as that of the foreign head office from sources outside the Philippines are exempt from the Philippine income tax. Corollarily, the gross income from sources within the Philippines of the foreign head of office is subject to the final income tax that must be withheld and remitted to the BIR by the Philippine payor, unless such income of the foreign head of office is attributed and thus taxed to the Philippine branch.

Bar Question [1999] - HK CO. is a Hong Kong company, which has a duly licensed Philippine branch engaged in trading activities in the Philippines. HK Co also invested directly in 40% of the shares of stock of A Co., a Philippine corporation. These shares are booked in the head of office of HK Co. and are not reflected as assets of the Philippine branch. In 1998, A Co. declared dividends to its stockholders. Before remitting the dividends to HK Co., A Co. seeks your advice as to whether it will subject the remittance to withholding tax. No need to discuss withholding tax rates, if applicable. Focus your discussion on what is the issue.

Suggested Answer: I will advise A Co to withhold and remit the withholding tax on the dividends. While the general rule is that foreign corporation is the same juridical entity as its branch office in the Philippines, when, however, the corporation transacts business in the Philippines directly and independently of its branch, the taxpayer would be the foreign corporation itself and subject to the dividend tax similarly imposed on non-resident foreign corporation. The dividends earned by a resident foreign corporation, which is exempt from tax.

TYPES OF RESIDENT FOREIGN CORPORATIONS

Under the 1997 Tax Code, there are 2 general types of resident foreign corporations:

1. Those that do not derive any income from sources within the Philippines and thus exempt from income tax; and
2. Those that are engaged in trade or business in the Philippines and thus subject to income tax at:
   a. Preferential tax rate, or
   b. Normal corporate income tax rate or minimum corporate income tax rate, whichever is higher.

Under the first category are the regional or area headquarters established in the Philippines pursuant to the provisions of E.O. 226, as amended by RA 8756, representative offices, and regional warehouses of multinational corporations in the Philippines. They are exempt from income tax because they are not engage in trade or business in the Philippines. They do not derive income from sources within the Philippines and are merely cost centers. The regional or area headquarters is exempt from income tax only if the amounts receive by it do not include fees or compensation for services rendered. The operating companies give such amounts only as reimbursement of their shares in the allocated expenses of the regional or area headquarters. There should also be no excess of amount received from the operating companies for the cost of operating the regional or area headquarters as its costs will be shared among the operating companies and should not result in any income.

Under the second category are branches engaged in trade or business in the Philippines. These branches are entitled preferential tax rates.

FOR TAXABILITY OF ESTATES AND TRUSTS REFER TO PAGE 103

DETERMINATION OF GROSS INCOME AND THE RULES ON INCLUSION AND EXCLUSION FROM GROSS INCOME

THE CONCEPT OF GROSS INCOME: Gross income means all income derived from whatever source, including [but not limited to] the following items:

1. Compensation for services in whatever form, paid, including, but not limited to, fees, salaries, wages, commissions, and similar items. *SITUS* – place where services rendered.
2. Gross income derived from the conduct or trade or business or the exercise of a profession (Business income). *SITUS* – place where these business are undertaken
3. Gains derived from dealings in property;
4. Interests. *SITUS* – residence of the debtor
5. Rents. *SITUS* – place of property subject of the contract of lease
6. Royalties. *SITUS* – place where the intangible property is used
7. Dividend. *SITUS*
   a. Received from domestic corporation – This is income purely within.
   b. Received from foreign corporation – Consider the income of the foreign corp. in the Philippines during the last preceding 3 taxable years:

      Rules:
      1. The income is purely within if the income derived from the Phil. Source is more than 85%
      2. It is purely without if the proportion of its Philippine income to the total income is less than 60%
      3. There should be an allocation if it is more than 50% but not exceeding 85%
8. Annuities. *SITUS* – Place where the contract was made
9. Prizes and winnings
   - Prizes may be given on account of services rendered – in which case, the tax situs is the place where the services were rendered.
   - If these prizes are not given on account or services, the tax situs is the place where the same was given.
   - Tax situs of winnings is the place where the same was given.
10. Pensions. *SITUS* – Place where this may be given on account of services rendered.
11. Partner's distributive shares from the net income of the general professional partnership. *SITUS* – place where the exercise of profession is undertaken.

How to determine gross income? Remove capital and other income excluded by law.

SOURCE OF INCOME

The term ***"source of income"*** is not a place but the property, activity, or services that produces the income. ***[Commissioner v. BOAC]***.

Dissent of Justice Feliciano in Commissioner v. BOAC- The source of income relates not to the physical sourcing of a flow of money or the physical *situs* of payment but rather to the *"property, activity or service which produced the income."* Where a contract for rendition of services is involved, the applicable source rule may be simply stated as follows: The income is sourced in the place where the service contracted for is rendered.

Gross income from sources within the Philippines

The following items of gross income shall be treated as gross income from sources within the Philippines:

1. Interests from sources within the Philippines, and interests on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise.

2. Dividends received from a domestic corporation and from a foreign corporation, unless less than 50% of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends was derived from sources within the Philippines.

3. Compensations for labor of personal services performed in the Philippines.

4. Rentals and royalties from property located in the Philippines.

5. Gains, profits and income from the sale of real property located in the Philippines.

6. Gains, profits and income from the sale of personal property if sold within the Philippines. [Section 42(A), NIRC]

Interest income- The residence of the obligor who pays the interest, rather than the physical location of the securities, bonds or notes or the place of payment, is the determining factor of the source of interest income. [National Development Corporation v. Commissioner, 151 SCRA 472].

Gross income from sources without the Philippines- Just the exact opposite of the items of gross income from sources within the Philippines. [Section 42(B), NIRC]

Income from sources partly within and partly without the Philippines- Gains, profits and income from the sale of personal property ***produced by the taxpayer within and sold without the Philippines***, or produced by the taxpayer without and sold within the Philippines shall be treated as derived partly from sources within and partly from sources without the Philippines. [Section 42(E), NIRC]

Purchase or sale personal property - Gains, profits and income derived from the purchase of personal property within and its sale without the Philippines, or from the purchase of personal property without and its sale within and Philippines shall be treated as derived entirely from sources within the country in which sold. [Section 42(E), NICR]

Gain from sale or shares of stock of a domestic corporation within - Gain from the sale of shares of stock in a domestic corporation shall be treated as derived entirely from sources within the Philippines regardless of where the said shares are sold.

The transfer by a non-resident alien or a foreign corporation to anyone of any share of stock issued by a domestic corporation shall not be effected or made in its book unless:

1. The transferor has filed with the Commissioner a bond conditioned upon the future payment by him or any income tax that may be due on the gains derived from such transfer; or

2. The commissioner has certified that the taxes, if any, imposed and due on the gain realized from such sale or transfer have been paid. [Section 42(E), NICR]

TAX TREATMENT OF SOFTWARE PAYMENTS

Does your company have any plan of purchasing computer software? Are you in the process of paying for a software you recently acquired?

For tax purposes and from the point of view of the recipients of these payments, the next question would be: What tax or taxes would apply on these software payments?

The BIR recently issued several rulings clarifying that payment for the acquisition of computer softwares from non-residents which shall be deemed to be a transfer of a copyrighted article shall be considered as business profits, not royalties, and may therefore be exempt from income and withholding tax in the Philippines.

When can acquisition of a software be considered a transfer of a copyrighted article? It may be recalled that the BIR has already issued two Revenue Memorandum Circulars (RMCs) governing the taxation of these software payments. The first circular RMC 77-2003, treats software payments generally as royalties. Accordingly, payments in consideration for the use of, or the right to use, a copy or a copyrighted article relating to software made during the effectivity of this circular are are generally taxable as royalty.

The second circular, RMC 44-2005, covered payments made as of September 8, 2005 and onwards. This subsequent circular substantially amends RMC No. 77-2003 by classifying the various types of software payments as **(i) business income, (ii) royalties, (iii) rental income, or (iv) capital gains,** depending on the nature of the transaction for which such payments are made. The characterization of the payments would depend on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program.

Section 5 of RMC 44-2005 characterizes the various types of payments relating to computer software as follows:

1. **Transfer of copyright rights** – payments is classified as royalty;
2. **Transfer of copyrighted articles** – payments is classified as business income;
3. **After-sales service** – under a mixed contract, payment will be apportioned, i.e., payments representing the use of the software is classified as royalty; payments representing the provision of services is treated as income from services;
4. **Site License/Enterprise License/Network License Arrangements** – payment is classified as business income
5. **Supply of Information** – payments may be classified as royalties to the extent that they represent, consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted;
6. **Transfer of Ownership** – payment is classified as either business income or capital gains.

Note that payments for software are characterized as business income under the following circumstances:

1. The transfer of copyright rights and all substantial rights has been transferred
2. The transferee does not acquire any of the rights (or only acquires a de minimis grant of such rights) described in the circular that would classify the transfer of software as a transfer of copyright right
3. An arrangement where the transferee obtains the right to make multiple copies of the program for operation within its own business.

The above characterization is important since payments made to a non-resident entity which does not have a permanent establishment here in the Philippines shall be exempt from the 35% final withholding income tax if the payment shall be classified as business profits.

The rulings issued by the BIR clarified the acquisition of softwares that may be classified in the nature of transfer of copyrighted articles. The transactions involved the grant of a non-exclusive, non-transferable license or right to use the software in specified locations using specified computers or computer networks and only for the internal processing and computing needs of the grantee. The grantee is prohibited from sharing the use of the software for a fee or providing computer services to third parties using the software. The grantee is not allowed to sublicense, transfer or assign its rights. There is no transfer of ownership of the copyrights. Ownership remains with the licensor.

Under the 2003 RMC, payments for such arrangements are treated as royalties. In the rulings, the BIR confirmed that, following the classifications under RMC 44-2005, such arrangements can be classified solely as transfers of copyrighted articles and payments therefore shall be considered business profits which are exempt from Philippine income tax and withholding tax if the recipient did not have a permanent establishment in the Philippines.

Companies are therefore encouraged to review their existing software licensing agreements and to determine if the tax treatment thereof has changed based on the provisions of RMC 44-2005. Securing a confirmatory ruling from the BIR may be considered if these payments qualify for exemption.

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

General Rule: The taxable income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer.

Exception: Computations shall be made in accordance with such method as in the opinion of the Commissioner clearly reflects the income:

a. If no such method of accounting has been so employed; or
b. If the method employed does not clearly reflect the income. [Section 43, NIRC]

Taxable year- Taxable year means the calendar year or the fiscal year ending during such calendar year, upon the basis of which the net income is computed.

Accounting periods

1. Calendar year – January 1 to December 31
2. Fiscal year – an accounting period of twelve (12) months ending on the last day of any month other than December.

When calendar year used?

1. If the taxpayer chooses the calendar year
2. If the taxpayer has no annual accounting period
3. If the taxpayer does not keep books
4. If the taxpayer is an individual

When Commissioner is authorized to terminate taxable period

1. When a taxpayer retires from business subject to tax
2. When he intends to leave the Philippines
3. When he removes his property from the Philippines
4. When he hides or conceals his property
5. When he performs any act tending to obstruct the proceedings for the collection of the tax for the past or current quarter or year
6. When he renders the collection of the tax totally or partly ineffective.

Methods of accounting

1. **Cash Basis**
   - Income, profits and gains earned by taxpayer are not included in gross income until received.
   - Expenses are not deducted until paid within the taxable year.

2. **Accrual Method**
   - Income, gains and profits are included in the gross income when earned, whether received or not.
   - Expenses are allowed as deductions when incurred, although not yet paid.

3. **Mixed/Hybrid**
   - Combination of the cash and accrual method.

4. Any other method which clearly reflects the income

Tax accounting v. financial accounting- While taxable income is based on the method of accounting used by the taxpayer, it will always differ from accounting income. This is so because of a fundamental difference in the ends the two concepts serve. Accounting attempts to match cost against revenue. Tax law is aimed at collecting revenue. It is quick to treat an item as income, slow to recognize deductions as losses. Thus, tax law will not recognize deductions for contingent future losses except in very limited situations. Good accounting, on the other hand, requires their recognition. [Consolidated Mines v. CTA, 58 SCRA 618]

Long-term contracts- The term *"long term contract"* means building, installation or construction contracts covering a period in excess of one year. [Section 48, NIRC]

Treatment of income from long-term contracts

1. Tax should be computed on percentage of completion basis

   Note: Section 48 of the NIRC provides that *"Persons whose gross income is derive in whole or in part from such (long term) contracts shall report such income upon the basis of percentage of completion."*

2. The return should be accompanied by a return certificate of architects or engineers showing the percentage of completion during the taxable year of the entire work performed under the contract.

Sales of dealers in personal property- A person who regularly sells or otherwise disposes of personal property on the instalment plan may return as income there from in any taxable year that proportion of the instalment payments actually received in that year, which the gross profit realized or to be realized when payment is completed, bears to the total contract price. [Section 49, NIRC]

Treatment of sales of realty and casual sales of personality- These include:

1. Casual sale or other casual disposition of personal property (other than property included in the inventory at the close of the taxable year) for a price exceeding P1000; and
2. Sale or other disposition of real property.
   - Treated either on instalment basis or deferred sales basis.

   - Instalment basis – if the initial payments do not exceed 25% of the selling price.

   - Deferred sales basis – if the initial payments exceed 25% of the selling price [Section 49, NIRC and Section 175, Revenue Regulations 2]

Initial payments- These include the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

The term *"initial payments"* contemplates at least one other payment in addition to the initial payment. [Section 175, Revenue Regulations 2]

Termination of leasehold [BOT] - Lessor who acquires building or improvements made by the lessee after the termination of the lease has two options in reporting said income:

1. Lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements; or

2. Lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the termination of the lease and report as income for each of the lease an adequate part thereof. [Section 49, Revenue Regulations 2]

Allocation of income and deductions- In the case of two or more organizations, trades or businesses (whether or not incorporated and whether or not organized in the Philippines) owned or controlled, directly or indirectly, by the same interests, the Commissioner is authorized to distributed, apportion or allocation gross income or deductions between or among such organization, trade or business, if he determines that such distribution, apportionment or allocation is necessary in order to prevent evasion taxes or clearly to reflect the income of any such organization, trade or business. [Section 50, NIRC]

EXCLUSIONS FROM GROSS INCOME

Exclusion refers to income received or earned but is not taxable as income because it is exempted by law or by treaty. Such tax-free income is not to be included in the income tax return unless information regarding it is specifically called for.

They are the following:

1. Proceeds from life insurance
2. Amount received by insured as return of premium
3. Gifts, bequests and devises
4. Compensation for injuries or sickness
5. Income exempt under treaty
6. Retirement benefits, pensions, gratuities, etc.
7. Income derived by foreign government
8. Income derived by the Philippine Government or its political subdivisions
9. Prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement.

10. Prizes and awards in sports competitions sanctioned by the national sports associations
11. 13th month pay and other benefits not exceeding P30,000.00. Applies both to public and private employees.
12. GSIS, SSS, Medicare and other contributions
13. Gains from the sale of bonds, debentures or other certificate of indebtedness. 5 years or more. If maturity is less than 5 years, it is taxable.
14. Gains from redemption of shares in mutual fund. It must emanate from the mutual fund.

I. "PROCEEDS OF LIFE INSURANCE"

Reason for exemption: it is a form of indemnity; however, this principle is only applicable in tax law and not in commercial law.

Subject to tax if:

1. the insurer and insured *agreed* that the amount of the proceeds shall be withheld by the insurer with the obligation to pay interest in the same, *the interest is the one subject to tax*;
2. there is *transfer* of the insurance policy;

   ***Example:* -** A transferred to B his life insurance policy. The value of the policy is P1 M. B paid a consideration amounting to P300, 000. B continued paying the premiums after the transfer such that the premiums amounted to P200, 000. Upon the death of the insured, the P1 M may be received by the heirs.

   Q. Is the full amount of P1 M exempt?
   A. NO, only the consideration given and the total premiums paid may be excluded. That is, P1M less P500, 000.

Problem: A obtained a life insurance policy for B. B is the president of A's corporation. A Corp. has an insurable interest in the life of its officers, so premiums may be paid by the employer A. Upon the death of B, his designated beneficiaries will receive the proceeds.

a. Is the amount representing the proceeds of the life insurance policy taxable?
b. What about the premium paid by the employer A? Does this amount form part of the gross compensation income?
c. Does the amount representing the proceeds of life insurance policy form part of the estate of the decedent?

Answers:

a. Let us first make *two (2) assumptions*. Let us assume that:
   1. the beneficiary designated is the employer;
   2. The beneficiary designated is the heir of the family of the insured.

   The Tax Code however, makes no distinction. Regardless of the designated beneficiary is the employer or the heirs, or the family of the insured proceeds of life insurance policy should always be excluded.

b. *Premiums* of life insurance policy **paid by the employer may form part of compensation income; hence, *taxable if the beneficiary designated are the heirs or the family or the employees*.**

   It is *not taxable compensation income if the designated beneficiary is the employer* because that is just a mere return of capital.

c. *Proceeds of life insurance policy may be excluded from the gross estate of the decedent under the following cases:*
   1. if the beneficiary designated is a 3rd person and the designation is irrevocable;
   2. It is a proceed of a group insurance policy.

   However*, it is included in the gross estate of the decedent:*
   1. if the beneficiary designated in the estate, executor or administrator of the estate or the family of heirs of the decedent;
   2. if the beneficiary designated is a 3rd person and the designation is revocable [see Section 85 (e)]

   As far as Sec. 85 (e) is concerned, an employer may be considered a 3rd person.

TIP ON ESTATE PLANNING- if you are sure of your beneficiaries, make the insurance policy irrevocable, so that it is non-taxable for income tax.

BAR 2005- Exclusions & Inclusions; ITR; Proceeds of life insurance - State with reasons the tax treatment of the following in the preparation of annual income tax returns: Proceeds of life insurance received by a child as irrevocable beneficiary;
Suggested answer: Not to be reported in the annual income tax returns because the proceeds of the life insurance are excluded from gross income. Proceeds of Life insurance policies paid to the heirs or beneficiaries upon the death of the insured is an exclusion from gross income. *(Sec.32[B][l],NIRC)*

BAR 2003- Exclusions & Inclusions; Life Insurance Policy- On 30 June 2000, X took out a life insurance policy on his own life in the amount of P2, 000,000.00. He designated his wife, Y, as irrevocable beneficiary to P1,000,000.00 and his son, Z, to the balance of P1,000,000.00 but, in the latter designation, reserving his right to substitute him for another. On 01 September 2003, X died and his wife and son went to the insurer to collect the proceeds of X's life insurance policy. (8%)
(a) Are the proceeds of the insurance subject to income tax on the part of Y and Z for their respective shares?

Explain.
(b) Are the proceeds of the insurance to form part of the gross estate of X? Explain.

SUGGESTED ANSWERS:
(a) No. The law explicitly provides that proceeds of life insurance policies paid to the heirs or beneficiaries upon the death of the insured are excluded from gross income and is exempt from taxation. The proceeds of life insurance received upon the death of the insured constitute a compensation for the loss of life, hence a return of capital, which is beyond the scope of income taxation. *(Section 32(B)(1) 1997 Tax Code)*

(b) Only the proceeds of P1, 000,000.00 given to the son, Z, shall form part of the Gross Estate of X. Under the Tax Code, proceeds of life insurance shall form part of the gross estate of the decedent to the extent of the amount receivable by the beneficiary designated in the policy of the insurance except when it is expressly stipulated that the designation of the beneficiary is irrevocable. As stated in the problem, only the designation of Y is irrevocable while the insured/decedent reserved the right to substitute Z as beneficiary for another person. Accordingly, the proceeds received by Y shall be excluded while the proceeds received by Z shall be included in the gross estate of X. *(Sect/on 85(E), 1997 Tax Code)*

II. "AMOUNT RECEIVED BY INSURED AS RETURN OF PREMIUM"

Reason for Exclusion: *It represents a mere return of capital*.

The **sources of this return of premium: (L.E.A.)**

1. Life Insurance Policy
2. Endowment contracts
3. Annuity contracts

Whether the premiums are returned during or at the maturity of the term mentioned in the contract or upon surrender of thee contract.

Problem: A took out an endowment policy amounting to P1 M. He paid premiums amounting to P800,000. Upon the maturity of the policy, A received that P1M. How much is the taxable amount?

Answer:
That is P1, 000,000. 00 – value of endowment policy
LESS: P 800,000. – representing amount of premium

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P 200, 000. 00 – taxable amount

III. "GIFTS, BEQUESTS and DEVISES"

Reason for exemption: subject to other tax

Coverage: What are contemplated here are donations which are *purely gratuitous in character* in order that it may be excluded.

Reason for exclusion:

- *Gifts* are excluded because these are subject to *donor's tax*.
- *Bequests and devises* are excluded because these may be subject to *estate tax*.
- What about remuneratory donations? *Remuneratory donations are subject to income tax.*

EXCEPTIONS TO THE RULE:>>> the **income or fruit** of such money given by donation, bequests or devise, including the income of this gift, bequest or devise in cases of transfer of divided interest is subject to income tax.

BAR 1994- Exemptions: Gifts & Donations
In 1991, Imelda gave her parents a Christmas gift of P 100,000.00 and a donation of P50,000.00 to her parish church. She also donated a parcel of land for the construction of a building to the PUP Alumni Association, a non-stock, non-profit organization. Portions of the building shall be leased to generate income for the association. 1) Is the Christmas gift of P 100,000.00 to Imelda's parents subject to tax? 2) How about the donation to the parish church? 3) How about the donation to the P.U.P, Alumni Association?

SUGGESTED ANSWER:

1) The Christmas gift of P100,000.00 given by Imelda to her parents is taxable up to P50,000.00 because under the law *(Sec. 92 (a) of the Tax Code),* net gifts not exceeding P50,000.00 are exempt.

2) The donation of P50,000.00 to the parish church even assuming that it is exclusively for religious purposes is not tax-exempt because the exemption granted under Article VI, Sec. 28(3) of the Constitution applies only to real estate taxes *(Lladoc v. Commissioner, 14SCRA292).*

3) The donation to the P.U.P. Alumni Association does not also qualify for exemption both under the Constitution and the aforecited law because it is not an educational or research organization, corporation, institution, foundation or trust.

(3) ALTERNATIVE ANSWER: Donation to the P.U.P. Alumni Association is exempt from donor's tax if it is proven that the association is a nonstock, non-profit charitable association, paying no dividends, governed by trustees who receive no compensation, and devoting all its income to the accomplishment and promotion of the purposes enumerated in its articles of incorporation. Not more than 30% of the gift should be used for administration purposes by the donee.

IV. "COMPENSATION FOR INJURIES OR SICKNESS"

Reason for Exclusion: This is just an *indemnification for the injuries or damages suffered*. This is compensatory in nature.

The sources are:

1. The compensation may be *paid by virtue of a suit*;

2. It may be *paid by virtue of health insurance, accident insurance or Workmen's Compensation Act*

   All damages awarded are tax-exempt **except** damages of representing loss of profit*.* Thus as regards ***damages representing loss of anticipated profit,*** this is the one that is taxable.

   However award for **salaries earned while the taxpayer's confinement** and did not work is not taxable, since it is a compensation for injuries. [Domondon says that it is taxable since if the taxpayer worked then such is taxable, however, the question is 'did the taxpayer worked?'. Justice Vitug believes that it is taxable.

   If damages are in the nature of moral, exemplary, nominal, temperate, actual and liquidated damages, as a rule, these may not be subject to tax.

Example: If a person suffered injury as a result of a vehicular accident, and an action is filed in court, the Court awards the following:

Moral - P100, 000. 00
Exemplary - P100,000. 00
Actual - P 60,000. 00 (hospitalization expenses)
P 20,000. 00 (repair of car)
P 60,000. 00 (loss of income)

DAMAGES FOR BREACH OF CONTRACT

Question: Are damages awarded by the Court on account of breach of contract taxable?

Answer: I qualify my answer. With regards to damages awarded **on account of loss of earnings** of the contracting party, it is taxable. If the damages awarded were not in pursuant thereto, then it is not taxable.

V. "INCOME EXEMPT UNDER TREATY"

Reason for the Exclusion: *Treaty has obligatory force of contract*.

General rule: excluded
Exception: taxable if provided for in the treaty.

Requisites:

- **a.** Taxpayer must prove that he is covered by a treaty
- **b.** Specifically invoke that he is availing the treaty, thus he must check the box in the return availing the treaty.

Though a taxpayer is required acquire a confirmatory ruling from the CIR affirming that he is exempt under a treaty.

VI. RETIREMENT BENEFITS, PENSIONS, GRATUITIES, ETC.

Exclusions include:

1. **Retirement benefits** under RA No. 7641 or a reasonable private benefit plan

2. Amount received by an official or employee or by his heirs from the employer due to **separation from the service because of death, sickness or other physical disability or for any cause beyond the control of the official or employee.**

3. **Social security benefits, retirement gratuities, pensions and other similar benefits** received by residents or non-resident citizens or resident aliens **from foreign government agencies** and other institutions, private or public.

4. **Payment of benefits to a resident person under the United States Veterans Administration**. Recipient must be a resident veteran.

5. Benefits received from or enjoyed under the Social Security System.

6. Benefits received from the Government Service Insurance System, including retirement gratuity received by government officials and employees.

NON-TAXABILITY OF RETIREMENT BENEFITS UNDER A REASONABLE PRIVATE BENEFIT PLAN- retirement benefits is non-taxable if the following requisites are present-

1. It must be received under RA 7641 or in accordance with a reasonable private benefit plan maintained by the employer. Approved by the BIR. Private benefit plan established for the common benefit of all employees or officials.

2. Retiring employee or official has been in the service of the same employer for at least ten (10) years and is not less than fifty (50) years of age at the time of his retirement.

3. Benefits granted under the provision shall be availed of by an official or employee only once [for the first time]. **Except** if second employer is government entity or institutions

Reasonable private benefit plan- It means a pension, gratuity, stock bonus or profit sharing plan maintained by an employer for the benefit of some or all of his officials or employees, or both, for the purpose of distributing to such officials and employees the earnings and principal of the fund thus accumulated, and wherein it is provided in said plan that at no time shall any part of the corpus or income of the fund be used for, or be diverted to, any purpose other than for the exclusive benefit of the said officials and employees.

NON-TAXABILITY OF BENEFITS WITHOUT A REASONABLE PRIVATE BENEFIT PLAN

BAR 2000- Withholding Tax: Retirement Benefit- Under what conditions are retirement benefits received by officials and employees of private firms excluded from gross income and exempt from taxation? (3%)

Suggested answer: The conditions to be met in order that retirement benefits received by officials and employees of private firms are excluded from gross income and exempt from taxation are as follows:

Under Republic Act No. 4917 [those received under a reasonable private benefit plan]:

- **a.** the retiring official or employee must have been in service of the same employer for at least ten (10) years;
- **b.** that he is not less than fifty (50) years of age at the time of retirement; and
- **c.** That the benefit is availed of only once.

Under Republic Act No. 7641 [those received from employers without any retirement plan]:

- Those received under existing collective bargaining agreement and other agreements are exempt; and

- In the absence of retirement plan or agreement providing for retirement benefits the benefits are excluded from gross income and exempt from income tax if:
  - **a.** Retiring employee must have served at least five(5) years; and
  - **b.** That he is not less than sixty (60) years of age but not more than sixty five (65).

SEPARATION PAY

- The taxability of a separation pay depends on the cause of the separation of the employee.

If separation is voluntary- employee was dismissed due to just causes under the labor code- separation pay is taxable.

Separation pay and amounts received due to involuntary separation- Any amount received by an official or employee or by his heirs from the employer due to death, sickness or other physical disability or for any cause beyond the control of the said official of employee is excluded form gross income.

Cause beyond the control of the employee- The phrase "for any cause beyond the control of the said official or employee" connotes involuntariness on the part of the official or employee. The separation from the service of the official or employee must not be asked for or initiated by him. [Section 2.78.1, Revenue Regulation 2-98] The separation was not of his own making.

Resignation of an employee is a cause within his control, but not involuntary resignation.

Terminal leave pay- In case of compulsory retirement

- Commutation of leave credits or terminal leave pay are given not only at the same time but also for the same policy considerations governing retirement benefits. This, not being part of the gross salary or income but a retirement benefit, terminal pay is not subject to income tax. [Commissioner v. Court of Appeals, 203 SCRA 72]

- Terminal leave pay is exempt from income tax. [Zialicita case, 190 SCRA 851]

VII. INCOME DERIVED BY A FOREIGN GOVERNMENT

Income derived from investments in the Philippines in loans, stocks, bonds or other domestic securities, or from interest on deposits in banks in the Philippines by:

1. Foreign governments;
2. Financing institutions owned, controlled, or enjoying refinancing from foreign governments; and
3. International or regional financial institutions established foreign governments.

VIII. INCOME BY THE PHILIPPINE GOVERNMENT

1. Income derived from any public utility or from the exercise of any essential governmental function.
2. Accruing to the Government or to any political subdivision thereof.

   Income of GOCC's not excluded from income tax.

IX. "AMOUNT OF THE ACCUMULATED SICK LEAVE AND VACATION LEAVE CREDITS"

The monetized value of these benefits may be subject to tax if these will not form part of the terminal leave pay.

The monetized value of sick leave credit is always tax exempt, if it forms part of the terminal leave pay.

As regards UNUSED VACATION LEAVE CREDIT, this is exempt only if the number of days is 10 days or less in excess of 10 days, it is already subject to tax.

If the *unused sick leave benefit is monetized*, if the employer allow such practice, and the same is given at the end of each year, it is subject to *withholding tax* because in this case, it does not form part of the terminal leave pay.

Reason for exemption of terminal leave pay: The accumulated value of unused sick leave and vacation leave credits included in the terminal leave pay is exempt from income tax because it is one received on account of a cause beyond the control of the employee. This terminal leave pay is usually given under a compulsory retirement. Compulsory retirement is a cause beyond the control of the employee.

X. "PRIZES AND AWARDS IN RECOGNITION OF RELIGIOUS, CHARITABLE, SCIENTIFIC, EDUCATIONAL, ARTISTIC, LITERARY OR CIVIC ACHIEVEMENT"

1. Made primarily in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement.

2. The recipient was selected without any action on his part to enter the contest or proceeding [recipient must not have join the contest].
3. The recipient is **not required to render substantial future services** as a condition to receiving the prize or award.

XI. PRIZES AND AWARDS IN SPORTS COMPETITIONS

1. Prizes and awards must be granted to athletes in local and international sports competitions and tournaments.
2. Sports competition or tournament held either in the Philippines or abroad.
3. Sports competition or tournament must be sanctioned by their national sports associations. If not accredited – 20% tax.

XII. GAINS IN REDEMPTION OF SHARES FROM MUTUAL FUNDS

- Gains are non-taxable.

EXCLUSION FROM GROSS INCOME BY REASON OF SPECIAL LAWS

1. Prices received by winners in charity horse race, sweepstakes from PCSO;
2. Back pay benefits;
3. Income of cooperative marketing association;
4. Salaries and stipends in dollars received by non- Filipino citizens on their technical skills of IRRI;
5. Supplemental allowances per diem, benefits received by officer or employees of the foreign service;
6. Income from bonds and securities for sale in the international market.

All receipts
Less- excluded income
- **Capital [cost]**
- **Additional exemptions**
Taxable income

SOURCES OF INCOME

These are the sources of income:

1) Services
    - Compensation income and other benefits
    - Income from the conduct of business
2) Interests Income
3) Dividends
4) Rents and royalties
5) Sale of property

GROSS INCOME FROM COMPENSATION INCOME AND OTHER BENEFITS

COMPENSATION FOR SERVICES - This means all remuneration for services performed by an employee for his employer under an employer-employee relationship.

If deductible to the ER, it is taxable to the EE.

Compensation paid in kind- Compensation may be paid in money or in some medium other than money.

DIFFERENT FORMS OF COMPENSATION INCOME

1. **Property/Kind** – Fair Market Value (FMV) of the property. If there is a price stipulated, it is the price stipulated that will be followed in the absence of contrary evidence.

2. **Promissory note or other evidence of indebtedness**
    a. If it is not discounted, it is the face value of the promissory note.
    b. If it is discounted, it is the fair discounted value of the promissory note.

3. **Stock –** FMV of that shares of stock

4. **Cancellation of indebtedness** – Cancellation of indebtedness has the following tax consequences:
    a. It may account to taxable compensation income if the indebtedness has been cancelled in consideration of the services rendered.
    b. It may account to taxable gift or donation of the indebtedness has been cancelled without any consideration at all.
    c. If may amount to capital transaction if the creditor is a corporation and the debtor is stockholder. If creditor corporation condoned the indebtedness of the debtor stockholder, that may amount to taxable capital transaction. This is the form of direct dividend.
5. **Tax liability of the employee** paid by the employer in consideration of services rendered – amount of tax liability.
6. **Premiums paid by the employer** on the life insurance policy of the employee.
    a. It is a taxable compensation income if the beneficiary designated is the heirs of the employee or his family. Deductible expense
    b. It is not a taxable compensation income if the beneficiary designated is the employer because it is just a mere return of capital. Non-deductible expense.

    If the designation of the employer as beneficiary is indirect (e.g.; It is the creditor of the employer that is designated as beneficiary), that is still not taxable compensation income.

    Example of Indirect designation of the employer as a beneficiary:
    a. Beneficiary is the wife of the President of a close corporation.

    b. If the employer may secure a loan from the insurance police.

Note: If the payment was received by the employee when he was no longer connected with his employer,

it is still considered compensation income. What is important here is that it must be received during the existence of the employer-employee relationship. Employees may be dismissed by the employer, and they may file complaint for illegal dismissal against the employer. Judgment was rendered by the arbiter in favour of the employee. All the wages supposed to be paid (e.g. backwages) can be taxed as compensation income. What about attorney's fees? That is exempt.

LIVING QUARTERS OR MEALS

General rule: If a person receives a salary as a remuneration for services rendered and, in addition thereto, living quarters or meals are provided, the value to such person of the quarters and meals so furnished shall be added to the remuneration paid for the purpose of determining the amount of compensation subject to withholding.

Exception: Employers convenience rule.

However, if living quarters or meals are furnished to an employee for the convenience of the employer, the value thereof need not be included as part of compensation income. [Section 2.78.1, Revenue Regulations 2-98]

Facilities and privileges of a relatively small value- Facilities are not considered as compensation subject to withholding if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, goodwill, contentment, or efficiency of his employees. [Section 2.78.1, Revenue Regulations, 2-98].

Tips and gratuities- Tips or gratuities paid directly to an employee by a customer of the employer which is not accounted for by the employee to the employer are considered as taxable income but not subject to withholding.

Fixed or variable transportation, representation and other allowances - In general, fixed or variable transportation, representation or other allowances which are received by a public officer or employee or officer or employee of a private entity, in addition to the regular compensation fixed for his position or office, is compensation subject to withholding.

Any amount paid specifically, either as advancements or reimbursements, for travelling, representation and other *bona fide* ordinary and necessary expenses incurred or reasonably expected to be incurred by the employee in the performance of his duties are not compensation subject to withholding, if the following conditions are satisfied:

1. It is for ordinary and necessary travelling and representation or entertainment expenses paid or incurred by the employee in the pursuit of the trade, business or profession; and
2. The employee is required to account or liquidate for the foregoing expenses in accordance with the specific requirements of substantiation for each category of expenses. The excess of actual expenses over the advances made shall constitute taxable income if such amount is not returned to the employer.

Vacation and sick leave allowances - Amounts of vacation leave or leave credits which are paid to an employee constitutes compensation. Thus, the salary of an employee on vacation or on sick leave, which are paid notwithstanding his absence from work constitutes compensation.

However, the monetized value of unutilized leave credits of ten (10) days or less which were paid to the employee during the year are not subject to income tax.

IMPOSITION OF FRINGE BENEFIT TAX

FBTx is a tax on the employee! Bur the employer is liable to pay the tax as the withholding agent.

How is a fringe benefit taxed? It depends on the classification of the employee-

Rank and file employee- fringe benefit forms part of the gross income, since it will form part of its compensation.

Managerial employee- subject to final tax at the rate of 32% based on the grossed-up monetary value of fringe benefit furnished or granted to the employee, except rank and file, by the employer, whether an individual or a corporation.

Grossed-up monetary value is acquired by dividing the actual monetary value of the fringe benefit by 68% effective 01 January 2000.

GUMV- less- FBTx= Actual FB received by the employer.

Sir Barlis: although in theory fringe benefit tax is a tax imposed on managerial employees, it actually an additional tax on the part of employers.

Why? Because when an employer gives a car worth 1M to his employee as part of his fringe benefit, he will be giving a functional car. Hindi naman tatanggalin ng employer ang mga accessories para magtuma un value ng car which will the employee receive less the fringe benefit tax.

Fringe benefit means any good, service or other benefit furnished or granted in cash or in kind by an employer to an individual employee, *except rank and file employees*, such as, but not limited, to the following:

1. Housing- ***General rule:*** taxable

   Exceptions: non-taxable if the- 1) house is located within 50 meters from the perimeter of the employer's business premises; 2) temporary housing for an employee who stays in a housing unit for 3 months or less.

CONVENIENCE OF THE EMPLOYER RULE- Under this rule, allows furnished to the employee for, and as a necessary incident to, the performance of his duties are not taxable.

Thus, the value of meals and living quarters given to a driver who is available any hour of the day when needed by his doctor-employer is not considered income of the said driver.

Fringe benefits may be exempt/not subject to tax if these are given for the benefit or advantage of the employer.

Note: If the housing or living quarters are provided outside the premises of the employer, even if that is for the convenience of the employer, this is only exempt up to 50% of the amount. So, 50% taxable, 50% exempt.

2. Expense account- e.g. credit card

3. Vehicle of ***any kind***;

4. Household personnel, such as maid, driver and others;

5. Interests on loan at ***less than market rate [12%] to the extent of the difference between the market rate and actual rate granted;***

Illustration: X is the employee of Beta Corporation. Beta Corp is engaged in lending. It extended loan to X at the rate of 15% and not 24% which is the normal rate which the company imposes. Is there fringe benefit on the part of X? None, since the difference between the actual rate imposed by the Corporation and the actual given rate is less than 12% which is the mate rate for interest.

6. Expenses for foreign travel;

- **Taxable if-** a) travel is related to the work; b) fully supported by documents or receipts.
- ***Limitations:***
  1. Lodging: only $ 300/day- not taxable; excess of $300- taxable
  2. Inland travel expense- not taxable
  3. Airfare: economy- not taxable; first class- not taxable up to 70% price of the ticket. The excess of 70% is taxable

7. Holiday and vacation expenses;

8. Educational assistance to the employee or his dependents; and;

- **General rule:** taxable on the part of employee or dependent.
- **Exception:**
  - **a. Not taxable on the employee if**- [1] educational assistance is related to business of employer; [2] there is a contract that employee render substantial services in the future.
  - **b. Not taxable on the dependent**- non-taxable if he acquired the educational benefits though a competitive scholarship scheme.

9. Life or health insurance and other non-life insurance premiums or similar amounts in excess of what the law allows.

Employer as beneficiary- no FBTx
Employee can choose beneficiary- subject to FBTx.

ITEMS NOT SUBJECT TO FBTx

a. Benefits which fall under the **Employer Convenience Rule.**
b. Benefits received by **Rank and file**.
c. Benefits received which are **exempt by law**.
d. Benefits classified as a de **Minimis benefits**.

BAR 2003- Fringe Benefit Tax: Employer required to Pay- A "fringe benefit" is defined as being any good, service or other benefit furnished or granted in cash or in kind by an employer to an individual employee. Would it be the employer or the employee who is legally required to pay an income tax on it? Explain. (4%)

Suggested answer: It is the employer who is legally required to pay an income tax on the fringe benefit. The fringe benefit tax is imposed as a FINAL WITHHOLDING TAX placing the legal obligation to remit the tax on the employer, such that, if the tax is not paid the legal recourse of the BIR is to go after the employer. Any amount or value received by the employee as a fringe benefit is considered tax paid hence, net of the income tax due thereon. The person who is legally required to pay *(same as statutory incidence as distinguished from economic incidence)* is that person who, in case of non-payment, can be legally demanded to pay the tax.

BAR 2001- Fringe Benefit Tax: Covered Employees- X was hired by Y to watch over V's fishponds with a salary of Php 10,000.00. To enable him to perform his duties well, he was also provided a small hut, which he could use as his residence in the middle of the fishponds. Is the fair market value of the use of the small hut by X a "fringe benefit" that is subject to the 32% tax imposed by Section 33 of the National Internal Revenue Code? Explain your answer. (5%)

Suggested answer: No, X is neither a managerial nor a supervisory employee. Only managerial or supervisory employees are entitled to a fringe benefit subject to the fringe benefits tax. Even assuming that he is a managerial or supervisory employee, the small hut is provided for the convenience of the employer, hence does not constitute a taxable fringe benefit. *(Section 33, NERC).*

BAR 1995- Exclusions & Inclusions; Facilities or Privileges; Military Camp- Capt. Canuto is a member of the Armed Forces of the Philippines. Aside from his pay as captain, the government gives him free uniforms, free living quarters in whatever military camp he is assigned, and free meals inside the camp. Are these benefits income to Capt. Canuto? Explain.

Suggested answer: No, the free uniforms, free living quarters and the free meals inside the camp are not income to Capt. Canute because these are facilities or privileges furnished by the employer for the employer's convenience which are necessary incidents to proper performance of the military personnel's duties.

DE MINIMIS BENEFITS

General Principles:

- Not taxable.
- These are facilities or privileges furnished or offered by an employer to his employees that are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, goodwill, contentment, or efficiency of his employee.

Of relatively small value – *limited to facilities or privileges furnished by employer to his employees merely as a means of promoting health, goodwill, contentment, or efficiency of employees, such as:*

a. Monetized unused vacation leave credits not exceeding ten (10) days during the year;
b. Medical cash allowance to dependents of employees not exceeding P750 per semester or P125 per month;
c. Rice subsidy of P1, 5000. 00 per month or 50 kgs/month;
d. Uniforms in the amount of P6, 000. 00/ year;
e. Medical benefits in the amount of P10, 000. 00/ year;
f. Laundry allowance of P300 per month;
g. Employee achievement awards, for length of service or safety achievement in the form of tangible personal property other than cash gift certificate, with an annual monetary value not exceeding ½ month of the basic salary of employee receiving the award under an established written plan which does not discriminate in favour of highly paid employees;
h. Christmas and major anniversary celebrations for employees and their guests in the amount of P5, 000. 00;
i. Company picnics and sports tournaments in the Philippines and are participated in exclusively by employees; and
j. Flowers, fruits, books or similar items given to employees under special circumstances on account of illness, marriage, birth of a baby, etc.
k. Daily meal allowance for overtime work of 25% of the basic wage.

BAR-2005: State with reasons the tax treatment of the following in the preparation of annual income tax returns: 13th month pay and *de minimis* benefits;

Suggested answer: The **13th month pay** not exceeding P30,000.00 shall not be reported in the income tax return because it is excluded from gross income (*Sec. 32[B][7], [e], NIRC*) The amount of the 13th month pay in excess of P30,000.00 shall be reported in the annual income tax return.

De minimis benefits which do not exceed the ceilings are excluded from gross income, and not to be considered for determining the P30,000.00 ceiling hence not reportable in the annual income tax return. *(Sec. 2.78.1[A][3], R.R. 2-98 as amended by Sec. 2.33 [C] and further amended by R.R. No. 8-2000)*

GROSS INCOME FROM CONDUCT OF TRADE OR BUSINESS

- Taxable on net income
- The term trade or business includes the performance of the functions of a public office. [Section 22 (S), NIRC]

KINDS OF BUSINESS

1. **Service oriented**- always governed by cash basis by reporting their income. Rentals are considered as income in the year it was collected. E.g. rental income
2. **Manufacturing**

GROSS INCOME FROM RENTALS

MEANING OF RENTAL INCOME - Rental income refers to earning derived from leasing, real estate as well as personal property. It includes all other obligations assume to be paid by the lessee to the third party in behalf of the lessor.

OPERATING LEASE- An operating lease is a contract under which the asset is not wholly amortized during the primary period of the lease, and where the lessor does not rely solely on the rentals during the primary period for his profits, but looks for the recovery of the balance of his costs and for the rests of his profits from the sale or re-lease of the returned assets at the end of the primary lease period.

FINANCIAL LEASE- Also called "full payout lease" is a contract involving payment over an obligatory period (also called primary or basic period) of specified rental amounts for the use of a lessor's property, sufficient in total to amortize the capital outlay of the lessor and to provide for the lessor's borrowing costs and profits.

Obligatory period is primary non-cancellable period of the lease which in no case shall be less than 730 days.

Lessee exercise choice over the asset.

THE FOLLOWING CONSTITUTES TAXABLE RENT INCOME:

1. The **regular rent** may be monthly, semi-annually or annually.
2. **Additional rent income** which includes:

   a. ***Obligation of the lessor assumed by the lessee.*** The following are obligations which may be assumed by the lessee: [**R.I.D.I.O.**]
   i) Real property taxed on leased premises

- **ii)** Obligation to pay insurance premium on the insured leased premises.
- **iii)** If the lessor is a corp., the obligation to distribute Dividends to its stockholders.
- **iv)** Obligation to pay interest on the bonds issued by the lessor.
- **v)** Other obligations of the lessor which may be assumed by the lessee.

b. ***Value of permanent improvements on leased premises.*** This may be reported through:

- **ii. Outright method** at the time of permanent is completed, he may report that as additional rent income – FMV of the building or permanent improvement.
- **iii. Spread out method** by allocating the depreciation among throughout the remaining term of the leased.

c. Advanced rentals

- **ii.** If in the nature of the prepaid rentals ***without restriction*** on the use of the amount, it is *taxable*. If there is restriction as to the use of the amount, then it is not taxable since the lessee has a claim of right against it.
- **iii.** If it is in the nature of ***security deposit***, it is taxable rent income if there is a violation of the term of the lease. It is not taxable if the is not violation since the lessee has a claim of right over it.
- **iv.** If it is in the ***nature of a loan*** to the lessor, it is not taxable.

ILLUSTRATION: Santiago owner of a 2 storey building entered with a lease contract with Guillermo for a period of 2 years. It was stipulated that Guillermo will make and advance deposit for two months and a security deposit. The advance deposit will be used during the last two months before the contract ends. Is the advance rent and security deposit considered income on the part of Santiago? If so when should he report the income?

Advance rent- yes, it is considered an income on the part of Santiago. Under the law and advance rent where it does not impose any restriction as to its disposition by the lessor is considered a taxable income on his part.

Santiago should report the income on the year that it was received. This is so because he has control over the disposition of the rent upon his receipt.

Security deposit- no, not considered as an income on the part of Santiago. Under the law and per the Claim of right doctrine, where a third person has a claim over a purported income, such income is not considered an income on the part of the taxpayer who is holding it. In this case, the security deposits belong to Guillermo since it will be returned to him after the termination of the lease.

However, the security deposit becomes a taxable income on the part of Santiago if Guillermo violates the conditions of the list and the security deposit was forfeited in favor of the former.

RULE ON INCOME FROM PRE-TERMINATION OF THE LEASE CONTRACT

1. If the improvement is destroyed before the termination of the lease contract -the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income.

2. If the lease is terminated prior to the expiration of the lease contract for any reason, other than a bonafide sale to the lessor- the lessor received "additional income" for the year the value of the improvements exceed the amount of income already reported.

RULE ON INCOME OF CORPORATION FROM LEASED PROPERTY- Where the property of a corporation is leased to the lessee in consideration that the latter shall pay in lieu of rental an amount to a certain rate of dividend on the lessor's capital stock; it shall be considered as:

- **a.** Rentals [income]- to lessee and lessor [income to the corporation]
- **b.** Dividend from the lessor corporation- as far as the shareholders is concerned.

RULE IF THE CONTRACT IS RENT TO OWN- WHO PAYS THE TAX? The Lessor because he will eventually become the owner of the property upon expiration of the contract.

GROSS INCOME FROM PASSIVE INCOME

Kind of Passive Income

R- Royalties
P-prizes
W-winnings
D-dividend
F- Fringe Benefits

Rule: If these passive incomes are subject to final tax, then it is not subject to income tax. If passive incomes [those earned without the Philippines] cannot be subject to final tax then it becomes part of the gross income.

INCOME FROM ROYALTIES

1. Royalties, except on books, as well as other literary works and musical compositions – 20%

2. Royalties on books literary works and musical compositions – 10%

INCOME FROM PRIZES AND OTHER WINNINGS

1. **Prizes** over P10,000 – subject of final tax of 20%

   Note: *Prizes less than P10, 000 are included in the income tax of the individual subject to the schedular rate of 5% up to P125, 000 +32% of excess of P500, 000*

   Prize- *given by some reason of effort or display of talent.*

2. **Winnings** regardless of the amount are subject to final tax of 20%, except PCSO and Lotto winnings.

   Winning*-* is by reason of luck or chance.

   Winnings of corporation*-* not subject to final tax, but included in the gross income of the corporation.

Illustration: Santi purchased a raffle ticket in the name of the corporation. Said ticket won the first cash prize. However, when Santi tried to claim the prize, the agent withholds 20% final tax on the prize. The agent insist that he should withhold a final tax, however Santi, being a law student also insisted that the winnings should not be subject to final tax since it will form part of the corporation's gross income and is subject to corporate income tax. Who among them is correct?
They are both correct.

The agent is correct that it has the right to withhold 20% final tax, since the price is a winning and the law mandates that a final tax must be withhold.

On the other hand, Santi is correct, since the winning forms part of the gross income of the corporation.

However, the withhold tax, will be become a creditable withholding tax on the part of the corporation, thus Santi should get a certificate of creditable withholding tax from the agent to ensure that the withhold tax will go to the government's treasury. If there is any deficiency in the tax, the corporation will pay the deficiency when it will pay its income tax.

3. **Cash rewards for informants** – 10%

INCOME FROM INTERESTS

1) Interest from any ***currency bank deposit*** and yield or any other monetary benefit from ***deposit substitutes*** and from ***trust accounts*** and similar arrangements – 20%
   - ***Bank deposits***
   - ***Deposit substitutes****-* alternative forms of borrowing from the public [***public*** for commercial purposes means 20 or more persons]. E.g. :Bonds

Exception*:* ***Foreign Currency Deposit****-* interest income derived by a resident individual- 7.5%

Note: non-resident citizen not included from a depositary bank under the expanded Foreign Service Deposit System.

2) Interest income from ***long term deposit or investment*** evidenced by certificates prescribed by BSP-
   a) ***Not subject to final tax,*** if investment is held for more than 5 years. The 5 year period must be a result of an agreed period and not just a result of renewal of contract.
   b) If investment is ***pre-terminated,*** interest income on such investment shall be subject to the following rates:

      20% -If pre-terminated in less than 3 years.
      12% - If pre-terminated after 3 years to less than 4 years.
      5%-If pre-terminated after 4 years to less than 5 years.

Long term deposits- contemplate bank deposits and do not include deposit substitutes, since the period for the latter is always more than 5 years.

BAR 1995-Interest: Deficiency Interest-What is a "deficiency interest" for purposes of the income tax? Illustrate.

Suggested answer: DEFICIENCY INTEREST for purposes of the income tax is the interest due on any amount of tax due or installment thereof which is not paid on or before the date prescribed for its payment computed at the rate of 20% per annum or the Manila Reference Rate, whichever is higher, from the date prescribed for its payment until it is fully paid.

If for example after the audit of the books of XYZ Corp. for taxable year 1993 there was found to be due a deficiency income tax of P125,000.00 inclusive of the 25% surcharge imposed under Section 248 of the Tax Code, the interest will be computed on the P125.000.00 from April 15, 1994 up to its date of payment.

BAR 1995- Interest: Delinquency Interest- What is a "delinquency interest" for purposes of the income tax? Illustrate.

Suggested answer: Delinquency interest is the interest of 20% or the Manila Reference Rate, whichever is higher, required to be paid in case of failure to pay:

(a) the amount of the tax due on any return required to be filed; or

(b) the amount of the tax due for which return is required; or

(c) The deficiency tax or any surcharge or interest thereon, on the due date appearing in the notice and demand of the Commissioner of Internal Revenue.

If in the above illustration the assessment notice was released on December 31, 1994 and the amount of deficiency tax, inclusive of surcharge and deficiency interest were computed up to January 30, 1995 which is the due date for payment per assessment notice, failure to pay on this latter date will render the tax delinquent and will require the payment of delinquency interest.

THEORETICAL INTEREST

CIR vs. FILINVEST
G. R. No. 163653; July 19, 2011

Facts: Filinvest corporation extended loans to its affiliates. Meanwhile to finance its operations Filinvest borrowed from commercial banks. Filinvest then received an assessment form the BIR stating that theoretical interest can be imputed in the loans that it extended to its affiliates; as such Filinvest should pay the tax for that income.

The BIR is of the theory that since considerable interest expenses were deducted by Filinvest when said funds were borrowed, the interest income should likewise be declared when the same funds were sourced for the advances Filinvest extended to its affiliates. Invoking Section 43 of the 1993 NIRC in relation to Section 179(b) of Revenue Regulation No. 2, the CIR maintains that it is vested with the power to allocate, distribute or apportion income or deductions between or among controlled organizations, trades or businesses even in the absence of fraud, since said power is intended "to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses."

Issue: Whether or not taxable interest can be imputed in the loans extended by Filinvest to its affiliates.

Held: No, said the Court- "despite the broad parameters provided, however, we find that the CIR's powers of distribution, apportionment or allocation of gross income and deductions under Section 43 of the 1993 NIRC and Section 179 of Revenue Regulation No. 2 does not include the power to impute "theoretical interests" to the controlled taxpayer's transactions. Pursuant to Section 28 of the 1993 NIRC, after all, the term "gross income" is understood to mean all income from whatever source *derived*, including, but not limited to the following items: compensation for services, including fees, commissions, and similar items; gross income derived from business; gains derived from dealings in property;" interest; rents; royalties; dividends; annuities; prizes and winnings; pensions; and partner's distributive share of the gross income of general professional partnership. While it has been held that the phrase "*from whatever source derived*" indicates a legislative policy to include all income not expressly exempted within the class of taxable income under our laws, the term "income" has been variously interpreted to mean "cash *received* or its equivalent", "the amount of money *coming* to a person within a specific time" or "something distinct from principal or capital." Otherwise stated, there must be proof of the actual or, at the very least, probable receipt or realization by the controlled taxpayer of the item of gross income sought to be distributed, apportioned or allocated by the CIR. "

Moreover, "even if we were, therefore, to accord precipitate credulity to the CIR's bare assertion that FDC had deducted substantial interest expense from its gross income, there would still be no factual basis for the imputation of theoretical interests on the subject advances and assess deficiency income taxes thereon. More so, when it is borne in mind that, pursuant to Article 1956 of the *Civil Code of the Philippines*, no interest shall be due unless it has been expressly stipulated in writing. Considering that taxes, being burdens, are not to be presumed beyond what the applicable statute expressly and clearly declares, the rule is likewise settled that tax statutes must be construed strictly against the government and liberally in favor of the taxpayer. Accordingly, the general rule of requiring adherence to the letter in construing statutes applies with peculiar strictness to tax laws and the provisions of a taxing act are not to be extended by implication. While it is true that taxes are the lifeblood of the government, it has been held that their assessment and collection should be in accordance with law as any arbitrariness will negate the very reason for government itself.

INCOME FROM DIVIDENDS

Dividends- means any distribution made by a corporation to its shareholders out of its earnings on profits and payable to its shareholders, whether in money or in other property.

Dividends received from a Domestic Corporation

a. This is exempt from tax if the recipient is a foreign government, financing institution, regional financing institution, international financing institution established by a foreign government. ***Sec. 32 B7a***

b. It is also exempt if the recipient of such dividend is another domestic corporation or resident foreign corporation, ***Sec. 28 A7d***

KINDS OF DIVIDEND INCOME

1. **Cash-** taxable
2. **Stock dividend/stock rights**- issued by a corporation from its own shares of stocks.
3. **Property dividend-** taxable
   - Includes stock dividends issued by a corporation from its shareholdings in another corporation.
4. **Liquidating dividend**

STOCK DIVIDEND

General rule: as a rule stock dividends are not taxable. This is so, because there is no income here. It merely represents the transfer of surplus accounts to the capital account.

EXCEPTION TO THE RULE: *Stock dividend may be subject to tax under the following exceptional cases:*

1. ***Taxable if there is an option given to stockholders which result in the change in the stockholder's interest in the net assets of the corporation;***

   Example: Santi owns 60% and Gil owns 40% of X Corp. X Corp declared dividends wherein the stockholders may choose from cash or stock [1 stock per share] dividends. Santi opted for stock dividend, while Gil opted for cash dividends. Is the dividends issued to the two taxable? Yes.

   In the case of Santi- the dividends is taxable since it substantially altered the ownership of Santi in X Corp. Before his equity is only 60% but after the availing of the dividends he now owns 75% of X Corp.

   In the case of Gil- dividends is taxable since it is in the form of cash.

2. ***If it is one issued by another corporation.*** This is called "***dividend stock***."
   - ***Stock dividend vs. Dividend stock:*** Stock dividend is not taxable, while dividend stock is taxable.

3. ***Redemption of stock dividend;***

4. ***If the corporation had issued to a stockholder 2 different classes of shares of stock, any stock dividend that may be issued to such stockholder shall be taxable.***

   Example:

Outstanding stock	Stock dividend	Taxability
1. Preferred	Common	Not Taxable
2. Common	Preferred	Not taxable
3. Preferred	Preferred	Not taxable
4. Common	Common	Not taxable
5. Preferred and Common	Preferred	Taxable
6. Common and preferred	Common	Taxable

- A stock dividend representing the transfer of surplus to capital account shall not be subject to tax.
- It shall be taxable only if subsequently cancelled and redeemed by the corporation.
- It is also taxable if it leads to a substantial alteration in the proportion of tax ownership in a corporation.

Alpha Corp, a domestic corporation owns Omega Corp, and Indonesian based corporation. Alpha Corp declared portions of its shareholdings in Omega Corporation as dividends. Are the dividends taxable?

Yes, the dividends are taxable.

Although as a general rule, stock dividends are not subject to tax being a mere representation of stockholders interest in the company, such dividends are taxable if it is issued by another corporation.

In this case the dividends are issued by Alpha Corporation from it shares in Omega corporation is considered a property dividends, therefore taxable under the law.

BAR 2003- Exemptions: Stock Dividends - On 03 January 1998, X, a Filipino citizen residing in the Philippines, purchased one hundred (100) shares in the capital stock of Y Corporation, a domestic company. On 03 January 2000, Y Corporation declared, out of the profits of the company earned after 01 January 1998, a hundred percent (100%) stock dividends on all stockholders of record as of 31 December 1999 as a result of which X holding in Y Corporation became two hundred (200) shares. Are the stock dividends received by X subject to income tax? Explain. (8%)

SUGGESTED ANSWER: No. Stock dividends are not realized income. Accordingly, the different provisions of the Tax Code imposing a tax on dividend income only includes within its purview cash and property dividends making stock dividends exempt from income tax. However, if the distribution of stock dividends is the equivalent of cash or property, as when the distribution results in a change of ownership interest of the shareholders, the stock dividends will be subject to income tax. *(Section 24(B)(2); Section 25(A)&(B); Section 28(B)(5)(b), 1997 Tax Code)*

When redemption of stock dividends by a corporation is "essentially equivalent to a distribution of taxable dividends" (CIR v. CA, et. al., G.R. No. 108576 dated 1/20/99) - If the source of the redeemed shares is the original capital subscriptions upon establishment of the corporation or from initial capital investment in an existing enterprise, its redemption to the concurrent value of acquisition would not be income but a mere return of capital. On the other hand, if the redeemed shares are from stock dividend declarations, the proceeds of the redemption is additional wealth, for it is not merely a return of capital, and thus, deemed as taxable dividends.

DIVIDENDS PAID IN PROPERTY

- Dividends paid in securities or other property, in which the earnings of a corporation have been invested, are income to the recipients to the amount of the full market value of such property when receivable by individual stockholders.

- A dividend paid in a stock of another corporation is not a stock dividend, even though the stock distributed was acquired through the transfer by the corporation declaring the dividends of property to the corporation the stock of which is distributed as a dividend. [Section 251, Revenue Regulations 2].

LIQUIDATING DIVIDENDS- Where a corporation distributes all its assets in complete liquidation or dissolution, the gain realized or loss sustained by the stockholder, whether individual or corporation, is a taxable income or deductible loss, as the case may be.

DISGUISED DIVIDENDS

- These are payments which are equivalent to dividend distribution.

- In the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as dividends [Section 71, Revenue Regulation 2]

GROSS INCOME FROM SALE OF REAL PROPERTY

The tax rate on transaction regarding real properties depends on the nature of the property, whether it is considered as an ordinary asset or capital asset.

ORDINARY ASSET- these are considered as ordinary assets-

1. Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

2. Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business

3. Property used in the trade or business, of a character which is subject to the allowance for depreciation.

4. Real property used in the trade or business of the taxpayer

5. Depreciable properties used in business.

Rate of Tax: gains derived from the sale of ordinary assets are included in the gross income and it is subject to normal tax. The rate of tax depends on the kind of taxpayer.

CAPITAL ASSETS- include

1. All properties not used in trade or business.
2. Property held by the taxpayer, whether or not connected with his trade or business, which is not an ordinary asset.

Assets are ordinarily capital and not ordinarily ordinary.

Subject to ***6% Capital gains tax*** on the selling price or fair market value whichever is higher.

What is fair market value – a value which is seller is willing to sell and a buyer is willing to buy the property. It is determined by the zonal value as imposed by the BIR or Assessed value as assessed by the Assessors. [See CIR vs. Aquafresh]

Transactions covered:

1. Barter [barterers are liable for CGTx],
2. involuntary sales,
3. sale on execution,
4. foreclosure sale, *p*
5. *acto to de retro or*
6. disposition of property within the Philippines.

Why not include those sales of real property without the Philippines? It cannot be since CGTx is a final tax, and to subject transaction of real property without the Philippines to a CGTx would violate territoriality principle since the government cannot order the buyer to withhold taxes. .

When to pay CGTx- 30 days from the date of sale, however for **execution sale-** pay CGTx shall be paid after the lapse of the period of redemption.

Is capital gains tax, a tax on the buyer or on the seller? *It is a tax on the seller*. But sometimes, through an agreement, *pwede nilang i-transfer sa buyer,* and there's nothing that can prevent the seller from transferring the tax to the buyer in the contract of sale.

GAINS DERIVED FROM THE SALE OF CAPITAL ASSETS

General rule: A final tax of 6% is imposed on the gross selling price **or** current fair market value, whichever is higher, for every sale or exchange of real property.

Exception:

a. Sale of real property to the government if the seller opted not to choose CGTx.
b. The sale or disposition of the principal residence of natural persons are exempt from capital gains tax if certain conditions are met.

Conditions for tax exemption of gain from the sale or exchange of principal residence:

1. Proceeds are fully utilized in acquiring or constructing a new principal residence within 18 months from the date of sale or disposition;

2. Historical cost or adjusted basis or the real property sold or disposed shall be carried over to the new principal residence built or acquired;

3. Notice to the Commissioner of Internal Revenue shall be given within thirty (30) days from the date of sale or disposition; and

4. If the proceeds of the sale were not fully utilized within the 18 months, the portion of the gain presumed to have been realized from the sale or disposition shall be subject to capital gains tax.

5. It can be availed once in every 10 years.

How can be BIR ensure that you will used the proceeds in the building another residence? It will order the taxpayer to open an escrow account

But the sale of real property by a real estate dealer is not a capital transaction, because the property involved is one primarily held for sale to customers in the ordinary course of business*. That is not a capital asset*.

ALTERNATIVE TAXATION IN CASE OF SALE TO GOVERNMENT: If the sale is made to the government or any of its political subdivisions or agencies or to government-owned or controlled corporations, the taxpayer has the option to choose from the final tax of 6% of gross selling price or fair market value, whichever is higher, or part of the gross income subject to the schedular tax rate of 5% up to P125, 000 + 32% of excess of over P500, 000.

BAR 2001- Capital Gain Tax; Nature- A, a doctor by profession, sold in the year 2000 a parcel of land which he bought as a form of investment in 1990 for Php 1 million. The land was sold to B, his colleague, at a time when the real estate prices had gone down and so the land was sold only for Php 800,000 which was then the fair market value of the land. He used the proceeds to finance his trip to the United States. He claims that he should not be made to pay the 6% final tax because he did not have any actual gain on the sale. Is his contention correct? Why? (5%)

SUGGESTED ANSWER: No, The 6% capital gains tax on sale of a real property held as capital asset is imposed on the income presumed to have been realized from the sale which is the fair market value or selling price thereof, whichever is higher. (Section 24(D), NIRC). Actual gain is not required for the imposition of the tax but it is the gain by fiction of law which is taxable.

WHEN TO PAY CAPITAL GAINS TAX ON FORECLOSED PROPERTIES

Extra judicial foreclosure- mere affidavit on no-redemption will suffice. Thus when to pay CGTx- 30 days after the lapse of the period of redemption.

Judicial foreclosure- 30 days after the lapse of equity of redemption.

FORECLOSURE OF MORTGAGE INVOLVING BANKS- Bank [mortgagee] juridical person [mortgagor] extra- period of redemption is shorter, mortgagor can only redeemed prior to the registration of cert of sale but not to exceed 3 months [thus if the sale is immediately registered then there is not redemption].

When to pay CGTx? Within 30 days after the lapse of 3 months of equity redemption.

Conditional sale- the CGTx shall be paid from the moment of the execution of the conditional sale *[Section 21(d)]*. The BIR can ask for the copy of the Deed of Conditional Sale to know the real intention of the parties.

What if the condition was not fulfilled, can you ask for refund? No since the law is clear that from the moment of execution of conditional sale, the obligation to pay CGTx attaches.

Remedy: Contract to Sell [ejectment] and not Conditional Sale [rescission].

TIPS WHEN IN PRACTICE:

If your Client is the buyer- execute a deed of conditional sale

- In conditional sale, possession passes to the buyer. Ergo, mahirap mapaalis ang buyer, since you need to determine the rightful possessor.
- The rule on ordinary procedure- recovery of ownership will apply. [Mas matagal to kesa sa summary procedure]

If your Client is the seller- execute a deed of Contract to Sell

- In contract to sell, the price is a positive suspensive condition, whereby failure to pay the consideration makes the contract rescissible. Thus, the possession of the buyer is only tolerated, and an ejectment suit will suffice pag nagsawa ka na sa pagmumukha ng buyer.
- The law on summary procedure will apply.

CAPITAL GAIN DERIVED FROM SALE OF SHARES OF STOCK- this presupposes that the transaction involving shares of stock was entered by a taxpayer who is not a dealer of securities. If the taxpayer involved in such transaction is a dealer of securities then the transaction is subject to normal tax.

Listed and traded through local stock exchange

- Income liability is zero since the ½ of 1% is a percentage tax.
- This is not subject to income tax but subject to percentage tax of ½ of 1% of the gross selling price.

Not listed and traded through local stock exchange- this is the one subject to income tax.

Not over P100, 000.00	5%
Amount over P100, 000.00	10%

If the share of stock is not listed and traded through local stock exchange, the basis of the tax is net capital gain. So, you should first deduct the capital loss.

If listed and traded through local exchange*,* there is no deduction allowed because the basis of the tax rate of ½ of 1% of the gross selling price.

The above-mentioned tax rates apply to all individual taxpayers.

Even if the shares are listed but the sale of the same was not done through the stock exchange, then it is subject to 5 or 10% as the case maybe.

Example: San Miguel sold his in in Meralco to GSIS through a negotiated sale. What kind of tax will be imposed? 5% or 10% as the case maybe, since that sae was not made through the stock exchange.

Distribution of **TREASURY STOCKS** should be considered ***taxable*** since the stocks are not sourced from the unissued shares of the corporation and there being no transfer from surplus to capital.

OTHER SOURCES OF INCOME

I. FORGIVENESS OF INDEBTEDNESS- *The cancellation and forgiveness of indebtedness may, dependent upon the circumstances, amount to:*

b. a payment of income;
c. a gift; or
d. A capital transaction.

If, for example, and individual performs services for a creditor who, in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his service.

If, however, a creditor merely desires to benefit a debtor and without any consideration thereof cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income.

If a corporation to which a stockholder is indebted forgives the debt, the transaction has the effect of payment of dividends. ***[Sec. 50, Rev. Reg. 2]***

Recovery of amounts previously written off- Considered as income

II. INCOME FROM INSTALMENT TRANSACTIONS

- Contemplates a seller of the property
- Payment of the tax by instalment
- It is important to know if the property sold was real or personal

What is installment transaction for tax purposes? The initial payment shall not exceed 25% of the contract price.

What if the initial payment exceeds 25% of the selling price? You must pay the whole tax, since it is considered as in a cash basis.

Note:

- ***"Initial payment"-*** means the payment received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.
- In payment by way of instalment, promissory note, bills of exchange and checks will not be considered in computing the 25% initial down payment.
- As a general rule profit accruing from a sale of property is taxable as income in the year the sale is made. But if the selling price was not received during such year, and a statute provides that income be taxable in the year in which it is received, the profit from an instalment sale is to be appointed between or among the years in which such instalments are paid and received.

What do you call the transaction? It is called deferred sale or deferred payment scheme.

Sale of real property- ***is it important to know if it is casual sale or regular sale?*** No, the only requirement is that the initial payments do not exceed 25% of the selling price.

Sale of personal property*- is it important to know if it is a casual or regular sale?* Yes.

- ***If casual sale*:** requirements for instalment payment of tax
    1. Selling price exceeds P 1, 000. 00
    2. Initial payment not exceeding 25% selling price.
- ***Regular sale-*** no requirement.

III. INCOME FROM LONG- TERM CONSTRUCTION PROJECTS – long term contracts means building, installation or construction contracts covering a period in excess of 1 year.

Method of reporting the income: Percentage of Completion method- Persons whose gross income is derived in whole or in part from long term construction projects shall report such income upon the basis of percentage of completion.

The return should be accompanied by a return certificate of architects or engineers showing the percentage of completion during the taxable year of the entire work performed under contract.

Allowable deductions: there should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the materials and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

DEDUCTIONS FROM GROSS INCOME

Deductions- Deductions are items or amounts which the law allows to be deducted under certain conditions from gross income in order to arrive at taxable income.

Basic principles governing deductions

1. The taxpayer seeking a deduction must point to some specific provisions of the statute authorizing the deduction; and

2. He must be able to prove that he is entitled to the deduction authorized or allowed.

Deduction v. exemption- Deduction is an amount allowed by law to be subtracted from gross income to arrive at taxable income. Exemption from taxation is the grant of immunity to particular persons or corporations or to persons or corporations of a particular class from a tax which others generally within the same taxing district are obliged to pay.

Deduction v. exclusion- Deduction is an amount allowed by law to be subtracted from gross income to arrive at taxable income. Exclusion refers to income received or earned but is not taxable as income because exempted by law or by treaty. Such tax-free income is not to be included in the income tax return unless information regarding it is specifically called for. [Section 61, Revenue Regulation 2].

Deduction v. Tax Credit

- Tax credit is a deduction from Philippine income tax.
- Tax as deduction includes those taxes which are paid or incurred in connection with the trade, business or profession of the taxpayer. However, the sources of a tax credit are foreign income tax paid, war profit tax, excess profit tax paid to the foreign country.

- The foreign income tax paid to the foreign country is not always the amount that may be claimed as tax credit because under the limitation provided under the tax Code, it must not be more than the ration of foreign income to the total income multiplied by the Philippine income tax.

- ***Discount*** is considered as an allowable deduction and not a tax credit.

TIME WITHIN WHICH TO CLAIM DEDUCTION

1. As a rule, if a taxpayer does not, within a year, deduct expenses, losses, interests, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year.
2. If he keeps his books on the cash receipts basis, the expenses are deductible in the year they are paid.

3. If on the actual basis, then in the year they are incurred, whether paid or not.

Who may not avail of deductions from gross income?

1. Citizens and resident aliens whose income is *purely compensation income.*
   - They are allowed personal and additional exemptions and deduction for premium payments on health and hospitalization insurance.
2. Non-resident aliens not engaged in trade or business in the Philippines
3. Non-resident foreign corporations

DEDUCTIONS FROM GROSS INCOME

- BITE DeDe LOSS CPR
  1. Expenses
  2. Interest
  3. Taxes
  4. Losses
  5. Bad debts
  6. Depreciation
  7. Depletion of oil and gas wells and mines
  8. Charitable and other contributions
  9. Research and development
  10. Pension trusts
  11. Premium payments on health and/or hospitalization insurance of an individual taxpayer

Kinds of deductions

1. **Itemized deduction** which is available to individual and corporate taxpayers. Itemized in ***Section 34 of NIRC.***

   - **Requires substantiation**- any claim for deduction must be back-up by competent proofs.

   - Any claim must be reasonable.

   - If a deduction requires withholding, then the withholding must have been required. Failure to withhold is a ground to disallow deduction.

   - Is it required that the deduction must be absolutely certain? No, absolute certainty is not required, what is required is reasonable certainty.

   COHAN RULE- In short, the Cohan Rule, as it has come to be known, stands for the proposition that taxpayers may use estimates when they can show that there is some factual foundation on which to base a reasonable approximation of the expense (i.e., when they can prove that they had made a deductible expenditure but just cannot prove how much that expenditure was). But remember; if you rely on Cohan (which means your records are incomplete) expect the BIR to put up a fight as to the proper amount of the allowable expense.

CIR VS. ISABELA CULTURAL CORPORATION- **All events tests**- consider the reasonableness of the claimed deduction by looking at all the relevant circumstances.

2. **Optional standard deduction** which is available to individual and corporate taxpayers only, except a non-resident alien.

   It must be specifically indicated in the return by checking the box corresponding therein. If not indication then it is presumed that the taxpayer is availing of the itemized deduction.

   - Individuals- 40% of ***gross receipts/gross sales***
   - Corporation- 40% of ***gross income***. [RA 9504]
   - No substantiation requirements [such as receipts]
   - A taxpayer who pays his tax in quarterly basis may avail of OSD or itemized deduction within the first 3 quarters, but it must choose at the end of the quarter which kind of deduction it would avail.

   Tax tip: More beneficial by those who do not keep track of their deductions or those who have minimal deductions. But if you have many expenses, then claim itemized deductions.

   E.G.: X, individual taxpayer who has gross sales of 1M. The cost of product is 600K. After deducting the costs, he will have a gross income of 400K. If he will avail of OSD, then 40% of his Gross Sales is 400K. Thus, he has no tax liability since 400K [GI]- 400 [deduction]=0

3. **Special deductions** which is available, in addition to the itemized deductions, to certain corporations, i.e. insurance companies and propriety educational corporations.

KINDS OF ITEMIZED DEDUCTIONS

Kinds of Allowable Deductions:

1. Ordinary business expenses
2. Bad debts
3. Interests
4. Taxes
5. Depreciation
6. Depletion
7. Losses
8. Charitable contributions
9. Pension Trusts
10. Research and development costs
11. Other forms of deductions

I. ORDINARY AND NECESSARY BUSINESS EXPENSES

BUSINESS EXPENSES refer to all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on or which are directly attributable to the development, management, operation and/or conduct of the trade, business or the exercise of a profession.

CAPITAL EXPENSES are expenditures for extraordinary repairs which are capitalized and subject to depreciation. These are expenses which tend to increase the value or prolong the life of the taxpayer's property.

ORDINARY EXPENSE- this simply refers to the expenses which are reasonably expected in the line of business or profession of the taxpayer and does not necessarily entail regularity.

An expense is ordinary when it is ***commonly incurred in the trade or business*** of the taxpayer as distinguished from capital expenditures. The payments, however, need not be normal or habitual in the sense that the taxpayer will have to make them often. The payment may be unique or non-recurring to the particular taxpayer affected.

Example: litigation expenses- if an action is filed in court, it is but normal to hire the services of a lawyer. So, the taxpayer has to pay attorney's fees. It is an ordinary expense under these circumstances.

NECESSARY EXPENSE- It is one which is useful and appropriate in the conduct of the taxpayer's trade or profession.

An ***expense is necessary when it is appropriate and helpful to the taxpayer's business or if it is intended to realize a profit or to minimize a loss***.

Are those which are incurred or paid in the development, operation management of the business, trade or profession of the taxpayer.

EXTRA-ORDINARY EXPENSES – *Not Deductible*. These are amortized or in lieu of the same, you may claim that so-called allowance for depreciation. And if it involves intangible asset, the word used is AMORTIZATION.

There is no hard and fast rule. An expense may be ordinary insofar as a particular taxpayer is concerned and it may not be an ordinary as regards another taxpayer.

Example: If you have business here in Manila and you also have business in Tawi-tawi, what is the expense that you may incur in Tawi-tawi which you may not possibly incur in Manila? In Tawi-tawi, you may need people to guard your business. But here in Manila, you may need not because of our new President-elect.

TIP: if an asset will benefit you for several years and its amounts is huge then treat it a capital expenditure.

However, even if an asset will benefit you for several years but has a relatively low value then treat it as an ordinary expense.

Ex: stapler, although it benefits your for many years but it has a relative low value which can be claimed as an outright deduction.

Improvements of permanent nature- capital expenditures

Improvements for ornamentation- ordinary expense.

OPTION TO PROPRIETARY EDUCATIONAL INSTITUTIONS REGARDING CAPITAL EXPENDITURES

General rule: expenditures/expenses for capital outlays not deductible as business expense.

Exception: Proprietary educational institution can claim it under 34 A (2). In **addition to the allowable deductions**, a private educational institution may, as its option, elect either:

1. To deduct expenditures otherwise considered as capital outlays of depreciable assets incurred during the taxable year for the expansion of school facilities [It can declare as outright business expenses capital expenditures for business expansion.]; or

2. To deduct allowance for depreciation thereof.

Why only private educational institution is mentioned and no other tax payers? This refers to Section 27 for private educational institution given to the educational institution

KINDS OF ORDINARY & NECESSARY EXPENSES [C.A.R.T.E.R.S.]

1. Compensation for services rendered.
2. Advertising & promotional expenses
3. Rent expenses
4. Travelling expenses
5. Entertainment expenses
6. Repairs & maintenance
7. Supplies and materials

Note: There is no need to prove that these expenses are ordinary and necessary because it is the law itself that made it ordinary and necessary expenses. All you have to prove is-it is incurred during the taxable year.

Requisites for deductibility of business expense

1. The expense must be ordinary and necessary.
2. It must be paid or incurred during the taxable year.
3. It must be paid or incurred in carrying on any trade or business or profession.
4. It must be reasonable in amount
5. It must be substantiated by sufficient evidence such as official receipts and other official records.
6. It must not be against the law, morals, public policy or public order.

Substantiation requirement for business expense

- Taxpayer needs to substantiate with sufficient evidence such as official receipts or other adequate records:
    1. The amount of the expense being deducted; and
    2. The direct connection or relation of the expense being deducted to the development, management, operation and/or conduct of the trade, business or profession of the taxpayer.

What are included in business expenses? Business expenses include:

1. Salaries, wages and other forms of compensation for personal services actually rendered, including the grossed-up monetary value of fringe benefit granted provided the fringe benefit tax has been paid.

2. Travel expenses, here and abroad, while away from home.

3. Rentals and/or other payments of property to which the taxpayer has *not taken or is not taking title or in which he has no equity other than that of a lessee, user or possessor.*

4. Entertainment, amusement and recreation expenses.

COMPENSATION FOR SERVICES AND SALARIES

Requisites for deductibility of compensation payments

1. The payments are reasonable.
2. They are, in fact, payments for personal services actually rendered.

Treatment of excessive compensation - In the case of excessive payments by corporations, if such payments correspond or bear a close a relationship to stockholdings, and are found to be distribution of earnings or profits, the excessive payments will be treated as dividends. [Section 71, Revenue Regulations 2]

If such payments constitute payment for property, they should be treated by the payor as capital expenditure and by the recipient as part of the purchase price. [Section 71, Revenue Regulations 2]

OTHER COMPENSATION

Requisites for deductibility of bonuses to employees

1. The bonuses are made in good faith

2. They are given for personal services actually rendered.
3. They do not exceed a reasonable compensation for the services rendered, when added to the stipulated salaries, measured by the amount and quality of services performed in relation to the taxpayer's business. [Section 72, Revenue Regulations 2]

In **Kuenzle v. CIR** [28 SCRA 365] and **C.M. Hoskins v. CIR** [30 SCRA 434], the Supreme Court disallowed deductions for bonuses given to the top officers of the involved corporations being unreasonable.

Aguinaldo case
Facts: A corporation engaged in selling fish nets and the corporation have a land sold through a broker. There were substantial profits gained from the sale. The profit was in turn given to the workers as special bonus. The corporation claimed the bonus as a deduction.

Issue: should the deduction be allowed.

Held: The SC did not allow the deduction for other forms of compensation. It must be made or given for services actually rendered. In this case the employees were not the one who sold the land but a broker.

PENSIONS AND COMPENSATION FOR INJURIES - Are pensions and compensation for injuries considered as ordinary and necessary expenses?

Amounts paid for pensions to retired employees or to their families or others dependent upon them, or on account of injuries received by the employee, and lump sum amounts paid or accrued as compensation for injuries are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise.

RULES ON REPAIRS

- Expenses for repairs are deductible if such repairs are incidental or ordinary, that is, made to keep the property used in the trade or business of the taxpayer in an ordinarily efficient operating condition.

- Repairs in the nature of replacement to the extent that they arrest deterioration and prolong the life of the property are capital expenditures and should be debited against the corresponding allowance for depreciation. [Section 68, Revenue Regulations 2]

- *Only ordinary or minor repairs are deductible.*

- *Extra-ordinary repairs cannot be claimed as deduction* and in lieu of that, the taxpayer may be allowed to claim depreciation.

- *If the cost of the repair increases the life of an asset for a period of more than one (1) year,* that amount is considered extra-ordinary repair. *Otherwise,* it is considered ordinary repair.

TRAVEL EXPENSES

- Travel expenses include transportation expenses and meals and lodging of an employee paid for the by employer. [Section 66, Revenue Regulations 2]

- This must be *incurred or paid while "away from home".*

- *"Home"* does not refer to your residence but to the station assignment or post.

- *Example:* From home office to branch office, the traveling expenses incurred are deductible. And this includes not only the transportation expenses but also meal allowance and hotel accommodations.

Requisites for deductibility of travel expenses

1. The expenses must be reasonable and necessary.
2. They must be incurred or paid "while away from home."
3. They must be paid or incurred in the conduct of trade or business.

TAX HOME- Tax home is the principal place of business, when referring to "away from home."

RENTAL EXPENSE

- In the form of 5% withholding tax
- A reasonable allowance for rentals and/or other payments which are required as a condition for the continued use or possession, for purposes of the trade, business or property to which the taxpayer has not taken of is not taking title or in which he has no equity other than that of a lessee, user or possessor is deductible from the gross income.

- Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an adequate part of such sum each year, based on the number of years the lease has to run.

- Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible rent to the tenant and taxable income to the landlord; the amount of tax being deductible by the latter.

- The cost borne by the lessee in erecting buildings or making permanent improvements on ground of which he is a lessee is held to be a capital investment and not deductible as a business expense.

Requisites for rental expense

1. Required as a condition for continued use or possession
2. For purposes of the trade, business or profession
3. Taxpayer has not taken or is not taking title to the property or has no equity other than that of a lessee, user or possessor.

Note: Leasehold improvements

Amount: annual depreciation of leasehold improvement

Life improvement/ remaining time of the lease whichever is shorter

REPRESENTATION EXPENSE- It refers to reasonable **allowance** for **entertainment**, **amusement** and **recreation** expenses

1. Reasonable in amount.

2. Incurred during the taxable period.

3. Directly connected to the development, management, and operation of the trade, business, or profession of the taxpayer, or that are directly related to or in furtherance of the conduct of his or its trade, business or profession.

4. Not to exceed such ceilings as the Secretary of Finance may, by rules and regulations, prescribe [.5% of net sales or 1% of net receipts].

5. Any expense incurred for entertainment, amusement or recreation which is contrary to law, morals, public policy, or public order shall in no case be allowed as a deduction.

   NOTE: Those expenses incurred for entertainment, amusement, or recreation that are contrary to law, morals, public policy or public order shall in no case be allowed as deduction.

   Bribes, kickbacks, and similar payments are not deductible as an ordinary and necessary expense.

   Also, the expenses incurred by the taxpayer in entertaining gov't officials in 5-star hotel to gain political influence are not deductible.

TREATMENT OF OTHER EXPENSES - Zamora v. Collector SCRA 163 **– Promotion expense held to constitute an ordinary and business expense**

1. **Advertising expense -** Not deductible business expense. Efforts to establish reputation are akin to acquisition of capital assets and, therefore, expenses related thereto are not business expense but capital expenditures, since it seeks to increase one's capital i.e. promotion of good will.

2. **Promotional expenses -** Same advertising expense

3. **Litigation expenses -** Litigation expenses that are incurred in the defense or protection of title are capital in nature and not deductible.

In **Guitierres v. CIR** [14 SCRA 34], it was held that litigation expenses defrayed by a taxpayer to collect apartment rentals and to eject delinquent tenants are ordinary and necessary expenses in pursuing his business.

BAR 2004- Deductions: Ordinary Business Expenses - OXY is the president and chief executive officer of ADD Computers, Inc. When OXY was asked to join the government service as director of a bureau under the Department of Trade and Industry, he took a leave of absence from ADD. Believing that its business outlook, goodwill and opportunities improved with OXY in the government, ADD proposed to obtain a policy of insurance on his life. On ethical grounds, OXY objected to the insurance purchase but ADD purchased the policy anyway. Its annual premium amounted to P100,000. Is said premium deductible by ADD Computers, Inc.? Reason. (5%)

SUGGESTED ANSWER: No, the premium is not deductible because it is not an ordinary business expense. The term "ordinary" is used in the income tax law in its common significance and it has the connotation of being normal, usual or customary **(Deputy v. Du Pont, 308 US 488 [1940])**. Paying premiums for the insurance of a person not connected to the company is not normal, usual or customary.

Another reason for its non-deductibility is the fact that it can be considered as an illegal compensation made to a government employee. This is so because if the insured, his estate or heirs were made as the beneficiary *(because of the requirement of insurable interest)*, the payment of premium will constitute bribes which are not allowed as deduction from gross income *(Section 34[A][l][c], NIRC).*

On the other hand, if the company was made the beneficiary, whether directly or indirectly, the premium is not allowed as a deduction from gross income *(Section 36[A}14], NIRC).*

II. BAD DEBTS

Bad debts are debts due to the taxpayer which are actually ascertained to be ***worthless and charged off within the taxable year.*** It presupposes that all reasonable reasons of collection must be exerted before there can be bad debts.

Bad debts can only be claimed if pursuant to a ***contract of loan***. No bad debts for ***loss of instruments.***

Requisites for deductibility of bad debts

1. There must be a valid and subsisting debt.
2. The debt must be actually ascertained to be worthless and uncollectible during the taxable year.
3. The debt must be charged off during the taxable year.
4. The debt must be connected with the trade, business or profession of the taxpayer, and not sustained in a transaction entered into between related taxpayers. *[PRC v. CA 256 SCRA 667]*

HOW TO PROVE THE WORTHLESSNESS OF OBLIGATION: *According to the Supreme Court, the following STEPS must be complied*:

1. There must be a statement of account sent to the debtor;

2. A collection letter;
3. If he failed to pay, refer the case to a lawyer;
4. The lawyer may send a demand letter to the debtor;
5. If the debtor fails to pay the same, file an action in court for collection.

DILIGENT EFFORTS TO COLLECT - In addition to the four requisites, the taxpayer must show that the debt is indeed uncollectible even in the future.

Furthermore, there are steps outlined to be undertaken by the taxpayer to prove that he exerted diligent efforts to collect the debts, viz: a) sending of statement of accounts; b) sending of collection letters; c) giving the account to a lawyer for collection; and d) filing a collection case in court. [**Philippine Refining Co. v. Court of Appeals,** 256 SCRA 667]

What cannot be deducted as bad debts?

1. Debts not incurred in connection with trade, business and profession of taxpayer;
2. Transactions entered into between parties mentioned under section 36 (B) namely:
   a. Between members of the family;
   b. Between an individual who owns more than 30% of outstanding capital stock of a corporation and that corporation;
   c. Between two corporation more than 50% of the outstanding capital stock of which is owned by or for the same individual;
   d. Between a grantor and fiduciary of any trust;
   e. Between two fiduciaries of two trusts who has the sae grantor;
   f. Between a fiduciary of a trust and above fiduciary of such trust.

MANNER OF PROVING INSOLVENCY OF A DEBTOR - in proving that the debtor is insolvent or bankrupt, mere allegation of the same is not enough. You should prove that the debtor is indeed bankrupt or insolvent. So you may secure a copy of that decision by the SEC or other agency as the case may be, declaring the debtor as bankrupt or insolvent. And then there must be a demand letter sent to him. In case the debtor was robbed, there must be a police report to that effect.

The debtor may be a NRFC, so you may argue that he may not be sued here. According to the SC, as a rule that is not an excuse. You should still send a demand letter to that NRFC. In other words, there must be diligent efforts to collect the indebtedness and to prove that in the near future such obligation is no longer collectible.

If the recovery of bad debts, resulted in a tax benefit to the taxpayer, that is taxable. If it did not result in any tax benefit to the taxpayer, that is not taxable. [Tax benefit Rule]

EQUITABLE DOCTRINE OF TAX BENEFIT [TAX BENEFIT RULE] - This doctrine holds that a recovery of bad debt previously deducted from gross income constitutes taxable income if in the year that account was written off, the deduction resulted in a tax benefit, that is, in the reduction of taxable income of the taxpayer.

BAR 1999- Deductions: Non-Deductible Items; Gross Income - Explain if the following items are deductible from gross income for income tax purposes. Disregard who is the person claiming the deduction. (5%)

1. Reserves for bad debts.
2. Worthless securities

RESERVE FOR BAD DEBTS are not allowed as deduction from gross income. Bad debts must be charged off during the taxable year to be allowed as deduction from gross income. The mere setting up of reserves will not give rise to any deduction. (Section 34(E). NIRC).

WORTHLESS SECURITIES, which are ordinary assets, are not allowed as deduction from gross income because the loss is not realized. However, if these worthless securities are capital assets, the owner is considered to have incurred a capital loss as of the last day of the taxable year and, therefore, deductible to the extent of capital gains. *(Section 34(D)(4), NIRC).* This deduction, however, is not allowed to a bank or trust company. *(Section 34(E)(2), NIRC).*

III. INTEREST EXPENSE

The amount of interest paid or incurred within a taxable year on indebtedness in connection with the taxpayer's profession, trade or business shall be allowed as deduction from gross income.

The loan must be legally demandable and interest bearing.

REQUISITES FOR DEDUCTIBILITY

1. There must be indebtedness;
2. The interest must be that of the taxpayer;
3. It must not be expressly disallowed by law to be deducted from the taxpayer's gross income.
4. The loan must be paid or incurred during the taxable year;
5. The loan must be paid or incurred in connection with the trade, business or profession of the taxpayer;
6. There must be a valid obligation with bona fide creditor-debtor relationship [the obligation to pay has not prescribed]
7. There must be an agreement in writing to pay interest.

GENERAL RULE: actual interest expense must be reduced by 33% or 42% of the interest income subject to final tax.

Is actual interest expense automatically deductible in full? No. The actual interest expense is not automatically deductible because it must be reduce by 33% or 42% as the case maybe, of an interest income subject to a final tax.

Formula:

Actual interest expense
Less 33% or 42% of the interest income subject to final tax.
Deductible interest expense

Individual taxpayer: The taxpayer's allowable deduction for interest expense shall be reduced by an amount equal to 33% by 01 January 2009 of the interest income earned by him which has been subjected to a final tax.

Corporate taxpayer: if there is an interest earned and is subject to final tax, the deductible interest is not in full amount. Rather the amount of deductible interest is 42% of the amount of the interest subject to final tax [Section 34 (B)].

What if the taxpayer has no interest income subject to final tax, is the actual interest expense deductible in full? Yes, since 0 x 33% or 42% is 0, so there is nothing to deduct in the actual interest expense.

BACK-TO-BACK INTEREST- Illustration: the taxpayer obtained a loan and at the same time deposited money in a bank earning interest. As a rule the interest to the loan is fully deductible as an expense, however, due to the back to back interest rule the taxpayer cannot deduct it in full.

Loan of 1M
Actual Interest expense: 100K - loan
Bank deposit: 100K- earned interest

Can the taxpayer deduct the 100K interest from the loan? No! The taxpayer can only deduct 33% or 42% of the amount of the interest subject to final tax. Thus the taxpayer can deduct: 33K or 42K and not the full amount of the interest of the loan he obtained.

Rationale: to counteract tax arbitrage system and to prevent the government from incurring a loss. Kasi kikita un taxpayer at the expense of the government. If the taxpayer deducts the full amount of 100K, he will have a tax saving of 67K or 58K as the case maybe.

TAX ARBITRAGE SCHEME- The practice of profiting from differences between the way transactions are treated for tax purposes. The complexity of tax codes often allows for many incentives which drive individuals to restructure their transactions in the most advantageous way in order to pay the least amount of tax. Some forms of tax arbitrage are legal while others are illegal. See the illustration supra.

EXCEPTIONS:

1. **Interest of a loan used for capital expenditures-** at the option of the taxpayer, interest incurred to acquire property used in trade, business or exercise of profession may be allowed as **deduction** or treated as a **capital expenditure**.

   Which is better to treat the interest as deduction or capital expenditure? It depends based on this important consideration- ask the question whether the taxpayer has interest income subject to final tax. If there is, then capitalize the interest, so that it forms part of the cost which can be claimed as a deduction by way of depreciation.

   If you treat it as a deduction, baka kakainin ng interest income subject to final tax and actual interest expense.

2. **Interest on a loan paid in advance-** is it deductible? Yes if claimed on the year where the taxpayer-obligor paid the interest, which is not the date the loan was extended.

   Ex: A loan of 1M was extended to Santi. The interest was deducted in advance at 20% per annum, which is 400K. He is to pay it in 2 installment basis within 2 years. When can Santi claim the interest expense as deductions?

   1st year- 200K
   2nd year- 200K

   These are the year that Santi realized and paid the interest of the loan.

Question 1: What about that interest on unclaimed salaries of the employees, is the interest deductions? NO, because there is no obligation or indebtedness. It is the fault of the employees in case they failed to claim their salaries.

Question 2: What about that interest charged to the capital of the taxpayer, is that deductible? Interest on cost-keeping purposes is not deductible. This does not arise under an interest-bearing obligation.

THEORETICAL INTEREST –an interest which is computed or calculated not paid or incurred, for the purposes of determining the opportunity cost of investing in a business. This does not arise from legally demandable interest-bearing obligation. This is ***not a deductible interest***.

Question 3: What about interest on preferred stock is this deductible? As a rule, ***interest on preferred stock is not deductible***, because there is no obligation to speak of. It is in effect an interest on dividend. The reason why it is not deductible is that the payment is dependent upon the profits of the corporation. It will only be paid if the corporation earn profits. And would not be paid of the corporation incurs losses.

BUT if it is not dependent upon corporate profits or earnings, that is deductible. If is payable on a particular date or maturity without regard to the corporate profits, it is deductible.

The Supreme Court mentions two (2) factors for taxability:

1) not dependent upon corporate profits; and

2) Agreement as to the date or term within which payment will be made.

INTEREST ON GOV'T SECURITIES IS NOW TAXABLE- So, if the taxpayer obtained a loan from PNB and used the proceeds in purchasing gov't securities, the interest is now taxable. Likewise, the interest expense paid on that loan, the proceeds of the same, had been used to purchase gov't securities is now deductible.

Q. What about an interest on a loan paid in advance, is this deductible? Let us say that the taxpayer obtained a loan from a bank and it is payable within 5 years. The loan obtained is P50, 000.00. Now, it was deducted in advance, can that be claimed as deductions?

A. NO. You can only deduct the same when the instalment is due a particular year.

DELINQUENCY INTEREST ON TAX PAYMENT DEDUCTIBLE- For interest to be allowed as deduction from gross income, it must be shown that there be an indebtedness, that there should be interest upon it, and that what is claimed as an interest deduction should have been paid or accrued within the year. The term "indebtedness" has been defined as an unconditional and legally enforceable obligation for the payment of money. Within the meaning of that definition, a tax may be considered as an indebtedness. Hence, interest paid for late payment of the donor's tax is deductible from gross income. [Commissioner v. Prieto, 109 Phil 592].

Surcharges, **penalties** and **fines** are not deductible.

INTEREST EXPENSES WHICH ARE NON-DEDUCTIBLE [PARC-PU]

1. Interest expense on PREFERRED STOCK;

2. When there is NO AGREEMENT in writing to pay interest;

3. Interest expense on loan entered into between RELATED TAXPAYERS.

4. Interest paid or calculated for COST-KEEPING PURPOSES

5. Interest on obligation to finance PETROLEUM EXPLORATION

6. Interest on UNCLAIMED SALARIES of the employees

WHO ARE RELATED TAXPAYERS?

a. Members of the same family which includes:

  1. spouses

  2. brothers and sisters

  3. descendants and ascendants

b. Between two (2) corporations owned or controlled by one individual. He must have a controlling interest over these two corporations. OR, if one corp. is considered as personal holding company of another corp.

c. Between a corp. and an individual; that individual owns or controls more than 50% of the outstanding capital stock of the corp.

d. Parties to a trust;

  1) grant of fiduciary

  2) fiduciary of one trust and fiduciary of another trust but there is only one grantor

  3) Beneficiary and fiduciary.

Your knowledge of related taxpayer is also important in determining whether losses are deductible or not. If losses were incurred or paid in connection with transactions between these related taxpayers, these are not deductible.

EXAMPLE OF INCOME SUBJECT TO FINAL TAX:

1) Interest on bank deposit

2) Interest on deposit maintained under the foreign currency deposit system

So, if the interest income on bank deposit amounted to P100, 000.00. And the total interest expense incurred or paid by the taxpayer is P200, 000.00. If this is incurred in 1998, 41% of P100, 000.00 is P41, 000.00. That P200, 000.00 interest expense incurred or paid, should be reduced to P41% of that P100, 000.00 to arrive at P159, 000.00 which is the interest that may be claimed as deduction.

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  P200, 000.00
 -  41,000.00
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  P159, 000.00
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The rule has been established that *TAXES are NOT ORDINARY OBLIGATIONS*. But the *Supreme Court in two (2) cases relaxed the distinction between taxes and ordinary obligations*.

a. The interest on deficiency donor's tax is deductible. The SC explained that taxes here are considered obligations or indebtedness. And it ruled that we have to relax the distinction between tax and ordinary obligation in this respect.

b. Interest on deficiency income tax can also be claimed as deductible interest expense because taxes here are considered ordinary obligations.

IV. TAXES

What taxes are deductible? As a **general rule**, all taxes, **nationa**l or **loca**l, paid or incurred with the taxable year in connection with the taxpayer's trade, business or profession are deductible from gross income.

Taxes means taxes proper and, therefore, no deductions are allowed for amounts representing interest, surcharges and fines or penalties incident to delinquency.

Requisites for deductibility:

1. This must be paid or incurred during the taxable year.
2. This must be taxes paid or incurred in connection with the trade, business or profession of the taxpayer.

Taxes can be claimed as: 1) deduction 2) tax credit

If claimed as deduction- it should be deducted from the gross income.

If claimed as tax credit- it should be deducted from the net Income tax due.

Deductible Taxes

1. Import duties
2. Business taxes- Vat and other percentage taxes and excise taxes;
3. Privilege or occupation taxes, licenses;
4. Documentary stamp taxes;
5. Income from war-profits and excess profits taxes imposed by the authority of any foreign country only if the taxpayer does not signify in his return his desire to have any extent the benefit of the provisions of law allowing credits against the tax for taxes of foreign countries.
6. Any other taxes of every amount and nature paid directly to the government or any political subdivision.

Non-deductible taxes [S.I.N.E]

1. **Special Assessment-** tax imposed on parcels of land which benefited from the construction made by the government.

2. **Income tax-** generally not deductible except foreign income tax. It include final tax since it is a kind of income tax.

   Foreign income tax may be claimed as a deduction from gross income or this may be claimed as tax credit against Philippine income tax. In the event that the taxpayer claims it as tax credit, he can no longer claim the same as deduction.

   If the law says that it is a deduction, can the taxpayer claim it as a tax credit and vice versa? No, except if the law allows the taxpayer to do the same, like in the case of foreign income tax.

3. Taxes which are not connected with the trade, business or profession of the taxpayer.
4. Estate tax
5. Donor's tax
6. Customs duties- they form part of the cost or the purchase price.

Tax as Deductions vs. Tax Credit

- Taxes as deductions may be claimed as deductions from gross income.

- Tax credit is a deduction from Philippine income tax due.

- Tax as deduction includes those which are paid or incurred in connection with the trade, business or profession of the taxpayer. However, the sources of a tax credit are foreign income tax paid, war profit, excess profit tax paid to the foreign country.

- The foreign income tax paid to the foreign country is not always the amount that may be claimed as tax credit because under the limitation provided under the Tax Code, it must not be more than the ratio of foreign income to the total income multiplied by the Philippine Income tax.

- Taxes are deductible only by the person upon whom the tax is imposed; except:
  1. Shareholder;
  2. Corporate bonds- tax free Covenant clause

The following are entitled to claim tax credit:

1. Resident Citizen
2. Domestic Corporation.

Why only the two? Because they are taxed on their worldwide income.

What is the consequence of a tax subsequently refunded or credited? Taxes previously allowed as deductions, when refunded or credited, shall be included as part of gross income in the year of receipt to the extent of the income tax benefit of said deduction.

Are taxes paid by non-resident alien engaged in trade or business and Resident Foreign Corporation deductible? In the case of a non-resident alien individual engaged in trade or business in the Philippines and a resident foreign corporation, deductions for taxes shall be allowed only if and to the extent that they are connected with income from sources within the Philippines.

TAX CREDIT

TAX CREDIT- Tax credit refers to the taxpayer's right to deduct from the income tax due the amount of tax he has paid to a foreign country subject to limitations.

Formula:

Gross Income
Less deductions
Net Income
X tax rate
Tax due
Less tax credit
Tax payable

Purpose of tax credit: to counteract the effects of double taxation.

What are the proofs of credits? The credit shall be allowed only if the taxpayer establishes to the satisfaction of the Commissioner the following:

1. The total of income from sources without the Philippines
2. The amount of income derived from each country, the tax paid or incurred to which is claimed as a credit; and
3. All other information necessary for the verification and computation of such credits.

Who can claim tax credit against tax for taxes of foreign countries? Credit may be claimed by a citizen, domestic corporation, member of general professional partnerships, and beneficiaries of estates and trusts.

An alien individual and a foreign corporation are not allowed to claim credits against the tax for taxes of foreign countries. **Why?** Because double taxation may not happen to alien individual and foreign corporation because they are only taxed on income derived from the Philippines.

Limitations on tax credit- The amount of the credit taken shall be subject to each of the following limitations:

1. The amount of the credit in respect to the tax paid or incurred to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's taxable income from sources within such country bears to his entire taxable income for the same taxable year; and

2. The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's taxable income from sources without the Philippines taxable under this Title bears to his entire taxable income for the same taxable year.

Central Luzon Drug Corp. Case: Involves the question whether the discounts given to senior citizens be claimed as deductions or tax credit.

Held: SC held that discount claimed by senior citizens shall not create tax credit but an allowable deduction.

Why the rule? Because tax credit is put at the bottom of the formula. Thus if the taxpayer has not tax liability, then the tax credit will be useless. Thus, it's better to treat it as a deduction because if the taxpayer gains a loss in the taxable year he can use NOLCO.

The taxpayer cannot refund the tax credit, since refund will ensue if it is allowed by law. In the Senior Citizens Act there is not grant for refunds of the discounts.

Problem:

I. Suppose you paid 100K net Income tax to US, can you claim as a deduction the whole 100K? What is the formula?

a. Formula
Step 1:
Net income tax: $\frac{\text{Gross Income from sources within}}{\text{Gross Income from entire world}}$

Step 2: quotient x Rate= amount which can be claimed as deduction.

b. Thus, you cannot claim the whole 100K, you can only claim the product of the quotient times the rate. This will be deduction at the bottom of the formula [sa computation ng Gross Income].

II. Suppose you are a Resident Citizen, you pay Net Income Tax to U.S., will you be able to deduct to claim it as tax deduction?

a. Generally, you can claim it as tax credit.
b. You can claim under Section 34 C (1) b

- If the taxpayer did not signify in his return his intention to avail himself of the benefit of the tax credit for taxes paid to foreign country.
- Taxes incurred not related to the trade or business, you have the option to:
  1. Claim it as tax credit; or
  2. Claim it as a deduction.

V. ORDINARY LOSSES

Losses imply an unintentional parting with an ordinary asset below its cost.

It is used in the income tax law in a very broad sense to comprehend all losses which are not general or natural to the ordinary course of business.

Requisites for deductibility of loss

1. The loss must be incurred in the trade, business or profession of the taxpayer;
2. It must be actually sustained and charged off within the taxable year;
3. It must be evidenced by a closed and completed transaction;

   Completed Transaction- this means that the loss must be fixed by identifiable event. Example: If it is a loss sustained from sale, the event may identify or complete the transaction is the consummation of the contract of sale.

   Casualty loss- Fire destroyed your property in 1995; no payment has been made because the insurer and the insured were still under negotiation. It was only in 1997 that they agreed on the amount. The amount agreed upon is P100, 000. The taxpayer may claim that casualty loss only in 1997 when payment was actually made. This is the event that will complete the transaction.

4. It must not be compensated for by insurance or other forms of indemnity.
5. If it is a casualty loss, the taxpayer has filed a sworn declaration of loss within 45 days after the date of the discovery of the casualty or robbery, theft, or embezzlement.
6. Not claimed as deduction for estate tax purposes [the law will not allow double deduction].

Losses of Branch of Office

- Loss of branch of office is deductible by the mother office since they form a single entity.
- Justified by the single entity concept.

Some recognized losses

1. Ordinary losses/business losses – sustained in the course of trade, business or profession
2. Casualty losses- notice must be made to the Bureau
3. Capital losses – involved are capital assets [cannot be deducted from gross income]
4. Securities becoming worthless
5. Losses from wash sales of stock or securities
6. Wagering losses/gambling losses- losses from wagering shall be allowed only to the extent of gains from such transactions.
7. Abandonment losses

Note: Capital losses and securities becoming worthless are governed by rules on loss from the sale or exchange of capital assets.

Non-deductible losses

1. Those transactions involving related taxpayers.
2. Losses arising from illegal transaction, such as in kidnapping.
3. Kickbacks and bribes
4. Wagering losses made in an illegal gambling.

KINDS OF LOSSES

1. **Casualty loss** - Loss arising from fires, storms, shipwreck, or other casualties, or from robbery, theft or embezzlement.

   Requisites:
   a. Establish the existence of casualty loss.
   b. This must be reported to the BIR within 45 days following the date of loss.

2. **Operating loss-** happens when the deductions is higher than the gross income. Apply NOLCO.

3. **Capital losses**
   - **Limitation:** Losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges.

4. **Losses Securities becoming worthless**
   a. Securities become worthless during the taxable year
   b. Securities are capital assets
   c. Losses are considered as losses from the sale or exchange, on the last day of such taxable year, of capital assets.

5. **Losses from wash sales of stock or securities-** No deduction for loss shall be allowed for wash sales unless the claim is made by a dealer in stock or securities and with respect to a transaction made in the ordinary course of the business of such dealer.

   What is a wash sale? A wash sale occurs where it appears that within a period beginning thirty (30) days before the date of the sale or disposition of shares of stock or securities and ending thirty (30) days after such date, the taxpayer has acquired (by purchase or exchange) or has entered into a contract or option to so acquire, substantially identical stock or securities.

6. **Wagering losses –** contemplates legal gambling, such as those operated by PAGCOR and LGU's.
   - Losses from wagering shall be allowed only to the extent of gains form such transactions.
   - The amount that is deductible must not exceed the gains.

7. **Abandonment losses.**

SPECIAL LOSSES – INCLUDE THE FOLLOWING:

1. **Abandonment losses**
   - In the event a contract area where petroleum operations are undertaken is partially or wholly abandoned, all accumulated exploration and

development expenditures pertaining thereto shall be allowed as a deduction.

- In case a producing well is subsequently abandoned, the unamortized costs thereof, as well as the undepreciated costs of equipment directly used therein, **shall not be allowed** as a deduction in the year such well, equipment or facility is abandoned by the contractor.

- **No NOLCO** because the operation was abandoned.

2. **Loss arising from voluntary removal of buildings as an incident to renewal or replacement**

   Problem: Supposed the taxpayer had a building constructed on a parcel of land. He owned this as well as the building erected thereon. He had business and his business was conducted within the premises. Then, he decided to remove such building as to construct a new building for new business.

   Is the cost of demolition to give way to a new building deductible loss? **YES.**

   Suppose A purchased that parcel of land of B and included in that sale was the building. A demolish this building in order to construct a new building. Is the cost of demolition deductible insofar as A is concerned? **NO.** That can only be claimed as deductions if the one demolishing the same is the taxpayer. The moment that is sold to another claim that as deductible loss. The treatment here is, the cost of demolition should be capitalized in the selling price.

   Exception: A may claim that as deductible loss if this was demolished by virtue of a court order because the gov't considered this as a fire hazard, loss of useful value of property or capital asset.

OPERATING LOSS

It means the excess of allowable deduction over gross income of the business in a taxable year.

OPERATING LOSS are losses incurred in the course of trade or business of the taxpayer. Net operating loss may be carried over by the taxpayer, whether corporate or individual, to the next three (3) consecutive years provided that during that year, such taxpayer is not exempt from taxation and there must be no substantial change in ownership of the corporation, in the case of the corporation. Substantial change may arise if less than 75% of the outstanding capital stock or paid up capital stock is held by the same person.

Case: The BOI registered industries are allowed to carry over operating losses. This time, those losses that were incurred during that period of 16 years operation may be carried over to succeeding taxable year.

General rule: expenses must be paid or incurred during the taxable year. You can claim those expenses as deduction during the year when the same were incurred or paid.

Exception: net operating loss carry-over and net capital loss carry-over**.**

NET OPERATING LOSS CARRY-OVER [NOLCO]

When a taxpayer avails optional standard deduction, he cannot avail of NOLCO. Why? Because if a taxpayer avails of OSD then there will always be a net income.

Duration: operating losses can be carried over within the next 3 succeeding taxable years.

Rule:

1) NOLCO shall be carried over as a deduction from the gross income for the next three (3) consecutive taxable years immediately following the year of loss.

2) Such loss shall be allowed as a deduction if it had not been previously offset as deduction from gross income.

3) However, any net loss incurred in a taxable year during which the taxpayer was exempt from income tax shall not be allowed as a deduction.

4) NOLCO shall be allowed only if there has been no substantial change in the ownership of the business or enterprise.

   There is no substantial change when:

   a. Not less than 75% in nominal value of outstanding issued shares, if the business is in the name of a corporation, is held by or on behalf of the same persons; or

   b. Not less than 75% of the paid up capital of the corporation, if the business is in the name of a corporation, is held by or on behalf of the same persons.

VI. DEPRECIATION

Depreciation means-

- Estimated value of the wear and tear of an asset.

- Depreciation is the gradual diminution in the useful value of tangible property used in trade, business or profession resulting from exhaustion, wear and tear, and obsolescence.

- The term is also applied to amortization of the value of intangible assets, the use of which in trade or business is definitely limited in duration.

- The income tax law does not authorize the depreciation of an asset beyond its acquisition cost. Hence, a deduction over and above the cost cannot be claimed and allowed. [**Basilan v. CIR,** 21 SCRA 17]

Purpose for deduction of depreciation: The idea here is not to recover profit, but to recover the cost of property invested in business. When the properties are used in trade, business or profession of the taxpayer, the law considers or recognizes the gradual loss or sale of property.

Depreciation is a question of fact- Depreciation is a question of fact and is not measured by a theoretical yardstick, but should be determined by a consideration of actual facts.

REQUISITES FOR DEDUCTIBILITY: [U P R A C]

1. The property must be **u**sed in trade, business or profession of the taxpayer;

2. There must be depreciable **p**roperties;

   The non-depreciable properties are:
   - **a.** Personal property not used in trade, business or profession of the taxpayer;
   - **b.** Inventoriable stocks and securities;
   - **c.** Land;
   - **d.** Mining and other natural **r**esources;

3. The allowance for depreciation must be reasonable;

4. The method in computing the allowance for depreciation must be in accordance with the method prescribed by the Secretary of Finance upon the recommendation of the BIR Commissioner.

   This prescribed methods includes:
   1. Declining balance method;
   2. Sum of the years digit method;
   3. Straight line method;
   4. Any other method as may be prescribed by the SEC of Finance upon the recommendation of the BIR Commissioner.

5. This must be **c**harged off during the taxable year.

DEDUCTION FOR OBSOLESCENCE- If the whole or any portion of the physical property is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its natural life, so that depreciation deductions alone would be insufficient to return the cost at the end of its economic terms of usefulness, reasonable deduction for obsolescence, in addition to depreciation, may be allowed.

PROPERTY HELD FOR LIFE- In case of property held by one person for life with remainder to another person, the deduction, shall be computed as if the life tenant were the absolute owner of the property and, shall be computed as such to the life tenant.

IN CASE OF PROPERTY HELD IN TRUST- Allowable deductions shall be apportioned between the income beneficiaries and the trustees in accordance with the pertinent provisions of the instrument creating the trust, or in the absence of such provisions, on the basis of the trust income allowable to each.

Certain methods in computing depreciation

1. **The straight line method** – Equal depreciation per unit of time, regardless of use or production output of the property.

2. **Declining balance method** – Amount of depreciation is subtracted annually from the cost of the property and the rate then only applied to the resulting balance.

3. **Sum of the year digit method** – application of a changing fraction to the taxpayer's cost basis for the property, reduced by the estimated residual salvage value.

4. **Unit of work or unit of production method** – A provision is made for equal depreciation per unit of use regardless of the lapse of time.

5. **Job basis method** – The allowance is computed as being equal to the difference between the cost of depreciation of the asset purchased for a particular job, and the salvage value at the end of the job.

6. **Retirement method** – The cost of the property retired each year is credited to the capital asset account and less net salvage value actual or estimated. Charged to expense in lieu of an annual provision for depreciation deductions.

7. Such other methods as may be allowed by the Sec. of Finance upon recommendation by the Commissioner.

AGREEMENT AS TO USEFUL LIFE ON WHICH DEPRECIATION RATE IS BASED

- Where the taxpayer and the commissioner have entered into an agreement in writing, specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the National Government in the absence of facts and circumstances not taken into consideration during the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification.

- Where the taxpayer has adopted such useful life and depreciation rate for any depreciable asset and claimed the depreciation expenses as deduction from his gross income without any written objection on the part of the commissioner or his duly authorized representative, the aforesaid useful life and depreciation rate so adopted shall be considered binding.

AMORTIZATION- refers to the depreciation of patent and copyright.

In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost or other basis of the patent or copyright.

The allowance should be computed by an apportionment of the cost or other basis of the patent or copyright over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or since March 1, 1913, as the case may be.

VII. DEPLETION OF OIL AND GAS WELLS AND MINES

- Depletion is the exhaustion of natural resources such as oil and gas wells and mines as a result of production or severance from such mines or wells.

- This involves natural resources such as oil, gas wells and mines since this are non-depreciable assets, but depletable assets.

- The requisites for deductibility are the same for depreciation except that the properties involved are natural resources.

- Purpose for depletion as allowable deduction: the idea is not for profit but to recover the cost of investment.

Determination of amount of depletion -In determining the amount of allowable depletion cost, the following three factors are essential, namely:

1. The basis for the cost of the property;
2. The estimated total recoverable units in the property; and
3. The number of units recovered during the taxable year in question.[Consolidated Mines V. CTA 58 SCRA 618]

Basis means the amount of the taxpayer's capital or investment in the property which he is entitled to recover tax-free during the period he is removing mineral in the deposit.

Intangible cost in petroleum operations- This refers to any cost incurred in petroleum operations which in itself has no salvage value and which is incidental to and necessary for the drilling of wells and preparation of wells for the production of petroleum.

Depletion and Depreciation

- Both are predicated upon the same basic premise of avoiding tax on capital.

- However, depletion is based upon the concept of the exhaustion of a natural resource, whereas, depreciation is based upon the concept of exhaustion of the property, not otherwise a natural resource, used in trade or business or held for the production of income. Thus, depletion and depreciation are made applicable to different types of assets.

VIII. CHARITABLE AND OTHER CONTRIBUTIONS

The amount of charitable contribution that may be claimed as deduction may be:

1. In the case of ***individual taxpayer:*** Not more than 10% of the net income before charitable contribution.
2. In the case of ***corporate taxpayer:*** Not more than 5% of the net income before the charitable contribution

10% or 5% of the net income donated is allowed as deduction- If the recipient of such contribution is any of the following Domestic Corporation formed or organized for: [REC]

1. Religious purpose and rehabilitation of veterans;
2. Educational purpose like educational corporations which are not qualified as NGO;
3. Charitable, cultural purpose;
4. Scientific, sports development and social welfare purpose.

Example: If an individual taxpayer has a gross income of P100,000 and the allowable deduction, except charitable contribution, is P50,000. The Charitable contribution is P5,000.

Deduction first P50,000 from P100,000 and the result is P50,000.

This P50,000 is the basis of that "10% or 5% of net income before charitable contribution". So, 10% of the P50,000 is P5,000. Hence, the actual contribution of P5,000 may be fully claimed as deduction.

But let us say, the amount of charitable contribution is P10,000. So, he can only deduct P5,000 as charitable contribution, and not the actual amount of P10,000 because the law imposes a limitation that the amount that may be claimed as deduction must not be more than 10% of net income before charitable contribution.

Who is claiming the deduction? Donor

Who are the donees?

1. Government of the Philippines or any of its agencies or any political subdivision thereof exclusively for public purpose;

2. Accredited domestic corporation or association organized and operated exclusively for religious, lions, charitable, scientific, youth, and sports development, cultural or educational purposes or for the rehabilitation of veterans, or to social welfare institution, or to non-government organization and no part of its net income inures to the benefit of any private stock holder or individual.

   Note: if the donee is a charitable institution or NGO, notice of donation must be given to the BIR per RR 2-2003.

What if the done is not one of those mentioned under the law, can the donor claim a deduction? No!

Note:

- Donee is **never an individual**.

- This allowable deduction is unique because it is deducted from the taxable net income and not from the gross income.

Illustration:

Gross income
Less allowable deduction
Net income
Less charitable contribution
Taxable income

If the Donor is a pure compensation income earner and he donates 100, 000 to the Church, can he claim it as a deduction? No, pure compensation income earner can only claim a deduction under Section 34 M [i.e. premium payments on health and/or hospitalization insurance of an individual taxpayer].

If the donee is the Government, what is the requirement? It must be made exclusively for public purposes.

What if the donee is a province? There must be a qualification that it is for public purpose.

If the donee is a domestic corporation? No part of its income inures to the benefit of any private shareholder or individual.

Kinds of charitable contributions

1. Ordinary or those which are subject to limitations as to the amount deductible from gross income.
2. Special or those which are deductible in full from gross income.

Requisite for deductibility of charitable contributions

1. The contribution must actually be paid, or made payable to the Philippine government or any political subdivision thereof, or any domestic corporation or association specified by the NIRC.

2. No part of the net income of the beneficiary must inure to the benefit of any private stockholder or individual.

3. It must be made within the taxable year.
4. It must not exceed 10% in case of an individual, and 5% in case of a corporation, of the taxpayer's taxable income (except when the donation is deductible in full) to be determined without the benefit of the contribution.

5. It must be evidenced by adequate records or receipts.

6. Annual administrative expense does not exceed 30% of the total expenses.

7. In case of dissolution [done corporation], the assets of which would be distributed to:
   a. Another non-profit domestic corporation organized for similar purpose;
   b. To the state for public purpose;
   c. Distributed by the court to another organization to be used in such manner which would accomplish the general purpose for within the dissolves organization was organized.

Contributions deductible in full

1. Donations to the Philippine Government or to any of its political subdivisions according to a national priority plan determined by the NEDA.
2. Donations to foreign institutions or international organizations which are fully deductible in pursuance of or in compliance with agreements, treaties or commitments entered into by the Philippines or in pursuance of special laws.
3. Donations to accredited non-governmental organizations.

Fully deductible contributions given to the following:

1. Government or its political subdivisions, agencies or instruments, for the purpose of undertaking priority projects of the government.

   These priority projects include:
   a) Sports and development, science and invention;
   b) Health and human settlement;
   c) Educational and economic development

   No conflict with partial deduction because they have different requirement;
   b. **Partial deduction-** donated for exclusively public purposes;
   c. **Full deduction-** donation is used in undertaking priority activities of NEDA.

2. **Foreign government or institution and international civic organizations** - This must be in compliance with agreement, treaties, or commitment entered into by the Philippine government and such donees.

3. **Accredited NGO -** NGO means non-profit domestic corporation which are formed and organized for any of the following purposes: [CHERS]
   - **a)** Research
   - **b)** Health
   - **c)** Education
   - **d)** Charitable, cultural, character building
   - **e)** Sports development and social welfare.

Non-governmental organization- It means a non-profit domestic corporation:

1. Organized and operated exclusively for scientific, research, educational, character-building, and youth and sports development, health, social welfare, cultural or charitable purposes, or any combination thereof, where no part of the net income of which inures to the benefit of any private individual.

2. Utilizes the contribution directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated not later than the 15th day of the month after the close of accredited NGO's taxable year in which the contribution were received.

3. Administrative expenses shall, in no case, exceed thirty percent (30%) of the total expense.

4. The assets, in the event of dissolution, would be distributed to another non-profit domestic corporation organized for a similar purpose, or to the state for public purpose, or would be distributed by a court to another organization.

Utilization

1. Any amount of cash or kind (including administrative expenses) paid or utilized to accomplish one or more purposes for which the accredited non-governmental organization was created or organized.

2. Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes for which the accredited non-governmental organization was created or organized.

Proof of deductions- Contributions or gifts shall be allowable deductions only if verified under the rules and regulations prescribed by the Sec. of Finance.

IX. RESEARCH AND DEVELOPMENT

Research is necessary especially in businesses which are highly competitive.

Research and development cost: should be capitalized, since it has something to do with the things you will sell in the future.

However, it will become a deduction if you will sell the articles which are the product of the research and you realized an income.

Duration: amortized the expense in 5 years from the date of research.

Requisites for deductibility:

1. It is paid or incurred during the taxable year;
2. Incurred in connection with trade, business, or profession;
3. Not chargeable to capital account.

THIS MAY NOT BE CLAIMED AS DEDUCTION IF THE AMOUNT IS:

1. Those spent for the acquisition or improvements of land or for the improvement or development of natural resources, or a character which is subject to depreciation and depletion.
2. Paid or incurred for the purpose of ascertaining the existence, location, extent or quality of any natural resources like deposits of ore or other minerals including oil or gas.

Amortization of certain research and development expenditures

Rule: at the election of the taxpayer, the following shall or may be treated as deferred expenses:

1. Paid or incurred by the taxpayer in connection with his trade, business or profession;
2. Not treated as expenses and;
3. Chargeable to capital account but not chargeable to property of a character which is subject to depreciation or depletion.

The election or option may be exercised for any taxable year after the effectivity of the Code but not later than the time prescribed by law for filing the return for such taxable year.

How to compute taxable income? Deferred expenses shall be allowed as deduction ratably distributed over a period of not less than 10 months as may be elected by the taxpayer [begins with the month the taxpayer first realizes benefits from expenditures].

X. PENSION TRUSTS

Who can claim the deduction? Employer.

What is a pension trust contribution? A deduction applicable to employer on account of its contribution to a private pension plan for the benefit of its employee. The deduction is purely business in character.

Requisites for the deductibility of payments to pension trusts

1. The employer must have established a pension or retirement plan to provide for the payment of reasonable pensions to his employees.
2. The pension plan is reasonable and sound.
3. It must be funded by the employer.
4. The amount contributed must no longer be subject to the control or disposition of the employer.
5. The payment has not been allowed as deduction.
6. The deduction is apportioned in equal parts over a period of ten (10) consecutive years beginning with the year in which the transfer or payment was made.

Contribution to pension trust may refer to the current year or past years.

CURRENT YEAR- this is considered as ordinary & necessary expenses

Employer may also make a contribution to the pension plan in regard to the services rendered for the past 10 years.

XI. PREMIUMS PAID FOR HOSPITALIZATION INSURANCE

- It is the premium paid which is deductible and not the hospitalization expenses itself.
- Maybe claimed by compensation earner.

Amount deductible:

XII. OTHER FORMS OF DEDUCTIONS [Section 37 NIRC]

1. Special deductions allowed to insurance companies
2. Mutual insurance companies
3. Mutual marine insurance companies
4. Assessment insurance companies
5. Estates and trust
6. Private education institutions

INSURANCE COMPANIES - Whether domestic or foreign, doing business in the Philippines, they are allowed to deduct, in addition to the itemized deductions under section 34 of the tax code, the following:

1. Net additions, if any, required by law to be made within the year to reserve funds, and
2. Sums other than dividends paid within the year or policy and annuity contracts. The released reserve shall be treated as income for the year of release.

MUTUAL INSURANCE COMPANIES - These are companies [other than mutual life and mutual marine] are allowed to deduct from gross income the following:

1. Any portion of the premium deposits returned to the policy holders;
2. Such portion of the premium deposits as are retained for the payment of losses, expenses, and reinsurance reserves.

MUTUAL MARINE INSURANCE COMPANIES - They are entitled to deduct from gross income the following:

1. Amounts repaid to policy holders on account of premium previously paid by them; and
2. Interest paid upon those amounts between the ascertainment date and the date of its payment.

ASSESSMENT INSURANCE COMPANIES - Whether domestic or foreign, they may deduct is a taxable year the sum actually deposited with the officers of the government of the Philippines, pursuant to law as additions to guarantee or reserve funds.

BAR 1998- Deduction: Facilitation Fees or "kickback"- MC Garcia, a contractor who won the bid for the construction of a public highway, claims as expenses, facilitation fees which according to him is standard operating procedure in transactions with the government. Are these expenses allowable as deduction from gross income? [5%]

Suggested answer: No. The alleged facilitation fees which he claims as standard operating procedure in transactions with the government comes in the form of bribes or "kickback" which are not allowed as deductions from gross income *(Section 34(A)(l)(c), NIRC)*.

BAR 2001- Deductions: Amount for Bribe- In order to facilitate the processing of its application for a license from a government office, Corporation A found it necessary to pay the amount of Php 100,000 as a bribe to the approving official. Is the Php 100,000 deductible from the gross income of Corporation A? On the other hand, is the Php 100,000 taxable income of the approving official? Explain your answers. (5%)

Suggested answer: Since the amount of Phpl00.000 constitutes a bribe, it is not allowed as a deduction from gross income of Corporation A, *(Section 34(A)(l)(c), NIRC)*. However, to the recipient government official, the same constitutes a taxable income. All income from legal or illegal sources are taxable absent any clear provision of law exempting the same. This is the reason why gross income had been defined to include income from whatever source derived. *(Section 32(A), NIRC)*. Illegally acquired income constitutes realized income under the claim of right doctrine *(Rutkin v. US, 343 US 130)*.

SPECIAL INCOME TAX TREATMENT OF GAINS AND LOSSES FROM DEALING IN PROPERTY

Rule one capital gains and losses- Capital losses can be offset only against and to the extent of capital gains.

Capital losses cannot be deducted from ordinary gains or income. This principle applies to all types of taxpayers [corporate or individual]. Capital losses are deductible only to the extent of capital gains.

Gains derived from dealings in property form part of Gross Income (Sec. 32 A. no. 3)

1. This may include sale or exchange of goods or properties.
2. If the property is sold for cash, that is considered as **sale.**
3. If it property for another property, this may be classified as **exchange** [Barter]**.**

What are ordinary assets?	What are capital assets?
1. Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year. **2.** Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. **3.** Property used in the trade or business, of a character which is subject to the allowance for depreciation. **4.** Real property used in the trade or business of the taxpayer. **5.** Depreciable properties used in business. Subject to normal tax	**1.** All properties not used in trade or business are considered capital asset. **2.** Property held by the taxpayer, whether or not connected with his trade or business, which is not an ordinary asset Subject to 6% capital gains tax.

ORDINARY GAIN OR INCOME- Ordinary income or gain includes any gain from the sale or exchange of property which is not a capital asset.

CAPITAL GAIN OR INCOME- Capital gain or income is any gain from the sale or exchange of a capital asset.

TAX RATE: *6% FINAL RATE*

- On the gross selling price or current fair market value prevailing at the time of the sale whichever is higher.
- The tax is payable within 30 days from the sale or disposition.
- Payment is condition precedent for the registration of the sale.
- In foreclosure sales, the tax shall be on the selling price at the foreclosure sale.

Transactions that may be subjected to Capital gains Tax

1) Real Estate dealers

- The 6% Final rate is ***not applicable***.
- Gain from the sale of real property is treated as ordinary income.
- Loss, is deductible from the gross income, but not from compensation income.

2) Shares of stock of domestic corporation

a) Stocks not listed, or sale not effected through the stock exchange:
   i. 5% of first P100,000
   ii. 10% of excess of P100,000

b) Listed and traded in the stock exchange:
   - ½ of 1%, regardless of the resulting gain or loss

c) Initial public offering
   i. 4% if 25% of stocks is offered
   ii. 2% if over 25% to 33%
   iii. 1% if over 33%

3) Sale or exchange is voidable or rescissible

- The sale or exchange is valid until annulled.
- Tax is legally due, and should be paid.

If annulled: No rebate or refund. The tax had already accrued and no supervening event will constitute a ground for recoupment.

If sale or exchange is void:

- Tax did not legally accrue.
- Rebate or refund is proper.

NET CAPITAL GAIN- Net capital gain means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.

NET CAPITAL LOSS- Net capital loss means the excess of the losses from sales or exchanges of capital assets over the gains from such sales or exchanges.

CALAZANS VS. CIR

Facts: The taxpayer inherited the property from her father and at the time of the inheritance it was considered a capital asset. In order to liquidate the inheritance, the taxpayer decided to develop the land to facilitate the sale of the lots.

Issue: was the property converted to ordinary asset?

Held: The conversion from capital asset to ordinary asset is allowed because section 39 is silent.

Are you allowed to convert ordinary asset to capital asset? *General rule*: it is not allowed, as per Revenue Regulation 7-2003. The case supra still applies despite of the issuance of said RR.

What is the conversion prohibited by the RR? Conversion of real estate property.

What are the properties involved in the RR 7-2003?

1. Those property for sale by realtors
2. Real property use in trade or business not necessarily realtors.

Is there an instance when an ordinary asset may be converted to capital asset? Yes, provided that the property is an asset other than real property, and it has been idle for two years.

What is the benefit of converting ordinary asset to capital asset? ***Section 40D***- final income tax of 6% if the real estate is capital asset: if it is an ordinary asset, it will be subject to income tax of 32% of the taxpayer is an individual and 35% if the taxpayer is a corporation.

GENERAL RULE ON THE RECOGNITION OF GAIN OR LOSS UPON THE SALE/ EXCHANGE OF PROPERTY

General rule: the entire amount of the gain or loss, as the case may be, shall be recognized, i.e. taxable or deductible.

Exceptions:

1. **Transactions where gains and losses are not recognized**
   - **a.** Exchange of property where the property received is not substantially different from the property disposed of. [Section 140, Reg. No.2]
   - **b.** Exchange of property solely in kind in pursuance of corporate mergers and consolidations. Stock for stock.
   - **c.** Exchange by a person of his property for stocks in a corporation as a result of which said person, alone or together with others not exceeding four persons, gains control of said corporation.

2. **Transactions where gain is recognized but not the loss**
   - **a.** Transactions between related taxpayers
   - **b.** Illegal transactions
   - **c.** Wash sales by non-dealers by securities and when not subject to the stock transfer tax
   - **d.** Sales and exchanges that are not in arm's length
   - **e.** Exchanges of property, not solely in kind, in pursuance of corporate mergers and consolidations

In determining the gain or loss in the sale or exchange of property, this is the basic formula:- "Amount received or realized **LESS** Cost or adjusted basis."

How to determine the cost or adjusted basis? It depends upon the manner of acquisition.

1. **If it was acquired through purchase, it is the cost of the property.**

   Example: I sell a property in the amount of P100, 000. I previously purchased the same at P60, 000, this P60, 000 is the cost of property.

2. **If the property sold was previously acquired through inheritance, it is the fair market value (FMV) of the property at the time of the acquisition.**

   - **"At the time of acquisition"** means at the time of the death of the decedent or testator.

3. **If the property sold was acquired through donation, the basis shall be the same as if it would be in the hands of the donor.**

   Situation: A, the donor donated property to B, the donee. Subsequently, such donated property was sold by the donee for P200,000. What must be the cost?

   Answer: The law says, the same basis in the hands of the donor. So, the donee should ask the donor the basis.

   It is also that A, the donor acquired the property from another either through purchase or donation. So, you should ask A, the last donor, his basis.

   Exception to the general rule: If the basis is greater than the FMV of the property at the time of the donation/gift then, for the purpose of determining loss, the basis shall be such FMV.

4. **If the property sold was acquired for less than an adequate consideration in money or money's worth, the basis of such property is the amount paid by the transferee for the property.**

   Situation: The seller acquired the property from A in the amount of P70, 000. The FMV of said property is P100, 000. So, the seller here is the transferee and A is the transferor. The seller sold the property at P200, 000. What must be the cost?

   Answer: It is the amount paid by the transferee. And the amount paid by the transferee who subsequently sold the property is P70, 000. So, he will have a gain of P130, 000.

   Remember, it is not the FMV of the property but the amount paid by the transferee.

RULES REGARDING OTHER CAPITAL ASSSETS

This rule does not apply **to sale of capital asset and sale of share of stock considered as capital assets** since by default they are subject to capital gains tax which is already fixed by law.

1. **CAPITAL LOSS LIMITATION RULE**
   - Meaning: capital losses are deductible only to the extent of capital gain.

- So, it follows that if there is no capital gain, there is no deductible losses.

- Capital loss cannot be deducted from ordinary gain.

- **However, there is no prohibition that ordinary loss be deducted from capital gain, since capital gains form part of the gross income.**

Note: This rule **applies to individual and corporate taxpayers EXCEPT** on **banks and trust companies** because they are considered as dealer in securities as far as issuance of bond and evidence of indebtedness are concerned.

Rationale: in any kind of deduction, there must be proper matching of income and expenses.

2) HOLDING PERIOD RULE

- The determination of gain or loss depends on the length of the holding period.

- Under this rule, if the property has been held by the taxpayer for a period of not more than 12 months, the gain or loss is 100% recognized. If it is more than 12 months, the gain or loss is 50% recognized.

- So, the gain or loss may be 100% or 50% taxable deductible as the case may be.

- This rule is applicable **only to individual taxpayers**. This is so because the capital gain derived from capital transaction of corporate taxpayers is always 100% recognized irrespective of the number of months during which the property was in the possession of the corp. taxpayer.

  Example: You sell your personal car. This is a capital transaction because the asset involved is a capital asset. Let us say that you sell the car at P200,000 and the cost of the car is P150,000. Here, there is a gain of P50,000.

  You must find out the date of the acquisition and the date of sale or disposition. If the date of acquisition and the date of sale fall within the 12 month period, this P50,000 100% taxable. But if exceeding 12 months, this P50,000 is 50% taxable.

When will the holding period not apply?

1. Property is an ordinary asset
2. Taxpayer is a corporation
3. Sale of real property considered as ordinary asset.

3) NET CAPITAL LOSS CARRY-OVER: This rule applies only to **individual taxpayers**.

Rule: Capital losses can be carried over against capital gains within the next succeeding **taxable year** in an **amount not to exceed the value of the net profit in the year where the capital loss was sustained**.

Example: In 1996, the capital gain is P100,000 and capital loss is P200,000. So, there is a capital loss of P100,000 which may be carried over in 1997 by the taxpayer. This net capital loss in 1996 may be claimed as deductions from the capital gain in 1997.

But if in 1996 the net income is P150,000 and the net capital loss is P100,000, so the net capital loss does not exceed the net income. The entire amount of P100,000 net capital loss can be carried over in 1997.

Can that P100, 000 net capital loss be carried over in 1998? NO, because the law says during the "succeeding taxable year". Tax exemption must be strictly construed against the taxpayer and liberally in favor of the govt.

SPECIAL CAPITAL TRANSACTIONS - Deemed capital transactions

1) Failure to exercise option to sell or buy property.
2) Distribution of assets or shares of stock to stockholders upon liquidation of a corporation.
3) Readjustment of a partner's interest in a partnership.
4) Retirement of bonds.
5) Short sale

I. FAILURE TO EXERCISE OPTION TO BUY

a. **No exercise or the right**- rule on capital gain/loss applicable.
b. **Right of option to buy was exercised**- option money form part of the selling price thus considered ordinary gain.

Requisites for Taxability

1. Taxpayer is an individual ;
2. Paid in the immediate succeeding year;
3. Applies only to short term capital gain;
4. Capital loss should not exceed net income in the year that it was incurred.

II. Gains and losses from short sales, etc. - Gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets.

What is a short sale?

- This is also considered as Capital Transaction.
- It is a sale of shares of stocks when the dealer is not yet the owner of the property/ shares of stock.
- Short sale is really **an obligation payable not in cash but in goods.** The seller of securities or stock will decline. And if it declines, he earns profit. However, if the price of securities increases, he incurs loss.
- **Example:** I borrow your securities on June 10 and I'll pay it on June 15. The price of securities on June 10 is P50 and you speculate that said price will decline on June 15. On June 15, the price has been lowered to P40. So, you earn a profit of P10 because I will pay my obligation at P50 on June 15 and not P40.

Tax consequence of short sale:

- If there is a gain, the gain is taxable. We call this Capital Gain.
- If there is a loss, the loss is deductible.

WASH SALE vs. SHORT SALE

- BOTH may be classified as **Capital Transactions.**
- The basic distinction is in wash sale, the loss that may be incurred is not deductible, whereas in short sale, the loss is deductible.

WASH SALES

- the loss that may be incurred is not deductible
- Not applicable to dealers of stocks or securities since their stocks are not considered capital assets.

30 days ***30 days***

Sold stocks ——|—— bought substantially identical stocks

1

Requisites for non-deductibility

1. the sale or other disposition of stocks or securities resulted in a loss;
2. there was an acquisition, or contract or option for acquisition of stock or securities within 30 days before the sale or 30 days after the sale; and
3. The stock or securities sold were substantially the same as those acquired within the 61 day period.

   - The word acquired means acquired by purchase or by an exchange and comprehends cases where the taxpayer has entered into contract or option within the 61 day period to acquire by a purchase of by such exchange.
   - Substantially identical- means that the stock must be of the same class, or in the case of bonds, the terms thereof must be the same.

The following are not substantially identical:

1. Common share and the preferred stock of the same corporation;
2. A non-voting stock and a stock with voting power;
3. The stock of the corporation and the stock of another corporation; and
4. Two series of bonds where one is secured by a mortgage and the other is not or which differ as to interest rates.

INSTALLMENT SALES AND DEFERRED SALES

- Contemplates the seller of property.
- Payment of tax be instalment.

Is it important to know if the property is personal or real? Yes.

In case of sale of real property is it important to know if it is a casual sale or regular sale? No, the only requirement is that the initial payments do not exceed 25% of the selling price.

What if the initial payment exceeds 25% of the selling price? What do you call the transaction? You must pay the whole amount of tax. It is called deferred sale.

In case or sale of personal property, is it important to know if it is casual or regular sale?

- Yes.
- Casual sale; requirements:
  - **a.** Selling price exceeds P1, 000. 00
  - **b.** Initial payment not exceeding 25% selling price.
- Regular sale: no requirement.

Initial payment- means the payment received in cash or property other than evidences of indebtedness of the purchaser during the period in which the sale or other disposition is made.

In payment by way of instalment promissory note, bills of exchange and checks will not be considered in computing the 25% initial down payment.

As a **general rule**, the whole profit accruing from a sale of property is taxable as income in the year the sale is made. But if not all the selling price was received during such year, and a statute provides that income shall be taxable in the year in which it is received, the profit from an instalment sale is to be apportioned between or among the years in which such instalments are paid and received.

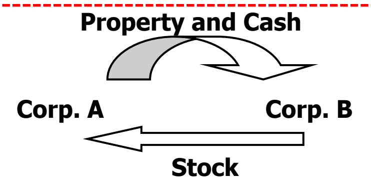
GAIN TAXABLE, LOSS NOT DEDUCTIBLE

- **Transaction: W.I.R.N.**
  1. Wash Sale
  2. Illegal transactions
  3. Those transactions involving Related taxpayers
  4. Transactions Not solely in kind.

Transaction solely in kind – this means that there are other consideration given other than those mentioned under transactions solely in kind (nos. 1 and 2 above, but cash is added).

Example: Corporation A [party to the merger] in a merger or consolidation transfers its cash and property to Corporation B, also a party to such merger or consolidation. Corporation B, in exchange, transfers its stocks to Corporation A.

Illustration:



Property: 50, 000
Cash: 50, 000
Total: 100, 000

FMV – Stock: P100,000

Let us say that FMV of stock given by Corp. B is P100, 000. The value of the property transferred by Corp. A is P50, 000 while cash is also P50,000.

So if you add all of these, the amount received or realized is P200, 000.

Now, you deduct the cost of the stock disposed of. Let us say that the cost of stock is P80,000. So, Corp. B derived gain of P120,000. **Is this taxable?**

Answer: YES, but only P100, 000 is taxable. This is so because of the limitation that it must not exceed the total cash and the FMV of the property. And if you add the FMV of the property and the total cash given, the total is P100, 000.

Under the law, there is that limitation in transactions which involves not only the property but also cash. The gain is recognized or taxable but the taxable gain must not exceed the cash given and the FMV of the property which forms part of the consideration.

On the other hand, supposed the cost of stock disposed of or transferred to Corp. A is P250, 000. So, there is a loss of P50, 000, is this recognized or deductible? NO.

If this property received under these transactions which is not solely in kind is subsequently disposed of, how do you determine the basis of that?

Answer: The basis of the property in the hands of the transferor less the FMV of the property, less cash received plus the gain recognized, if any, plus the dividend that may be treated as such, if there is any.

Basis in the hands of the transferor
Less: FMV of the property
Cash received

Plus: Gain recognized, if any
Dividend recognized, if any

MERGER OR CONSOLIDATION- Mergers or consolidations shall be understood to mean the (a) ordinary merger or consolidation of (b) the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock.

Such merger or consolidation must be undertaken for a *bona fide* business purpose and note solely for the purpose of escaping the burden of taxation.

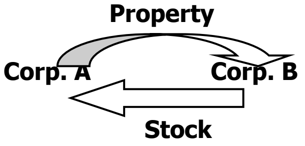
NO GAIN, NO LOSS RECOGNIZED - The basic rule is, in the sale or exchange of property if there is a gain, the gain taxable; If there is loss, the loss is deductible.

EXCEPTION TO THE BASIC RULE (NO GAIN OR LOSS SHALL BE RECOGNIZED):

1. **Transactions made pursuant to plan of merger or consideration.** Sometimes, we call this **"Tax Exempt Transactions"** or **"Transactions Solely in Kind".**

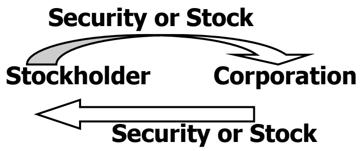
   a. A corporation, party to merger or consolidation exchanges its properties solely for stock in corp., which is a party to the merger or consolidation.

   Illustration:



   b. A stockholder of a corp. party to a merger or consolidation exchanges his stock solely for stock in another corp. party to that merger or consolidation.

   Illustration:



   1. Stock for Stock

   2. Securities for stock

   3. Securities for Securities

   Sometimes, the above-mentioned transactions are called **"Transactions solely in kind"** or **"Tax Exempt Transactions".**

2. If a person alone or together with others or not exceeding four (4) (so, the total number should be five (5) exchanges his property for stock in a corp. and this person or persons, after this exchange, acquired controlling interest over that corp. This means that they acquired at least 15% of the shares of stock of such corp.

   This is also a transaction solely in kind.

Question: Suppose these persons, at the time of transaction, already acquired controlling interest over such corp., is the transaction or exchange taxable?

Answer: Even if these persons acquired controlling interest at the time of the transaction, the rule is still applicable in which case that is still tax exempt.

Question: So, if these properties acquired under this tax exempt transactions are subsequently disposed of, how will you determine the basis?

Answer: The basis of the stock or properties acquired under this no gain, no loss recognized shall be the same basis in the hands if the transferor.

TAXATION INCOME OF INDIVIDUAL TAXPAYERS

How are individuals taxed? Individual citizens, both resident and non-resident, and an individual resident alien, are taxed similarly.

A non-resident alien engaged in trade or business shall be subject to the same income tax rates as a citizen and a resident alien.

Thus, only a non-resident alien who is not engaged in trade or business is taxed differently from other individual taxpayers.

On what income taxed? A resident citizen is taxed on all income derived from sources within and without the Philippines. The tax base is net income.

A non-resident citizen is taxed only on income derived from sources within the Philippines. The tax base is net income.

An alien, whether a resident or not, is taxed only on income from sources within the Philippines. However, the tax base for a resident alien and non-resident alien engaged in trade or business is net income, while the tax base for a non-resident alien not engaged in trade or business is gross income.

When a Non-resident Citizen returns to the Phils, his income may also be taxed as Resident citizen or Non-resident citizen.

Illustration:

A an OCW, arrived in the Philippines sometime in June 1998. He will be taxed as a non-resident citizen as regards to the income which he earned that covers the period from January to June, however, with respect to the income that he may earn from the period of his arrival in June until December, he will taxed as a Resident Citizen.

If the Non-resident citizen is not in the Philippines from the period of January to December, he will be taxed as a Non-resident citizen for that period, if he, however, returns and stays in the Philippines from January to December, he will be taxed as a Resident citizen for that period.

The Non-resident citizen must prove to the satisfaction of the Commissioner the fact of physical presence abroad with the intention of residing therein.

When a Non-resident citizen returns to the Philippines, he must prove his intention to reside here permanently.

Now, the term Non-resident citizen, includes: ***overseas contract workers, immigrants, and those who stay outside the Philippines due to employment.***

TYPES OF INCOME TAXED

1. Items of income included in the gross income.
2. Passive income.
3. Capital gains from sale of shares of stock not traded in the stock exchange.
4. Capital gains from the sale or exchange of real property

Where an individual has all three categories of income

1. Compensation income
2. Taxable net income
3. Passive income subject to final tax

In this case what shall the taxpayer do? The taxpayer shall treat separately his liability on each of such incomes.

KINDS OF INDIVIDUAL TAXPAYERS

TAX ON INDIVIDUAL CITIZEN [RESIDENT AND NON-RESIDENT] AND INDIVIDUAL RESIDENT ALIEN

Items of income included in the gross income- A schedular rate of five percent (5%) to P125,000 + 32% of excess over P500,000, by January 1, 2000, is imposed on items of income of an individual citizen and individual resident alien which are properly included in the gross income.

Rates of tax on certain passive income

1. Interest from any currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements – 20%
2. Royalties, except on books, as well as other literary works and musical compositions – 20%
3. Royalties on books literary works and musical compositions – 10%
4. Prizes over P10,000 – 20%

   Note: *Prizes less than P10,000 are included in the income tax of the individual subject to the schedular rate of 5% up to P125,000 +32% of excess of P500,000*

5. Other winnings, except PCSO and Lotto, derived from sources within the Philippines – 20%
6. Interest income derived by a resident individual (Note: non-resident citizen not included) from a

depositary bank under the expanded foreign service deposit system – 7.5%

7. Interest income from long term deposit or investment evidenced by certificates prescribed by BSP:
   a. Exempt, if investment is held for more than 5 years

   b. If investment is pre-terminated, interest income on such investment shall be subject to the following rates:

   20% - If pre-terminated in less than 3 years
   12% - If pre-terminated after 3 years to less than 4 years.
   5%- If pre-terminated after 4 years to less than 5 years.

8. Cash and/or property dividends

   10% FINAL TAX, BY JANUARY 1, 2000, ON THE FOLLOWING:

   a. Cash and or property dividend actually or constructively received from a domestic corporation or from a joint stock company, insurance or mutual fund companies and regional operating headquarters of multinational companies.

   b. Share of an individual in the distributive net income after tax of a partnership except a general professional partnership of which he is a partner

   c. Share of an individual in the net income after tax of an association, joint account, or a joint venture or consortium taxable as a corporation of which he is a member or a co-venturer

9. Cash rewards for informants – 10%

	RC, NRC, RA	NRA-ETB	NRA-NETB
ROYALTIES	20% *except in the case of literary works, books and musical compositions which are subject to 10% final tax*	Same as RC, NRC, RA	25 %
PRIZES exceeding P10,000.00 *If it is P10,000.00 or less, it is NOT subject to final tax but the same must be included in other income* (e.g. compensation, business, professional)	20%	20%	25 %
WINNINGS *except PCSO & Lotto*	20%	20%	25 %
INTERESTS ON BANK DEPOSITS, etc.	20%	20%	25 %
DIVIDENDS RECEIVED from domestic corp., etc.	Subject to increasing rates of 6% if received in 1998; 8% in 1999; and 10% in 2000.	20%	25 %
SHARE OF A PARTNER in the net income after a tax of a taxable partnership, etc.	- do- 6, 8 & 10	20%	25 %

I. **RESIDENT CITIZEN-** taxed in all of its income, whether derived within or without the Philippines, unless it is exempt.

II. **NON-RESIDENT CITIZEN-** taxed on income derived within the Philippines, unless such income is exempt.

Three types of no-resident citizens

1. Immigrants;
2. Employees of foreign entities in a permanent basis;
3. Overseas contract workers.

Immigrants and employees of foreign entities in a permanent basis are treated as non-resident citizens from the time they depart from the Philippines.

However overseas contract workers must be physically present abroad most of the time during the calendar year to qualify as a non-resident citizen. The phrase *'most of the time'* means at least 183 days during the calendar year. His presence abroad, however need not be continuous.

BAR 1999- Personal; Income Tax: Non-Resident Citizen - A Co., a Philippine corporation, has an executive (P) who is a Filipino citizen. A Co. has a subsidiary in Hong Kong (HK Co.) and will assign P for an indefinite period to work full time for HK Co. P will bring his family to reside in HK and will lease out his residence in the Philippines. The salary of P will be shouldered 50% by A Co. while the other 50% plus housing, cost of living and educational allowances of P's dependents will be shouldered by HK Co. A Co. will credit the 50% of P's salary to P's Philippine bank account. P will sign the contract of employment in the Philippines. P will also be receiving rental income for the lease of his Philippine residence. Are these salaries, allowances and rentals subject to the Philippine income tax? (5%)

SUGGESTED ANSWER: The salaries and allowances received by P are not subject to Philippine income tax. P qualifies as a non-resident citizen because he leaves the Philippines for employment requiring him to be physically present abroad most of the time during the taxable year. *(Section 22(E), NIRC).* A non-resident citizen is taxable only on income derived from Philippine sources. *(Section 23, NIRC).* The salaries and allowances received from being employed abroad are incomes from without because these are compensation for services rendered outside of the Philippines. *(Section 42, NIRC).*

However, P is taxable on rental income for the lease of his Philippine residence because this is an income derived from within, the leased property being located in the Philippines. *(Section 42, NIRC).*

III. ALIENS- classified into resident and non-resident alien.

1. **RESIDENT ALIEN-** taxed on income derived within the Philippines.

2. **NON-RESIDENT ALIEN INDIVIDUAL-** classified into non-resident alien engage in trade or business in the Philippines and non-resident alien not engage in trade or business in the Philippines.

NON-RESIDENT ALIEN ENGAGED IN TRADE OR BUSINESS - A non-resident alien engaged in trade or business shall be subject to the same income tax rates as a citizen and a resident alien.

Exception: Cash and/or property dividends received by a non-resident alien *Individual* shall be subject to a final tax of 10% since year 2000.

Remuneration received by a non-resident alien as president of a domestic company taxable in the Philippines (Ms. Juliane Baier-Nickel, as represented by Marina Q. Guzman v. CIR, CTA Case No. 5514 dated 4/29/99)

A consultant, president of a domestic company or person involved with "product development" is subject to Philippine Income taxation. Any remuneration received would stem from her employment as company president and thus, negates her allegation that she is just a sales agent who receives commissions. While petitioner tried to show that she stayed in the country for less than 180 days, her remuneration in the form of commissions is still taxable in the Philippines since it is borne by a permanent establishment in the Philippines.

BAR 2000- Personal; Income Tax: Non-Resident Alien- Mr. Cortez is a non-resident alien based in Hong Kong. During the calendar year 1999, he came to the Philippines several times and stayed in the country for an aggregated period of more than 180 days. How will Mr. Cortez be taxed on his income derived from sources within the Philippines and from abroad? (5%)

SUGGESTED ANSWER: Mr. Cortez being a non-resident alien individual who has stayed for an aggregated period of more than 180 days during the calendar year 1999, shall for that taxable year be deemed to be a non-resident alien doing business in the Philippines. Considering the above, Mr. Cortez shall be subject to an income tax in the same manner as an individual citizen and a resident alien individual, on taxable income received from all sources within the Philippines. *[Sec. 25 (A) (1), NIRC of 1997]*

Thus, he is allowed to avail of the itemized deductions including the personal and additional exemptions but subject to the rule on reciprocity on the personal exemptions. *(Sec. 34 (A) to (J) and (M) in relation to Sec. 25 (A) (1), Ibid, Sec. 35 (D), Ibid.]*

NOTE: It is suggested that full credit should be given if the examinee's answer only cover the first two paragraphs.

BAR 1991- Newtex International [Phils], Inc is an American firm duly authorized to engage in business in the Philippines as branch office. In its activity of acting as a buying agent for foreign buyers of shirts and dresses abroad and performing liaison work between its home office and the Filipino garment manufacturers and exporters, Newtex does not generate any income. To fiancé its office expenses here, its head office abroad regularly remits to it the needed amount. To oversee its operation for two years, the head office assigned 3 foreign personnel.

Are the 3 foreign personnel subject to Philippine income tax?

SUGGESTED ANSWER: the 3 foreign personnel are subject to tax on the income that they receive for services rendered in the Philippines. Non-resident aliens are subject to tax on income from sources within the Philippines. Income is deemed derived from sources within the country when it is earned for services rendered in the Philippines.

NON-RESIDENT ALIEN NOT ENGAGED IN TRADE OR BUSINESS - A non-resident alien individual not engaged in trade or business shall pay a tax equivalent to 25% on all items of income, ***except***, for gain on sale of shares of stock in any domestic corporation and real property which shall be subject to the same rate applied to other individual taxpayers.

Gain on sale of shares of stock:

1. Not over P100,000 - 5%
2. Over P100,000 -10%

Capital gains on sale or disposition of property **–** 6% of GSP or FMV, whichever is higher.

OTHER INDIVIDUAL TAXPAYERS

1. Alien individual employed by regional or area headquarters and regional operating headquarters of multinational companies.

2. Alien individual employed by offshore banking units.

3. Alien individual employed by petroleum service contractor and sub-contractor.

Note: The salaries, wages, annuities, compensation, remuneration and other emoluments, such as honoraria and allowance received by these individuals and their Filipino counterparts occupying the same position as these alien individuals shall be subject to 15% tax.

All other income derived by these individuals shall be subject to the same rate as that of other individual taxpayers.

REGIONAL OR AREA HEADQUARTERS-A regional or area headquarters is a branch established in the Philippines by multinational companies and which headquarters do not earn or derive income from the Philippines and which acts as supervisory, communications and coordinating center for their affiliates, subsidiaries, or branches in the Asia-Pacific region and other foreign markets.

REGIONAL OPERATING HEADQUARTERS- A regional operating headquarter shall mean a branch established in the Philippines by multi-national companies which are engaged in certain specified services, i.e. general administration and planning, business planning and coordination, sourcing and procurement or raw materials and components, among others.

TAXATION OF OBU EMPLOYEES (BIR RULING NO. 147-98 DATED OCT.16 1978)-The 15% preferential rate shall apply only in cases where an alien concurrently holds a position similar to that of the Filipino employee. Thus, this preferential tax treatment shall not apply where the counterpart expatriate is recalled to the head office or reassigned elsewhere, whether temporarily or otherwise, and only Filipinos are the ones so employed by an OBU for the time being or where the post vacated by the expatriate is subsequently assumed by a Filipino to replace the expatriate, as a result of which all top management posts are now being occupied by Filipinos.

FILIPINO STAFF OF THE ADB SUBJECT TO 15% PREFERENTIAL TAX RATE (NO. 29-99, 3/11/99)- Filipino employees occupying managerial or technical positions as those of aliens employed by the Asian Development Bank (ADB), which is not only a regional or area headquarters in the Philippines but the headquarters itself, are subject to the preferential tax rate of 15% on their gross compensation income pursuant to Sec. 25 C, of the NIRC, 1997.

GENERAL PROFESSIONAL PARTNERSHIPS - General professional partnerships are partnerships formed by persons for the sole purpose of exercising their common profession, no part of the income of which is derived from engaging in any trade or business.

Persons engaged in business as partners in a general professional partnership shall be liable for income tax only on their separate and individual capacities.

Each partner shall report as gross income his distributive share, actually or constructively received, in the net income of the partnership.

The net income of the general professional partnership shall be computed in the same manner as a corporation for purposes of computing the distributive shares of the partners.

DEDUCTIONS ALLOWED ONLY TO INDIVIDUAL TAXPAYERS

1. Personal exemption
2. Additional exception
3. Premium payments on health and/or hospitalisation insurance – if the taxpayer has no compensation income, this can be claimed as deduction from gross income from business, trade or profession.

PREMIUMS ON HEALTH AND HOSPITAL INSURANCE

Limitations:

1. It must not be more than 2, 400. 00 a year. In other words, 200. 00 a month.
2. The family must have an income of not more than 250, 000. 00 a year
3. The claimant must be the spouse claiming the additional exemption.

Premiums on life insurance policy are also included here because it is included under the health insurance policy.

If taxpayer has no compensation income, these deductions may be claimed against the gross income of his business, trade, or profession.

BASIC PERSONAL EXEMPTIONS

Personal exemptions are arbitrary amounts allowed, in the nature of a deduction from taxable income, for personal, living or family expenses of an individual taxpayer. They are considered to be the equivalent of the minimum of subsistence of the taxpayer.

Who are allowed personal exemptions?

1. Citizens
2. Resident aliens
3. Non-resident aliens engaged in trade or business in the Philippines under certain conditions
4. Estates and trusts, which are treated for purposes of personal exemptions, as a single individual

Are estates entitled to basic personal exemptions? Yes up to 20K only.

Amount of personal exemptions allowed to citizens and resident aliens

- P50, 000. 00 whether single or married.
- Only the spouse deriving taxable income can claim the P350000 personal exemption; if both have taxable income, each can claim P50,000 exemption.

HEAD OF THE FAMILY - It means an unmarried or legally separated man or woman with one or both parents, or with one or more brothers or sisters, or with one or more legitimate, recognized natural or legally adopted children living with and dependent upon him or her for their chief support.

Such brothers or sisters or children should be not more than 21 years old, unmarried and not gainfully employed, or where such children, brothers or sisters, regardless or are, are capable of self-support because of mental or physical defect.

A head of family is an individual who actually supports and maintains in one household one or more individuals, who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation.

Note: Consider discrepancy between definition of *"head of family"* and *"dependent"* i.e. children.

To be a head of a family, one or more **legitimate, recognized natural or legally adopted children** must live with and depend on an unmarried or legally separated man or woman.

A dependent, on the other hand, may be a **legitimate, illegitimate or legally adopted child.**

Both, however, define or qualify different terms.

Living with- The term *"living with"* the person giving support does necessarily mean actual and physical dwelling together at all times and under all circumstances.

Family- The term *"family"* includes an unmarried or legally separated person with:

1. one or both parents;
2. one or more brothers or sisters; or
3. One or more legitimate, recognized natural, or legally adopted children living with and dependent upon him or her for their chief support.

Head of the family – unmarried man or woman legally separated man or woman who has the following qualified dependents:

1. **Parents-** one or both parents. Must be living with the taxpayer and dependent upon the taxpayer for chief support. They must be the natural parents of the taxpayer.

2. **Brothers or sister**- to be qualified they must be:
   a) Living with the taxpayer
   b) Dependent upon the taxpayer for chief support;
   c) Unmarried;
   d) Not gainfully employed;
   e) Not more than 21 years old except if physically or mentally incapacitated and who is a brother or sister of the taxpayer. [One sibling is enough]

3. **Children-** must be legitimate, illegitimate, legally adopted or stepchildren

   Conditions:
   a. Living with the taxpayer;
   b. Dependent upon the taxpayer for chief support;
   c. Unmarried;
   d. Not gainfully employed
   e. Not more than 21 years old except if physically or mentally incapacitated.

ADDITIONAL EXEMPTION

A married person or a head of a family may claim an additional exemption of P25, 000 for each dependent, not exceeding four (4).

The additional exemption shall be claimed by only one of the spouses in the case of married individuals. It is the husband that should claim the additional exemption except if the husband waives the same of he is a NINJA [no income, no job or asset☺☺☺] or the husband's income is subject to final taxes.

In the case of legally separated spouses, it may be claimed only by the spouse who has custody of the child or children.

Sir Barlis: if seems that there is a prejudice to married individuals. Why? In the case of unmarried persons who lives as husbands and wife. Pedro and Petra are unmarried but living as husband and wife.

Suppose that they have 4 dependent children living with them, is it possible for Pedro to claim additional exemption for the 4 children, and Petra also claim additional exemption for the 4 children? Yes there is no prohibition, since distinction between illegitimate and legitimate children is immaterial. The law requires only that the dependent children lives with the parents.

That is the prejudice since, in case of married individuals, only one of them can claim the additional exemption.

Insight: so if you're so concern about your tax then do not marry ☺☺☺

DEPENDENT- Refers only to the legitimate, illegitimate or legally adopted child of the taxpayer

1. The child is:
2. living with the taxpayer;
3. chiefly dependent upon the taxpayer for support;
4. not more than 21 years of age;
5. not married; and
6. Not gainfully employed or, even though over 21 years old, incapable of self-support because of mental or physical defect.

Dependent is considered ***living with the taxpayer*** even if the former or the latter are not physically together if that is brought about by force of circumstances. Example if one of the parents will have to work abroad.

Chief support- means more than 50% of the needs of the dependents are provided by the taxpayer.

Problem: If the child or the brother/sister got married and then he has found to be physically or mentally incapacitated, so bumalik si dependent sa tatay for chief support, can he qualify as dependent?

Answer: No, physical or mental defect applies only to age requirement. Once the child or brother/sister got married, he is automatically disqualified as dependent.

There is a provision in the Tax Code, which is not so clear. For purposes of ***head of the family,*** in the case of natural children or child, there is that word ***"acknowledged or recognized".***

For purposes of the definition of head of the family, it is clear that to qualify as dependent, the natural child or legitimate child must be acknowledged or recognized by the taxpayer.

But in the definition of the dependent, ***dependent*** means legitimate, illegitimate or legally adopted child or children. There is no word acknowledged or recognized.

Was this deliberately omitted by our Congressmen? Does this imply that since they have so many illegitimate children, they may not be required to acknowledge or recognize them and they can claim this illegitimate child as their dependent? This is not clear. If we will try to interpret the law literally, there is no need of any recognition on the part of the taxpayer.

Is this really the intention of law? No. The intention of the law has always been to recognize this illegitimate child and this is one way of compelling the taxpayers to recognize this child.

Problem:

CHANGE OF STATUS

- Taxpayer marries or have additional dependents
- Taxpayer dies during the taxable year
- If the spouse or any of the dependents dies or if any of such dependent marries, becomes 21 years old, or becomes gainfully employed

Note: As a general rule, interpret in favour of taxpayer. Presumed that the change of status transpired at the end of the taxable year.

There is a change of status when:

1. Death of spouse during the taxable year;
2. Death of dependent during the taxable year;
3. Death of the taxpayer during the taxable year; estate of the taxpayer may claim the basic personal exemption;
4. Additional dependent during the taxable year;
5. Taxpayer got married during the taxable year;
6. Gainful employment during the taxable year;
7. Dependent became more than 21 years old during the taxable year.

Even if the above-mentioned change of status happened during the taxable year, the taxpayer may still claim the basic personal exemption because it is as if the change of status happened at the end of the taxable year.

The ***President of the Republic of the Phils. cannot issue an executive order to increase the basic personal exemption*** because the provision under the Old Tax Code authorizing the President to increase the personal and additional exemption upon the recommendation of the Sec. of Finance has been removed or deleted by RA 8424.

Now, you can only increase the amount of personal and additional exemption by legislative enactment.

PERSONAL EXEMPTIONS TO NON-RESIDENT ALIEN INDIVIDUAL

- Only personal exemption
- Non-resident alien individual engaged in trade or business
- Entitled only to personal exemption
- Amount allowed is limited to exemptions granted to Filipino citizens who are not residents in the alien's domicile country – but not to exceed the amount allowed to citizens or residents of the Philippines in the NIRC.

Legend: / - *available*; **X** – *not available*

	R.C.	N.R.C.	R.A.	NRA-NTB	NRA-NETB
Personal Exemption	/	/ within	/ within	/ Subject to the rule on reciprocity. But it must not exceed the maximum allowable personal exemption.	X
Additional Exemption	/	/ within	/ within	X Rule on reciprocity does not apply.	X

ITEMS NOT DEDUCTIBLE

1. Personal, living or family expenses;
2. Capital expenditures
   a. Any amount paid out for new buildings or for permanent improvements, or betterments made to increase the valued of any property or estate
   b. Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made
3. Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, individually or corporate, when the taxpayer is directly or indirectly a beneficiary under such policy [Section 36, NIRC];
4. Losses between related taxpayers;
5. Losses on wash sales;
6. Illegal expense i.e. bribes, kickbacks, and other similar payments [Section 34 (A) (1) (c), NICR].

ITEMS NOT DEDUCTIBLE

1. **Personal, living and family expenses** *are deductible* for the simple reason that these are not connected with the business, trade or profession of the taxpayer. In lieu of the same, the taxpayer may claim the so-called "Personal and Additional Exemption" in the case of individual taxpayers.

2. **Capital expenditures**
   a. Any amount paid out for new buildings or for permanent improvements, or betterments made to increase the value of any property or estate.
   b. Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made
   c. Cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense
   d. The amount expended for architect's services is part of the cost of the building
   e. Expenses of the administration of an estate such as court costs, attorney's fees, and executor's commissions are chargeable against the *"corpus"* of the estate and are not allowable deductions
   f. In case of a corporation, expenses for organizations, such as incorporation fees, attorney's fees and accountant's charges are ordinarily capital expenditures, but where such expenditures are limited to purely incidental expenses, a taxpayer may charge such items against income in the year in which they are incurred. [Section 120, Revenue Regulations, 2]

3. ***Life or health insurance and other non-life insurance premiums or similar amounts in excess of what the law allows***

General rule: The cost of life or health insurance and other non-life insurance premiums borne by the employer for his employee shall be treated as taxable fringe benefit.

Exceptions

1. Contribution of the employer for the benefit of the employee pursuant to the provisions of existing law, i.e. SSS, GSIS, among others
2. The cost of premiums borne by the employer for the group insurance of his employees. [Revenue Regulations 3-98]

RULES:

- *Premiums paid on the insurance policy of the officer or employee may be claimed as deduction by the employer,*If the beneficiary is the family or the heirs of the officer or the employee.

- *It is not deductible on the part of the employer,* If the beneficiary designated directly or indirectly is the employer. *If the beneficiary designated is the creditor or the heirs of the employer,* the designation is indirect; hence, that premium is not deductible.

- On the other hand, on the part of the employees, these premiums may be a taxable compensation income. *It is taxable compensation income on* *the part of the employee* if the beneficiary designated is the family of heirs of the employee.

- ***Therefore,*** *if these premiums are deductible on the part of the employer, that is taxable on the part of the employee. If these premiums are not deductible on the part of the employer, that is not taxable on the part of the employee.*

4. RELATED TAXPAYERS

a) Between members of a family (which shall include only his brothers and sisters, spouse, ancestors and lineal descendants)
b) Between an individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual – except in the case of distributions in liquidation
c) Between two corporations more than 50% in value of the outstanding stock of each of which is owned, directly or indirectly by or for the same individual
d) Between the grantor and the fiduciary of a trust
e) Between the fiduciary of a trust and the fiduciary of another trust if the same person is a grantor with respect to each trust
f) Between the fiduciary of a trust and a beneficiary of such trust [Section 36(B), NIRC]

Relevant points regarding related taxpayers

1. Payment of interests is not deductible.
2. Bad debts are not deductible.
3. Losses from sales or exchanges of property are not deductible.

RETURNS AND PAYMENT OF TAX

Who are required to file individual returns?

1. Every Filipino citizen residing in the Philippines
2. Every Filipino citizen residing outside the Philippines, on his income from sources within the Philippines
3. Every alien residing in the Philippines, on income derived from sources within the Philippines
4. Every non-resident alien engaged in trade or business or in the exercise of a profession in the Philippines

Who are not required to file individual returns?

1. An individual whose gross income does not exceed his total personal and additional exemptions.

   However, a Filipino citizen and any alien individual engaged in business or practice of profession within the Philippines shall file an income tax return, regardless of the amount of gross income.

2. An individual with respect to pure compensation income derived from sources within the Philippines, the income tax on which has been correctly withheld.

   However, an individual deriving compensation concurrently from two or more employees at any time during the taxable year shall file an income tax return.

   Further, an individual whose pure compensation income derived from sources within the Philippines exceeds P60, 000 shall also file an income tax return.

3. An individual whose sole income has been subjected to a final withholding tax.

4. An individual who is exempt from income tax pursuant to the NIRC and other laws, general or special.

WHERE TO FILE

1. Authorized agent bank
2. Revenue District Officer
3. Collection agent
4. Duly authorized Treasurer of the city or municipality in which such person has his legal residence or principal place of business in the Philippines
5. Office of the Commissioner if there be no legal residence of place of business in the Philippines

WHEN TO FILE

- On or before April 15 of each year covering income from the preceding taxable year
- Thirty (30) days from each transaction and a final consolidated return on or before April 15 covering all stock transactions of the preceding year in case of sale or exchange of shares or stock not traded through a local stock exchange.
- Thirty (30) days following each sale or other disposition in case of sale or disposition of real property

HUSBAND AND WIFE - Married individuals, whether citizens, resident or non-residents aliens, who do not derive income purely from compensation, shall file a return for the taxable year to induce the income of both spouses.

However, if it is impracticable for the spouses to file one return, each spouse may file a separate return of income but the returns so filed shall be consolidated by the BIR for purposes of verification for the taxable year.

RETURN OF PARENT TO INCLUDE INCOME OF CHILDREN- The income of unmarried minors derived from property received from a living parent shall be included in the return of the parent, except:

1. When the donor's tax has been paid on such property; or
2. When the transfer of such property is exempt from donor's tax.

SELF-EMPLOYED INDIVIDUALS

Declaration of income tax for individuals

Every individual subject to income tax, who is receiving self-employment income, whether it constitutes the sole source of his income or in combination of salaries, wages and other fixed or determinable income, shall make and file a declaration of his estimated income for the current taxable year on or before April 15 of the same taxable year.

Non-resident Filipino citizens with respect to income from without the Philippines and non-resident aliens not engaged in trade or business in the Philippines are not required to render a declaration of estimate income tax.

SELF-EMPLOYMENT INCOME- Self-employment income consists of the earnings derived by the individual from the practice of profession or conduct of trade or business carried on by him as a sole proprietor or by a partnership of which he is a member.

Return and payment of estimate income tax by individuals- The amount of estimated income shall be paid in four (4) instalments.

Estimated tax

- Estimated tax means the amount which the individual declared as income tax in his final adjusted and annual income tax return for the preceding taxable year minus the sum of the credits allowed against the said tax.

- If, during the current taxable year, the taxpayer reasonably expects to pay a bigger income tax, he shall file an amended declaration during any interval of instalment payment dates.

Can a taxpayer pay his tax liability in installment? Yes, if the tax liability does not exceed 2, 000. 00

CORPORATE INCOME TAX

CORPORATE TAXPAYER- Corporation, includes, partnerships no matter how created or organized, joint account companies, or insurance companies and other associations.

It excludes:

1. General Professional Partnerships;

2. Joint venture for the purpose of undertaking construction projects;

3. Joint consortium for the purpose of engaging in petroleum, geothermal and other energy operations pursuant to a consortium agreement with the government.

What about country clubs or polo clubs? Although they are non-stock corporations, their services are not devoted for charitable activities but to luxurious activities.

Usually, they cater to whim and caprices of rich people. May golf course sa loob, hotel sa loob etc…

Saint Luke Hospital Case- it was organized as Non-stock Corporation. Income is taxable since it is not devoted for charitable purposes, Dito nga nagpapagamot ang mga mayayaman sa Pilipinas.

Bottomline: even if the structure is for Non-stock Corporation such entity is not automatically exempt. It is the activity of the entity that makes it tax exempt. The activity must for charitable purposes.

KINDS OF CORPORATE TAXPAYER

I. RATES OF INCOME TAX ON DOMESTIC CORPORATIONS

In General

- Rate of tax, in general:
  1997 – 35%
  1998 – 34%
  1999 – 33%
  Current rate– 30%

- Tax is imposed on taxable or net income.

- These rates are not applicable if the amount corresponding to the rates is lower than 2% of the gross income of such corporate income taxpayer. This is called the "***Minimum Corporate Income Tax".***

OPTIONAL 15% TAX ON GROSS INCOME

- The President, upon the recommendation of the Secretary of Finance, may, effective Jan. 1, 2000, allow corporations the option to be taxed at ***15%*** of gross income, provided certain conditions are satisfied.

- This is available to firms whose ratio of cost of sales to gross sales or receipts from all sources do not exceed 55%.

- Once elected by the corporation, the option shall be irrevocable for the succeeding three consecutive years.

Conditions to be satisfied for the availability of the 15% optional corporate tax:

1. A tax effort ratio of twenty percent (20%) of the Gross National Product;
2. A ratio of 40% between total income tax collection and to total tax revenues;
3. A VAT tax effort ratio of 4% of the Gross National Product;
4. A 0.9% ration between the Consolidated Public Sector Financial Position to the GNP.

TAX RATE FOR PROPRIETARY EDUCATIONAL INSTITUTIONS AND HOSPITALS

- 10% on taxable income, except of certain passive incomes.

- **Predominance test** – The ordinary rate on corporations shall apply to proprietary educational institutions and hospitals when their gross income form unrelated trade, business or other activity exceeds 50% of their total gross income derived from all sources.

UNRELATED TRADE, BUSINESS OR OTHER ACTIVITY- This means any trade, business or other activity, the conduct of which is not substantially related to the exercise or performance by such educational institution or hospital of its primary purpose or function.

PROPRIETARY EDUCATIONAL INSTITUTION- A proprietary educational institution is any private school maintained and administered by private individuals or groups with an issued permit to operate from the DepEd, CHED, or TESDA, as the case may be.

GOCCs, AGENCIES OR INSTRUMENTALITIES- All corporations, agencies or instrumentalities owned or controlled by the government shall pay such rate of tax upon their taxable income as are imposed upon corporations or associations engaged in a similar business, industry, or activity.

Exceptions: GOCCs and instrumentalities not subject to tax are the ff:

1. GSIS
2. SSS
3. Phil Health Insurance Corporation
4. PCSO
5. PAGCOR

RATES ON CERTAIN PASSIVE INCOME SUBJECT TO FINAL TAX

1. Interest from deposits and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements – 20%

2. Royalties – 20%

3. Interest income derived from a depositary bank under the expanded foreign currency deposit system – 7 ½%

4. Capital gains from sale of shares of stock ***not*** traded in the stock exchange
   - **a.** Not over P100,000 – 5%
   - **b.** Over P100,000 - 10%

5. Tax on income derived by a depositary bank under the expanded foreign currency deposit system from foreign currency transactions – 10%

   Note: This is different from interest income. This pertains to the income derived by the depositary bank itself.

   Note: Any income of non-residents, whether individuals or corporations, from transactions with a depositary bank under the expanded system is ***exempt from income tax.***

6. Intercorporate dividends – exempt

7. Capital gains realized from sale, exchange or disposition of lands and or buildings – 6%

Sale of corporate real property that has ceased to be used in trade or business subject to 6% capital gains tax- A final tax of 6% is imposed on the gains presumed to have been realized in the sale, exchange or disposition of lands and/or buildings which are not actively used in the business of a corporation and which are treated as capital assets based on the gross selling price or fair market value, whichever is higher.

MINIMUM CORPORATE INCOME TAX [MCIT]

MCIT is 2% of the gross income. The ***minimum corporate income tax*** rule means that the taxpayer must pay income tax not lower than the 2% of its gross income. If the tax liability on the net income is lower than 2%, then the 2% should be paid, however, if the tax liability on the net income is higher than the 2%, then the actual tax liability should be paid.

- **Is MCIT an additional tax for corporations?** No it is only a modification of tax for corporations. MCIT is targeting corporations which are always declaring losses.

- **Applicable-**
  - **a.** Only to Domestic Corporations and Resident Foreign Corporations; and
  - **b.** Such corporation is subject to ordinary corporate income tax rate of 30%.
  - **c.** It shall **begin on the fourth taxable year immediately following the year in which such corporation commenced its business operations, when the minimum income tax is greater than the regular corporate income tax for the taxable year**.

Example: If a corporate taxpayer has a gross income of P20M, two percent of that would be P400, 000. If the gross income is P20M, and the deductions are P19M, we only have P1M as net or taxable income. Multiply that by 32%, thereby coming up with P320, 000; this amount should be the tax payable, if not for the rule that corporate taxpayers should pay a minimum of 2% of their gross income. Since the 2% on the gross income is higher than the 32% on the net income, the 2% or P400, 000, should be paid.

CARRY FORWARD OF EXCESS MINIMUM TAX – Any excess of the minimum corporate income tax over the normal income tax shall be carried forward and credited against the **normal income tax** payable for the **next three years immediately succeeding the taxable years** in which the minimum corporate income tax was paid.

Relief from the minimum corporate income tax under certain conditions- The Sec. of Finance may suspend the imposition of the minimum corporate income tax on any corporation which suffers losses on account of:

1. Prolonged labor dispute;
2. force majeure;
3. Or because of legitimate business reverses.

If ordinary tax is higher do not forget MCIT. If MCIT is higher forget about ordinary tax.

TAX TIP: if you availed MCIT, do not declare all your deduction on the next succeeding year so that your ordinary tax will go higher and you can carry over the excess of MCIT.

Example:

2012- GI of 1M & deduction of 900K. Taxable net income of 100K.

100K x 32%= 320, 000 - ordinary tax
100K x 2%= 400, 000 – MCIT

For 2012- MCIT will be used since it is higher than the ordinary tax rate. However the difference [80K] between MCIT and tax due using ordinary rate will be credited against tax liability via ordinary rate if ordinary rate was used on the succeeding year when the MCIT was used.

2013- GI of 1M & deduction of 600K. Taxable net income of 400K.

400K x 32%= 128K –ordinary rate
400K x 2%= 80K - MCIT

For 2013 Ordinary rate will apply, the 80K which is the difference between MCIT and tax due via ordinary rate will be credited against the tax liability for 2013.

Thus, the tax liability for 2013 will be-

128, 000
- 80, 000
48, 000- tax liability for 2013.

Bar 2001- Rationale Minimum Corporate Income Tax - What is the rationale of the law in imposing what is known as the Minimum Corporate Income tax on Domestic Corporations? (3%)

SUGGESTED ANSWER: The imposition of the Minimum Corporate Income Tax (MCIT) is designed to forestall the prevailing practice of corporations of over claiming deductions in order to reduce their income tax payments. The filing of income tax returns showing a tax loss every year goes against the business motive which impelled the stockholders to form the corporation. This is the reason why domestic corporations (and resident foreign corporations) after the recovery period of four years from the time they commence business operations, they become liable to the MCIT whenever this tax imposed at 2% of gross income exceeds the normal corporate income tax imposed on net income. (Sponsorship Speech, Chairman of Senate Ways and Means Committee).

BAR 2001- Minimum Corporate Income Tax; Exemption - Is a corporation which is exempted from the minimum corporate income tax automatically exempted from the regular corporate income tax? Explain your answer. (2%)

SUGGESTED ANSWER: No, the minimum corporate income tax is a proxy for the normal corporate income tax, not the regular corporate income tax paid by a corporation. For instance, a proprietary educational institution may be subject to a regular corporate income tax of 10% (depending on its dominant income), but it is exempt from the imposition of MCIT because the latter is not intended to substitute special tax rates. So is with PEZA enterprises, CDA enterprises etc…

[**Note:** If what is meant by regular income tax is the 32% tax rate imposed on taxable income of corporations, the answer would be in the affirmative, because domestic corporations and resident foreign corporations are either liable for the 2% of gross income (MCIT) or 32% of net income (the normal corporate income tax) whichever is higher.]

ALTERNATIVE ANSWER: No. A corporation which is exempted from the minimum corporate income tax is not automatically exempted from the regular corporate income tax. The reason for this is that MCIT is imposed only beginning on the fourth taxable year immediately following the year in which such corporation commenced its business operations. Thus, a corporation may be exempt from MCIT because it is only on its third year of operations following its commencement of business operations.

Meaning of gross income and cost of goods sold under minimum corporate income tax (Sec. 27 E) compared with the meaning of gross income and cost of goods sold under Sec. 27 A

	Section 27 A	**Section 27 E**
Gross Income	Equivalent to gross sales less sales returns, discounts and allowances and cost of goods sold.	
Cost of goods sold	Includes all business expenses directly incurred to produce the merchandise to bring them to their present location and use	

Cost of goods sold on a trading or merchandising concern	Includes all costs of production of finished goods, such as raw materials used, direct labor and manufacturing overhead, freight cost, insurance and other costs incurred to bring the raw materials to the factory or warehouse.	
Gross income for taxpayers engaged in the sale of service	Gross receipts less sales returns, allowances and discounts	Gross receipts less sales returns, allowances and discounts and cost of service
Cost of services		All direct costs and expenses necessarily incurred to provide the services required by the customers and clients including: a. Salaries and employee benefits of personnel, consultants and specialists directly rendering the service and, b. Cost of facilities directly utilized in providing service such as depreciation and rental or equipment used and cost of supplies. For banks it includes interest expense.

Note: definition of gross income for taxpayers engaged in the sale of service includes "cost of services" in MCIT but not in the case of the optional 15% tax on gross income (Sec. 27 A NIRC).

II. TAX ON RESIDENT FOREIGN CORPORATIONS

Resident Foreign Corporation

- A resident foreign corporation is one organized, authorized, or existing under the laws of any foreign country, engaged in the trade or business within the Philippines.

- In order that a foreign corporation may be regarded as doing business within a state, there must be continuity of conduct and intention to establish a continuous business, such as the appointment of a local agent, and not one of temporary character.

- **Rate of tax, in general:**
  1997 – 35%
  1998 – 34%
  1999 – 33%
  2000 onwards – 32%

- Tax is imposed on taxable or net income.

- These rates are not applicable if the amount corresponding to the rates is lower than 2% of the gross income of such corporate income taxpayer. This is called the "***Minimum Corporate Income Tax" (same as with domestic corporation)***

- ***Optional 15% tax on gross income –*** The option to be taxed at 15% on its gross income is also available to Resident Foreign Corporations, subject to the same conditions.

Available to firms whose ratio of cost of sales to gross sales or receipts from all sources does not exceed 55%.

TAX ON SPECIFIC RESIDENT FOREIGN CORPORATIONS

1. **International Carrier** – 2 ½ of Gross Philippine Billings

2. **Offshore Banking Units** - 10% of income derived from foreign currency transactions with local commercial banks, including branches of foreign banks that may be authorized by the BSP to transact business with offshore banking units, including any interest income derived from foreign currency loans granted to residents

   Any income of non-residents, whether individuals or corporations, from transactions with said offshore banking units shall be exempt from income tax.

3. **Tax on branch profits remittances** – 15% of total profits applied or earmarked for remittance without deduction for the tax component thereof.

4. Regional or area headquarters shall not be subject to income tax

5. Regional operating headquarters shall be subject to a tax of 10% of their taxable income.

GROSS PHILIPPINE BILLINGS FOR INTERNATIONAL CARRIERS

- "Gross Philippine Billings" refer to the amount of gross revenue derived from carriage of persons, excess baggage, cargo and mail originating from the Philippines in a continuous and uninterrupted flight, irrespective of the place of sale or issue and the place of payment of the ticket or passage document.

- Tickets revalidated, exchanged and/or endorsed to another international airline form part of the Gross Philippine Billings of the passenger boards a plane in a port or point in the Philippines.

- For a flight which originates from the Philippines, but transhipment of passenger takes place at any port outside the Philippines on another airline, only the aliquot portion of the cost of the ticket corresponding to the leg flown from the Philippines to the point of transhipment shall form part of the Gross Philippine Billing.

GROSS PHILIPPINE BILLINGS FOR INTERNATIONAL SHIPPING- "Gross Philippine Billings" means gross revenue whether for passenger, cargo or mail, originating from the Philippines up to final destination, regardless of the place of sale or payments of the passage or freight documents.

ARE INCOME FROM SALE OF TICKETS IN THE PHILIPPINES BY AIRLINES WITHOUT LANDING RIGHTS TAXABLE THEREIN? Yes!

BRITISH OVERSEAS AIRWAYS CORP VS. CIR

April 30, 1987

Facts: British Overseas Airways Corp (BOAC) is a 100% British Government-owned corporation engaged in international airline business and is a member of the Interline Air Transport Association, and thus, it operates air transportation services and sells transportation tickets over the routes of the other airline members.

From 1959 to 1972, BOAC had no landing rights for traffic purposes in the Philippines and thus, did not carry passengers and/or cargo to or from the Philippines but maintained a general sales agent in the Philippines - Warner Barnes & Co. Ltd. and later, Qantas Airways - which was responsible for selling BOAC tickets covering passengers and cargoes. The Commissioner of Internal Revenue assessed deficiency income taxes against BOAC.

Issue: Whether the revenue derived by BOAC from ticket sales in the Philippines, constitute income of BOAC from Philippine sources, and accordingly taxable.

Held: The source of an income is the property, activity, or service that produced the income. For the source of income to be considered as coming from the Philippines, it is sufficient that the income is derived from activity within the Philippines. Herein, the sale of tickets in the Philippines is the activity that produced the income. The tickets exchanged hands here and payment for fares was also made here in the Philippine currency.

The situs of the source of payments is the Philippines. The flow of wealth proceeded from, and occurred within Philippine territory, enjoying the protection accorded by the Philippine government. In consideration of such protection, the flow of wealth should share the burden of supporting the government. Off-line air carriers having general sales agents in the Philippines are engaged in or doing business in the Philippines and that their income from sales of passage documents here is income from within the Philippines. Thus, in that case, we held the off-line air carrier liable for the 32% tax on its taxable income.

This ruling was affirmed by South African Airways vs. CIR.

SOUTH AFRICAN AIRWAYS VS. CIR

February 16, 2010

Facts: Petitioner South African Airways is a foreign corporation organized and existing under and by virtue of the laws of the Republic of South Africa. Its principal office is located at Airways Park, Jones Road, Johannesburg International Airport, South Africa. In the Philippines, it is an internal air carrier having no landing rights in the country. Petitioner has a general sales agent in the Philippines, Aerotel Limited Corporation (Aerotel). Aerotel sells passage documents for compensation or commission for petitioner's off-line flights for the carriage of passengers and cargo between ports or points outside the territorial jurisdiction of the Philippines. Petitioner is not registered with the Securities and Exchange Commission as a corporation, branch office, or partnership. It is not licensed to do business in the Philippines. It paid a corporate tax in the rate of 32% of its gross billings. However it subsequently filed for refund contending that its income should be taxed at the rate of 2 1/2% of its gross billings.

Issues: whether or not petitioner's income is sourced within the Philippines and is to be taxed at 32% of the gross billings?

Held: Yes! In the instant case, the general rule is that resident foreign corporations shall be liable for a 32% income tax on their income from within the Philippines, except for resident foreign corporations that are international carriers that derive income "from carriage of persons, excess baggage, cargo and mail originating from the Philippines" which shall be taxed at 2 1/2% of their Gross Philippine Billings. Petitioner, being an international carrier with no flights originating from the Philippines, does not fall under the exception. As such, petitioner must fall under the general rule. This principle is embodied in the Latin maxim, *exception firmat regulam in casibus non exceptis*, which means, a thing not being excepted must be regarded as coming within the purview of the general rule.

To reiterate, the correct interpretation of the above provisions is that, if an international air carrier maintains flights to and from the Philippines, it shall be taxed at the rate of 2 1/2% of its Gross Philippine Billings, while international air carriers that do not have flights to and from the Philippines but nonetheless earn income from other activities in the country will be taxed at the rate of 32% of such income.

BRANCH REMITTANCE TAX

On the imposition of branch remittance tax, a distinction must be made regarding a branch and a subsidiary corporation.

Branch office- is an extension of a corporation in another country. The only way that it remits profits to its principal is through branch profit remittance.

Subsidiary corporation- it is registered in the SEC. they only way that it will remit profit to its mother corporation is only through the declaration of dividends.

It is not subject to Branch Remittance tax, but to dividends tax of 30%.

Branch remittance tax is a tax of 15% of the branch profit earmarked or applied to be remitted.

TAX ON BRANCH PROFIT REMITTANCES - Any profit remitted by a branch to its head office shall be subject to a tax of 15% which shall be based on the total profits applied or earmarked for remittance without any deduction for the tax component thereof except those activities which are registered with the Philippine Economic Zone Authority.

The following shall not be treated as branch profits unless the same are effectively connected with the conduct of its trade or business in the Philippines:

1. Interests
2. dividends
3. rents
4. royalties
5. remuneration for technical services
6. salaries
7. wages
8. premiums
9. annuities
10. emoluments
11. Other fixed or determinable annual, periodic, or casual gains, profits, income and capital gains.

Illustration: X- USA has a branch in the Philippines- X Phil Branch. X Phil Branch has an income of 100M. It plans to remit 50M to X-USA. What are the imposable taxes?

Answer: a 30% corporate tax on the 100M income of X Phil branch and a 15% branch remittance tax on 50M which will be remitted to X-USA. Thus-

100M
X 30%
300M- income tax

700M is the total income of X-Phil branch wherein 50M of which will be remitted to X-USA.

50M
X15%
7.5M – branch remittance tax

42.5M- total amount which will be remitted to X-USA as a branch profit.

Marubeni v. Commissioner [177 SCRA 500] - Marubeni Corporation is a resident foreign corporation

A resident foreign corporation is one that is incorporated under the laws of a foreign country and is engaged in trade or business on the Philippines. Marubeni Corporation was duly organized under the laws of Japan and it is duly licensed to engage in trade or business under Philippine laws. Marubeni Corporation maintains a branch office to carry out its business in the country.

Marubeni Corporation in Japan directly invested in AG & P a domestic corporation. The equity investments were investments of the mother corporation and not of the local branch office.

Branch profit remittance tax applies only to profits remitted by local branch offices to their mother corporation. It does not apply to cash dividends paid to the mother corporation directly, from other domestic corporations.

Only profits remitted abroad by a branch office to its head office which are effectively connected with its trade or business in the Philippines are subject to the 15% profit remittance tax.

To be effectively connected, it is not necessary that the income be derived from the actual operation of Taxpayer Corporation's trade or business; it is sufficient that the income arises from the business activity in which the corporation is engaged.

The dividends received by Marubeni-Japan from AG & P are not income arising from the business activity in which the local branch of Marubeni is involved. Accordingly, said dividends if remitted abroad, are not considered branch profits for purposes of the 15% profit remittance tax.

Note: The test of whether remittance of profit by a branch to its head office comes under the purview of the profit remittance tax, is whether the branch made the remittance. In this case, it was not Marubeni's branch in the Philippines, but AG & P, which remitted the dividends to Marubeni-Japan.

Also, only the branch office is the authorized withholding agent for the profit remittance tax. AG&P, being an investee of Marubeni, erred in withholding the profit remittance tax from the dividends it remitted to Marubeni.

In **Marubeni v. Commissioner,** Marubeni-Japan invested directly in AG & P Manila. Since Marubeni has a branch in the Philippines, AG & P withheld 15% as branch profits remittance tax from the cash dividends. SC held that the dividends remitted were not subject to the 15% branch profit remittance tax as they were not income earned by a Philippine branch of Marubeni-Japan.

In the 15% remittance tax, the law specifies its own tax base to be on the "profit remitted abroad". There is absolutely nothing equivocal or uncertain about the language of the provision. The tax is imposed on the amount sent abroad, and the law calls for nothing further. ***[Bank of America NT v. Court of Appeals 234 SCRA 302]***.

Interest received by a foreign corporation from Philippine sources not effectively connected with the conduct of its business not considered branch profits. (Hongkong-Shanghai Hotels, Ltd. V. CIR, CTA Case No. 5243 dated 4/29/99) **-** Interest received by a foreign corporation during each taxable year from all sources within the Philippines is not considered branch profits except when the same is effectively connected with the conduct of its business. In the instant case, the interest income from bank placements is not effectively connected with the business of hotel management, thus, it is excluded from profits subject to the 15% branch profit remittance tax.

Regional or area headquarters of multinational companies- Regional or area headquarters shall not be subject to income tax.

Regional operating headquarters of multinational companies- Regional operating headquarters shall pay a tax of ten percent (10%) on their taxable income.

Tax on certain incomes received by a resident foreign corporation

1. Interest from deposits and yield or any other monetary benefit from deposit substitutes, trust funds and similar arrangements and royalties.

   Interest income from any currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements and royalties derived from sources within the Philippines shall be subject to a final income tax at the rate of twenty percent (20%) of such interest.

   However, interest income derived by a resident foreign corporation from a depository bank under the expanded foreign currency deposit system shall be subject to a final income tax at the rate of seven and one-half percent (7 ½%) of such interest income.

2. Income derived under the expanded foreign currency deposit system

   This refers to income derived by a depositary bank under the expanded foreign currency deposit system from foreign currency transactions with local commercial banks including branches of foreign bank that many be authorized by the Bangko Sentral ng Pilipinas to transact business with foreign currency deposit system units and other depositary banks under the expanded foreign currency deposit system, including interest income from foreign currency loans granted by such depositary banks under said expanded foreign currency deposit system to residents.

   A final income tax at the rate of ten percent (10%) is imposed on such income.

3. Capital gains from sale of shares of stock not traded in the stock exchange
   a) Not over P100,000 – 5%
   b) Over P100,000 – 10%

4. Intercorporate dividends- Dividends received by a resident foreign corporation from a domestic corporation liable to tax under the NIRC shall not be subject to income tax.

TAX SPARING RULE

Concept: the government will forego or spare the collection of some taxes.

Requisites of Tax Sparing Rule

1. Involves inter-corporate dividends received by a **non-resident foreign corporation** from a domestic corporation

2. Only 15% final withholding tax on cash and/or property dividends is imposed

3. Provided the country in which the non-resident foreign corporation is domiciled shall allow a credit against the tax due from the non-resident foreign corporation taxes deemed to have been paid in the Philippines, which is 32% by 2000 [Sec. 28, (B) (5) (b)]

What if the country of the NRFC does not impose income tax, is tax sparing rule applicable? Yes.

How does tax sparing rule operate? The BIR will impose normal dividend tax of 30%. However, the NRFC must show his tax return in its country to the BIR that his tax in the Philippines is credited [regardless of the amount credited] against his tax liability therein. If satisfied then the BIR is satisfied, it will grant a refund of 15% of the amount paid.

Situation: NRFC received dividend, cash or property dividend from DC. That dividend received from DC is subject to 15% FINAL WITHHOLDING TAX.

This 15% may be imposed on this dividend received from DC if the foreign government of the NRFC allows a tax credit at least 19% (1998), 18% (1999), 17% (2000). It should be credited from the taxed deemed paid by this NRFC in the Phils.

If so, the foreign government does not allow a tax credit of at least 19%, the tax there is not 15% but 34%. Thus the tax spared or saved is 19% because normally the tax is 34%. So, 34% less 15% equals 19%, that is the tax saved and that represents the tax credit allowed by the foreign government.

Question: Must the foreign government actually grant a tax credit or is it enough that the foreign government allow such tax credit?

Answer: There is no statutory provision that requires actual grant. Neither is there a Revenue Regulation requiring actual grant. It is clear that the provision of the law says "allows." SO, it is enough to prove that the foreign corporation allows a tax credit. It is not incumbent upon the foreign corporation to prove the amount actually granted.

Question: Does a withholding agent or a subsidiary corp. have the personality to file a written claim or refund?

Answer: The withholding agent has the personality to file a written claim for refund. A withholding agent is technically a taxpayer because it is required to deduct and withhold the tax, and it has the obligation to remit the same to the govt. So, withholding agent is liable for tax. It has therefore the personality to file a written claim for refund.

Withholding agent is not only an agent of the taxpayer but also an agent of the government. Since it is an agent of the taxpayer, it is *ipso facto* authorized to file a written claim for refund.

Tax tip: which is better, to establish a branch or a subsidiary? It depends since the following circumstances are to be considered.

The percentage risk involve in the business. If the business venture is too risky, such that closure of the corporation has a great possibility, then it is better to establish a subsidiary. Under the law a subsidiary and a mother corporation have a separate and distinct identity, thus liability of a subsidiary corporation is confined only to itself and cannot be enforced against the mother corporation unless there is a ground to price the corporate veil.

While if a branch is establish, the principal unit will be liable for the obligation of the branch office since they are considered as a single entity.

If the business is not too risky then it is better to establish a branch since it is subject to 15% branch remittance tax, unlike a subsidiary corporation which is subject to 30% dividends tax if the tax sparing rule is not present.

III. TAX ON NON-RESIDENT FOREIGN CORPORATION

Taxation of a non-resident foreign corporation, in general

- Rates of tax, in general
  1997 – 35%
  1998 – 34%
  1999 – 33%
  2000 – 32%
- However, the tax is imposed on gross income, not on taxable or net income.
- Such gross income may include interests, dividends, rents, royalties, salaries, premiums (except reinsurance premiums), annuities, emoluments or other fixed or determinable annual, periodic or casual gains, profits and income, and capital gains, except capital gains from the sale of shares of stock not traded in the stock exchange.

Taxation of certain non-resident foreign corporations

1. Non-resident cinematographic film owner, lessor or distributor – 25% of gross income
2. Non-resident owner or lessor of vessels chartered by Philippine nationals – 4 ½% of gross rentals, lease or charter fees
3. Non-resident owner or lessor of aircraft, machineries and other equipment – 7 ½% of gross rentals or fees

Non-resident cinematographic film owner, lessor or distribution- A cinematographic film owner, lessor, or distributor shall pay a tax of twenty five percent (25%) of its gross income from all sources within the Philippines.

Non-resident owner or lessor of vessel chartered by Philippine nationals- A non-resident owner or lessor of vessels shall be subject to a tax of four and one-half percent (4 ½%) of gross rentals, lease or charter fees from leases or charters to Filipino citizens or corporations, as approved by the Maritime Industry Authority.

Non-resident owner or lessor of aircraft, machineries and other equipment- Rentals, charters and other fees derived by a non-resident lessor of aircraft, machineries and other equipment shall be subject to a tax of seven and one-half percent (7 ½%) of gross rentals or fees.

Tax on certain incomes received by a non-resident foreign corporation

1. Interest on foreign loans

   A final withholding tax at the rate of twenty percent (20%) is hereby imposed on the amount of interest on foreign loans contracted on or after 01 August 1986.

2. Intercorporate dividends

A Final withholding tax at the rate of fifteen percent (15%) is hereby imposed on the amount of cash and/or property dividends received by a non-resident foreign corporation from a domestic corporation, subject to the condition that the country in which the non-resident foreign corporation is domiciled shall allow a credit against the tax due from the non-resident foreign corporation taxes deemed to have been paid in the Philippines equivalent to thirty two percent (32%) in the year 2000.

This is the so-called tax sparing rule.

3. Capital gains from sale of shares of stock not traded in the stock exchange
   a) Not over P100,000 – 5%
   b) Over P100,000 – 10%

TAX ON IMPROPERLY ACCUMULATED EARNINGS

Imposition of the tax - In addition of the other income taxes, there is hereby imposed for each taxable year on the improperly accumulated taxable income of each corporation an improperly accumulated earnings tax equal to ten percent (10%) of the improperly accumulated taxable income [Section 29, NIRC]

Corporations subject to improperly accumulated earnings tax - The improperly accumulated earnings tax shall apply to every corporation formed or availed for the purpose of avoiding the income tax with respect to shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

Exceptions to improperly accumulated earnings tax - The improperly accumulated earnings tax shall not apply to:
1. Publicly-held corporations
2. Banks and other non-bank financial intermediaries
3. Insurance companies

EVIDENCE OF PURPOSE TO AVOID INCOME TAX

- **Prima Facie Evidence**: The fact that any corporation is a mere holding company or investment company shall be *prima facie* evidence of a purpose to avoid the tax upon its shareholders or members.

- **Evidence Determinative or Purpose**: The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members unless the corporation, by clear preponderance of evidence, shall prove to the contrary.

- The term "reasonable needs of the business" includes the reasonable anticipated needs of the business.

- "Reasonable needs of the business" includes the reasonably anticipated needs of the business.

Computation of improperly accumulated taxable income - Taxable income adjusted by:
1. Income exempt from tax;
2. Income excluded from gross income;
3. Income subject to final tax; and
4. Amount of net operating loss carry-over deducted;

And reduced by the sum of:
1. Dividends actually or constructively paid; and
2. Income tax paid for the taxable year.

Coverage: For corporations using the calendar basis, the accumulated earnings tax shall not apply on improperly accumulated income as of 31 December 1997.

For corporations adopting the fiscal year accounting period, the improperly accumulated income not subject to this tax shall be reckoned as of the end of the month comprising the 12-month period of fiscal year 1997-1998.

Note: If a corporate profit is subjected to Improperly Accumulated Earning Tax and later on declared as dividends, then it is not subject to dividends tax.

EXEMPTION OF CERTAIN ORGANIZATIONS

Exemption from tax on corporations
- If corporation exempt from tax have real property and lease it to another, the rent income is subject to tax
- If corporation exempt from tax have deposit in a bank, the interest income on the same is subject to tax
- If corporation exempt from tax sell property for profit, that is subject to tax

The following organizations shall not be taxed in respect to income received by them as such:
1. Labor, agricultural or horticultural organization not organized principally for profit; may derive incidental income.

2. Mutual savings bank not having a capital stock represented by shares, and cooperative bank without capital stock organized and operated for mutual purposes and without profit;

3. A beneficiary society, order or association, operating for the exclusive benefit of the members such as a fraternal organization operating under the lodge system, or a mutual aid association or a non-stock corporation organized by employees providing for the payment of life, sickness, accident, or other benefits exclusively to the members of such society, order, or

association, or non-stock corporation or their dependents;

4. Cemetery company owned and operated exclusively for the benefit of its members;

5. Non-stock corporation or association organized and operated exclusively for religious, charitable, scientific, athletic, or cultural purposes, or for the rehabilitation of veterans, no part of its net income or asset shall belong to or inure to the benefit of any member, organizers, officer or any specific person;

6. Business league chamber of commerce, or board of trade not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual;

7. Civic league or organization not organized for profit but operated exclusively for the promotion of social welfare;

8. A non-stock, non-profit educational institution;

9. Government educational institution;

10. Farmers' or other mutual typhoon or fire insurance company, mutual ditch or irrigation company, mutual or cooperative telephone company, or like organization of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meetings its expenses; and

11. Farmers' fruit growers', or like association organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses on the basis of the quantity of products finished by them. [Section 30, NIRC]

Income by exempted corporations which are not exempted- "Notwithstanding the provisions in the preceding paragraphs, the income of whatever kind and character of the foregoing organizations from any of their properties, real or personal, or from any of their activities conducted for profit regardless of the disposition made of such income, shall be subject to tax imposed under this Code." [2nd paragraph, Section 30, NIRC]

Thus, the following income of the exempted organizations shall not be exempted:

1. Income of whatever kind and character from an of their properties, real or personal
2. Income from any of their activities conducted for profit

See **Commissioner v. CA** re. YMCA case in General Principles of Taxation

Commissioner v. CA, CTA and Ateneo de Manila University, 271 SCRA 605- In conducting researches and studies of social organizations and cultural values thru its IPC, is Ateneo performing the work of an independent contractor and thus taxable for the contractor's tax?

NO. An academic institution conducing researches pursuant to its commitments to education and ultimately to public service cannot be considered as an independent contractor when it accepts sponsorships for its research activities from international organizations, private foundations and government agencies.

The research activity of the IPC is done in pursuance of maintaining Ateneo's university status and not in the course of an independent business of selling such research with profit in mind.

It is error to apply the principles of tax exemption without first applying the well-settled doctrine of strict interpretation in the imposition of taxes – it is obviously both illogical and impractical to determine who are exempted without first determining who are covered by a provision of the NIRC.

CORPORATE RETURNS

- Every corporation subject to income tax, except foreign corporations not engaged in trade or business in the Philippines, shall render, in duplicate, a true and accurate:
    1. Quarterly income tax return; and
    2. Final or adjustment return.

- The return shall be filed by the president, vice president or other principal officer, and shall be sworn to by such officer and by the treasurer or assistant treasurer.

- A corporation may employ either the calendar year or fiscal year as basis for filing its annual income tax return

- Every corporation deriving capital gains from the sale or exchange of shares of stock not traded through a local stock exchange shall file a return within thirty (30) days after each transaction and a final consolidated return of all transactions during the taxable year on or before the fifteenth (15th) day of the fourth month following the close of the taxable year.

Declaration of quarterly corporate income tax- Every corporation shall file in duplicate a quarterly summary declaration of its gross income and deductions on a cumulative basis for the preceding quarter or quarters upon which the income tax shall be levied, collected and paid.

The tax computed shall be decreased by the amount of tax previously paid or assessed during the preceding quarters and shall be paid not later than sixty (60) days from the close of each of the first three (3) quarters of the taxable year, whether calendar or fiscal year.

Fiscal adjustment return - Every corporation liable for tax shall file a final adjustment return covering the total taxable income for the preceding calendar or fiscal year.

If the sum of the quarterly tax payments made during the said taxable year is not equal to the total tax due on the entire taxable income of that year, the corporation shall either:

1. Pay the balance of tax still due; or
2. Carry over the excess credit; or
3. Be credited or refunded with the excess amount paid, as the case may be.

Carrying-over or crediting or excess to succeeding quarters - In case the corporation is entitled to a tax credit or refund of the excess estimated quarterly income taxes paid, the excess amount shown on its final adjustment return may be carried over and credited against the estimated quarterly income tax liabilities for the taxable quarters for the succeeding taxable years.

But this is not automatic. The corporation need to apply for crediting of such excess or tax credit to succeeding quarters.

COMPUTATION OF INCOME TAX

Formula:

1. All Income for taxable year less exclusions = *Gross Income*
2. Less Allowable deductions = *Net Income*
3. Less Personal and additional exemptions = *Taxable Net Income*
4. Multiply with appropriate tax rate = *Income Tax Due*
5. Less Creditable Withholding tax or Tax Credits = ***Net Income Tax Payable***

BAR 2004- Effect: Dissolution; Corporate Existence - For failure to comply with certain corporate requirements, the stockholders of ABC Corp. were notified by the Securities and Exchange Commission that the corporation would be subject to involuntary dissolution. The stockholders did not do anything to comply with the requirements, and the corporation was dissolved. Can the stockholders be held personally liable for the unpaid taxes of the dissolved corporation? Explain briefly. (5%)

SUGGESTED ANSWER: No, as a general rule, stockholders cannot be held personally liable for the unpaid taxes of a dissolved corporation. The rule prevailing under our jurisdiction is that a corporation is vested by law with a personality that is separate and distinct from those of the persons composing it **(Sunio v. NLRC, 127 SCRA 390{1984]}.**

NOTE: additional point should be given to the examinee if he answers in the following that: However, stockholders may be held liable for the unpaid taxes of a dissolved corporation if it appears that the corporate assets have passed into their hands **(Tan Tiong Bio v. CFR, 4 SCRA 986 [1962]).** Likewise, when stockholders have unpaid subscriptions to the capital of the corporation they can be made liable for unpaid taxes of the corporation to the extent of their unpaid subscriptions.

PAYMENT OF TAX IN GENERAL

Payment of tax, in general- The total amount of tax shall be paid by the person subject thereto at the time the return is filed.

Instalment payment

- A taxpayer, other than a corporation, may opt to pay the tax in two equal instalments when the tax due is in excess of two thousand pesos (P2, 000).
- In such cases, the first instalment shall be paid at the time the return is filed and the second instalment on or before July 15 following the close of the calendar year.

Payment of capital gains tax

- It shall be paid on the date the return prescribed therefore is filed by the person liable thereto.
- In case the taxpayer elects and is qualified to report the gain by instalments, the tax due from each installment payment shall be paid within thirty (30) days from the receipt of such payments.

Assessment and payment of deficiency tax - The term deficiency means:

1. The amount by which the tax imposed by this Title exceeds the amount shown as the tax by the taxpayer upon his return.

   However, the amount so shown on the return shall be increased by the amount previously assessed (or collected without assessment) as a deficiency, and decreased by the amount previously abated, credited, returned or otherwise repaid in respect of such tax; or

2. If no amount is shown as the tax by the taxpayer upon his return, or if no return is made by the taxpayer, then the amount by which the tax exceeds the amounts previously assessed (or collected without assessment) as a deficiency.

   However, such amounts previously assessed or collected without assessment shall first be decreased by the amounts previously abated, credited, returned or otherwise repaid in respect of such tax.

WITHHOLDING TAX

Importance of withholding tax

a) ***To ensure the payment of taxes***- withholding tax is a method of collecting income tax in advance from taxable income of the recipient of income. Thus, if the income of the recipient is exempt from income tax, no withholding of tax is required to be made by the payor of such income, which is constituted as the withholding agent.

b) ***Effect of non-withholding to allowable deductions***- the duty to withhold is different from the duty to pay income tax. Indeed, the revenue officers generally disallow the expenses claimed as deductions from gross income, if no withholding tax as required by law or the regulations was withheld and remitted to the BIR within the prescribed dates.

There are two kinds of withholding tax, namely: final withholding tax and creditable withholding tax.

BAR 2001- Withholding Tax; Domestic Corporation; Cash Dividends - What do you think is the reason why cash dividends, when received by a resident citizen or alien from a domestic corporation, are taxed only at the final tax of 10% and not at the progressive tax rate schedule under Section 24(A) of the Tax Code? Explain your answer. (5%)

SUGGESTED ANSWER: The reason for imposing final withholding tax rather than the progressive tax schedule on cash dividends received by a resident citizen or alien from a domestic corporation, is to ensure the collection of income tax on said income. If we subject the dividend to the progressive tax rate, which can only be done through the filing of income tax returns, there is no assurance that the taxpayer will declare the income, especially when there are other items of gross income earned during the year. It would be extremely difficult for the BIR to monitor compliance considering the huge number of stockholders. By shifting the responsibility to remit the tax to the corporation, it is very easy to check compliance because there are fewer withholding agents compared to the number of income recipients.

Likewise, the imposition of a final withholding tax will make the tax available to the government at an earlier time. Finally, the final withholding tax will be a sure revenue to the government unlike when the dividend is treated as a returnable income where the recipient thereof who is in a tax loss position is given the chance to offset such loss against dividend income thereby depriving the government of the tax on said dividend income.

[**Note:** *It is recommended that any of the foregoing answers can be given full credit because the question involves a policy issue which can only be found in the deliberations of Congress.*]

ALTERNATIVE ANSWER: The reason why cash dividends received by a resident citizen or alien from a domestic corporation are subjected to the final withholding tax of 10% and not at the progressive rate tax schedule is to lessen the impact of a second layer of tax on the same income.

FINAL WITHHOLDING TAX

Final withholding tax- under the final withholding tax system, the amount of income tax withheld by the withholding agent is constituted as a full and final payment of the income tax due from payee on the said income.

The finality of the withholding tax is limited only to the payee's income tax liability on the particular income. It does not extend to the payee's other tax liability on said income, such as when the said income is further subject to a percentage tax, such as gross receipts tax in the case of a bank.

When to withhold taxes? Since the withholding agents [who have control, custody, or receipt of the funds] deduct the withholding taxes when the income payments are paid or payable, they are described as 'withholding taxes at source. In other words, the tax is withheld and deducted at the source and time of payment. This is particularly significant where the payee is a non-resident individual or a non-resident foreign corporation.

Who is the taxpayer? Income earner
Who shall pay the tax? The Employer. The liability for payment of the tax rests primarily on the payor as a withholding agent.

What is the effect of non-withholding? In case of the withholding agent's failure to withhold the tax or in case of under-withholding, the deficiency tax shall be collected from him.

Is the payee [income earner] required to file a return? The payee is not required to file a return for the particular income, nor is he liable for the payment of the tax.

Example of incomes subject to final tax:

5. Interests
6. Dividends
7. Prizes and winning
8. Rentals
9. Royalties
10. Fringe benefits tax
11. Capital gains tax

BAR 2001- is a non-resident alien who is not engaged in trade or business in the exercise of profession in the Philippines but who derives rental income from the Philippines required to file an income tax return on April of the year following his receipt of said income. If not, why not? Explain your answer.

Suggested Answer- No, the income tax on all income derived from Philippine sources by a non-resident alien who is not engaged in trade or business in the Philippines is withheld by the lessee as a final withholding tax. The government cannot require persons outside of its territorial jurisdiction to file a return; for this reason, the income tax on income derived from within must be collected though the withholding tax system and thus relieve the recipient of the income the duty to file income tax returns.

CREDITABLE WITHHOLDING TAX

Nature: under the creditable withholding tax system, taxes withheld on certain income payments are intended to equal or at least approximate the tax due of the payee on said income.

FILING OF RETURN- the income recipient is still required to file and income tax return, as prescribed in Section 51 and 52 of the Tax Code, to report the income and/or pay the difference between the tax withheld and the tax due on the income. Taxes withheld on income payments covered by the expanded withholding tax and compensation income are creditable from the ordinary income tax of an individual or a corporation.

TYPES OF CREDITABLE WITHHOLDING TAXES

1. Expanded withholding tax on certain income payments made by private persons to resident taxpayers.
2. Withholding tax on compensation income for services done in the Philippines.
3. Withholding tax on money payment of the government.

REQUISITES FOR EXPANDED WITHHOLDING TAX

1. An expense is paid or payable by the taxpayer, which is income to the recipient thereof subject to income tax;
2. The income is fixed or determinable at the time of payment;
3. The income is one of the income payments listed in the regulations that is subject to withholding tax;
4. The income recipient is a resident of the Philippines liable to income tax; and
5. The payor-withholding agent is also a resident of the Philippines.

2nd req- the income is fixed or determinable at the time of payment: income is fixed when it is to be paid in amounts definitely pre-determined.

It is determinable, whenever there is a basis for calculation by which the amount to be paid may be ascertained. An income is described as annual or periodical, when it is paid from time to time, whether or not at regular intervals. The income need not be paid annually if it is paid periodically.

3rd req- the income is listed in the regulations as subject to withholding: revenue regulations no 2-98, as amended, enumerates the different income payments subject to the expanded withholding tax. If the income payment is not one of those listed in the regulations then it is not subject to withholding tax.

4th req- the recipient of income is a resident of the Philippines: the provisions of the expanded withholding tax regulations apply only where the recipient of income is a resident of the Philippines.

Thus, the status of the withholding agent-payor of income is immaterial. Whether or not the payor of income is a corporation or association organized under the laws of the Philippines or registered with the SEC, or whether or not the payor of income is taxable or exempt from tax, it has the responsibility of withholding and remitting the proper tax.

If the recipient of the income is a non-resident taxpayer, the income payment shall ***be subject to the final withholding tax***, not to the creditable withholding tax.

5th req- the payor-withholding agent is resident of the Philippines: the power of the government to require the withholding of tax extends only to taxpayers who are residing [i.e. doing business within the Philippines].

Thus, non-resident foreign corporations and foreign embassies in the Philippines may not be constituted nor be compelled to act as withholding agents of the government because in case of non-compliance with their obligations to withhold, the Philippines may not enforce its tax laws beyond its territorial jurisdiction.

PERSONS EXEMPT FROM WITHHOLDING TAX: the withholding of creditable withholding tax shall not apply to income payments made to the following-

1. National government and its instrumentalities, including provincial, city or municipal governments and barangays, except GOCC
2. Persons enjoying exemption from payment of income taxes pursuant to the provisions of any law, general or special, such as but not limited to the following:
   - **a)** Sales of real property by a corporation which is registered with and certified by HLURB or HUDCC as engaged in socialized housing project where the selling price of the house and lot or only the lot does not exceed 180, 000. 00 in Metro Manila and other highly urbanized areas and 150, 000. 00 in other areas;
   - **b)** Corporations registered with the BOI, PEZA and SBMA, enjoying exemption from income tax under EO 226. RA 7916, and RA 7227;
   - **c)** Corporations which are exempt from income tax under Section 30 of the Tax Code, such as GSIS, SSS, and PHIC;
   - **d)** General professional partnerships;
   - **e)** Joint ventures or consortium formed for the purpose of undertaking construction projects or engaging in petroleum pursuant to an

operating or consortium agreement under a service contract with the government.

WITHHOLDING AGENT

The following persons are constituted as withholding agents:

1. In general, any juridical person, whether or not engaged in trade or business;
2. An individual, with respect to payments made in connection with his trade or business. However, insofar as taxable sale, exchange or transfer of real property is concerned, individual buyers who are not engaged in trade or business are also constituted as withholding agents; and
3. All government offices, including GOCC, as well as provincial, city and municipal governments and barangays.

TIME TO WITHHOLD TAX

Withholding tax shall be deducted and withheld by the withholding agent when the income payment is paid or payable or accrued, or the income payment is accrued or recorded as an expense or asset, whichever is applicable, in the payor's books, whichever comes first. The term payable refers to the dates the obligation becomes due, demandable or legally enforceable.

Where the income is not paid or payable but the same has been recorded as an expense or asset, whichever is applicable, in the payor's book, the obligation to withhold shall arise in the last month of the return period in which the same is claimed as an expense or amortized for tax purposes.

VENUE FOR FILING WITHHOLDING TAX RETURNS AND TIME FOR PAYMENT OF TAX

Creditable withholding taxes deducted and withheld by the withholding agent/buyer shall generally be filed with the Authorized Agent Bank located within the principal place of business of the withholding agent.

However, expanded withholding taxes on the sale, transfer or exchange or real property classified as ordinary asset, shall be paid by the withholding agent/buyer upon filing of the return with the authorized agent bank located within the Revenue District Office having jurisdiction over the place where the property being transferred is located within 10 days following the end of the month in which the transaction occurred.

However, taxes withheld in December shall be filed on or before January 25 of the following year. Larger taxpayers who file their tax returns and pay their taxes electronically are allowed 5 days after the deadlines set for taxpayers filing tax returns manually.

TAX BASE OF WITHHOLDING TAX

I. GROSS INCOME

General rule: the tax base is **Gross Income**.

Exception: the tax base for the withholding tax is not just the income but may include return of capital, which is not subject to income tax:

1. ***Gross payments*** to *resident individuals* and *corporate cinematographic film owners, lessors or distributors*- 5%
2. ***Gross payments*** to contractors- 2%
3. ***Gross selling price*** paid to sellers of real property classified as ordinary asset- 1.5%
4. Gross amounts paid by any credit card company to any business entity representing sales of goods or services- ½ of 1%
5. Income payments made any of the top 10, 000 corporations to their regular local suppliers of
   - **a)** Goods- 1%
   - **b)** Services- 2%
6. Income payments be the government on their purchases of goods from local suppliers- 2%

II. GROSS SELLING PRICE OR FAIR MARKET VALUE, WHICHEVER IS HIGHER

A creditable withholding tax based on the gross selling price/ total amount of consideration or the fair market value, whichever is higher, paid to the seller/owner for the sale, transfer or exchange of real property, other than capital asset, shall be imposed upon the withholding agent/buyer, in accordance with the following schedule:

1. Upon the following values of real property, where the seller/transferor is habitually engaged in the real estate business as per proof of registration with the HLURB or HDCC:
   - Φ With a selling price of 500, 000. 00 or less- 1.5%
   - Φ With a selling price of more than 500, 000 but not more than 2M- 3.0%
   - Φ With a selling price of more than 2M- 5.0%
2. Where the seller/transferor is not habitually engaged in the real estate business- 6%
3. Where the seller/transferor is exempt from creditable withholding tax- exempt

WITHHOLDING TAX RATES

The withholding tax rates applied on income payments liable to income tax are as follows:

1. Professional fees for services rendered by individuals:
   - Φ If gross income for current year exceeds 720K or professional does not file Sworn

Declaration of first semester of the year with BIR, regardless of gross income- 15% of GI
- Φ If gross income for current year does not exceed 720K- 10% of GI

2. Professional entertainers and athletes, and directors
- Φ If gross income for current year exceeds 720K- 15% of GI
- Φ If gross income for current year does not exceed 720K- 10% of GI

3. Rent income
- Φ Real properties- 5%
- Φ Personal properties- %%
- Φ Poles, satellites and transmission facilities- 5%
- Φ Billboards- 5%

4. Income distribution to beneficiaries- 15%
5. Income payments to certain brokers and agents- 10%
6. Income payments to partners of GPP
- Φ If gross income for current year exceeds 720K- 15%
- Φ If gross income for current year does not exceed 720K- 10%

7. Professional fees paid to medical practitioners
- Φ If gross income for current year exceed 720K- 15%
- Φ If gross income for current year does not exceed 720K- 10%

8. Gross additional payments to government personnel from importers, shipping and airline companies, or their agents- 15%
9. Commissions of independent and exclusive distributors, medical/technical and sales representative, and marketing agents of multi-level marketing companies- 10%
10. Tolling fees paid to refineries- 5%
11. Income payments made by pre-need- 1%
12. Payments made to embalmers- 1%
13. Income payments to certain contractors- 2%

BAR 2004- Withholding Tax; Coverage- Citing Section 10, Article VIII of the 1987 Constitution which provides that salaries of judges shall be fixed by law and that during their continuance in office their salary shall not be decreased, a judge of MM Regional Trial Court questioned the deduction of withholding taxes from his salary since it results into a net deduction of his pay. Is the contention of the judge correct? Reason briefly. (5%)

Suggested answer: No, the contention is incorrect. The salaries of judges are not tax-exempt and their taxability is not contrary to the provisions of Section 10, Article VIII of the Constitution on the non-diminution of the salaries of members of the judiciary during their continuance in office. The clear intent of the Constitutional Commission that framed the Constitution is to subject their salaries to tax as in the case of all taxpayers. Hence, the deduction of withholding taxes, being a manner of collecting the income tax on their salary, is not a diminution contemplated by the fundamental law. *(Nitafan et. al. v. CIR, 152 SCRA 284 [1987]).*

BAR 2002- Withholding Tax: Royalty- The MKB-Phils. is a BOI-registered domestic corporation licensed by the MKB of the United Kingdom to distribute, support and use in the Philippines its computer software systems, including basic and related materials for banks. The MKB-Phils. provides consultancy and technical services incidental thereto by entering into licensing agreements with banks. Under such agreements, the MKB-Phils. will not acquire any proprietary rights in the licensed systems. The MKB-Phils. pays royalty to the MKB-UK, net of 15% withholding tax prescribed by the RP-UK Tax Treaty. Is the income of the MKB-Phils. under the licensing agreement with banks considered royalty subject to 20% final withholding tax? Why? If not, what kind of tax will its income be subject to? Explain. (5%)

SUGGESTED ANSWER: Yes. The income of MKB-Phils. under the licensing agreement with banks shall be considered as royalty subject to the 20% final withholding tax. The term royalty is broad enough to include technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme. (Sec. 42(4)(f), NIRC). Accordingly, the consultancy and technical services rendered by MKB-Phils, which are incidental to the distribution, support and use of the.

Bar 1994- Withholding Tax; Non-Resident Alien - Four Catholic parishes hired the services of Frank Binatra, a foreign non-resident entertainer, to perform for four (4) nights at the Folk Arts Theater. Binatra was paid P200.000.00 a night. The parishes earned P1, 000,000.00 which they used for the support of the orphans in the city. Who are liable to pay taxes?

SUGGESTED ANSWER: The following are liable to pay income taxes:

(a) The four catholic parishes because the income received by them, not being income earned "as such" in the performance of their religious functions and duties, is taxable income under the last paragraph of Sec. 26, in relation to Sec. 26(e) of the Tax Code. In promoting and operating the Binatra Show, they engaged in an activity conducted for profit. (Ibid.)

(b) The income of Frank Binatra, a non-resident alien under our law is taxable at the rate of 30%, final withholding tax based on the gross income from the show. Mr. Binatra is not engaged in any trade or business in the Philippines.

BAR 1994- Withholding Tax; Non-Resident Corporation- Bates Advertising Company is a non-resident corporation duly organized and existing under the laws of Singapore. It is not doing business and has no office in the Philippines. Pilipinas Garment Incorporated, a domestic corporation, retained the services of Bates to do all the advertising of its products abroad. For said services, Bates' fees are paid through outward remittances. Are the fees received by Bates subject to any withholding tax?

SUGGESTED ANSWER: The fees paid to Bates Advertising Co., a non-resident foreign corporation are not subject to withholding tax since they are not subject to Philippine tax. They are exempt because they do not constitute income from Philippine sources, the same being compensation for labor or personal services performed outside the Philippines (Sec. 36{c) (3) and Sec. 25(b)(l), Tax Code).

Bar 1999- Dividends: Withholding Tax - HK Co., is a Hong Kong company, which has a duly licensed Philippine branch, engaged in trading activities in the Philippines. HK Co. also invested directly in 40% of the shares of stock of A Co., a Philippine corporation. These shares are booked in the Head Office of HK Co. and are not reflected as assets of the Philippine branch. In 1998, A Co. declared dividends to its stockholders. Before remitting the dividends to HK Co., A Co. seeks your advice as to whether it will subject the remittance to WT. No need to discuss WT rates, if applicable. Focus your discussion on what is the issue. (10%)

SUGGESTED ANSWER: I will advise A Co. to withhold and remit the withholding tax on the dividends. While the general rule is that a foreign corporation is the same juridical entity as its branch office in the Philippines, when, however, the corporation transacts business in the Philippines directly and independently of its branch, the taxpayer would be the foreign corporation itself and subject to the dividend tax similarly imposed on non-resident foreign corporation. The dividends attributable to the Home Office would not qualify as dividends earned by a resident foreign corporation, which is exempt from tax. *(Marubeni Corporation v. Commissioner, GR No. 76573, September 14, 1989*).

ESTATE AND TRUST

MEANING OF ESTATE

- As estate is created by operation of law, when an individual dies, leaving properties to his compulsory or other heirs.

MEANING OF TRUST

- **Clue**- the owner imposes an obligation on his property.
- A legal arrangement whereby the owner of the property [trustor] transfer ownership to a person [trustee] who is to hold and control the property belonging to the owner's instructions, for the benefit of a designated person [beneficiary].
- Legal title to the trust property is vested in the trustee, while equitable title belongs to the beneficiary.

WHAT ARE THE INCOME OF THE ESTATES OR TRUSTS WHICH ARE INCLUDED FOR TAXATION?

1. Income accumulated in trust for the benefit of unborn or unascertained person or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust.
2. Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct.
3. Income received by estates of deceased persons during the period of administration or settlement of the estate.
4. Income, which in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

EXEMPTION ALLOWED TO ESTATES AND TRUSTS- There shall be allowed an exemption of twenty thousand pesos (P20, 000) from the income of the estate or trust.

TAXABILITY OF AN ESTATE

Estate under judicial settlement- treated by law as separate taxpayer. When the law speaks of judicial settlement, it may include estate or intestate proceedings.

Estate under extra-judicial settlement-it is not subject to tax because that will not earn income considering that the heirs agreed to settle the estate extra-judicially.

Estate was not used for profit- The estate will not be taxable, the heirs will be taxed relative to theirs shares in the estate.

Estate was used for profit- it will be taxed as a corporation.

Thus relative to the taxability of an estate is CO-OWNERSHIP as a result of death.

CO-OWNERSHIP

- There is co-ownership whenever the ownership of an undivided things or right belongs to different persons. For income tax purposes, the individual co-owners in a co-ownership report their share from the income from the property owned in common by them in their individual tax returns for the year, and the co-ownership is not considered as a separate taxable entity or a corporation.

- In a co-ownership arising from the death of a decedent, the court clearly established that such co-ownership is automatically terminated upon the partition and distribution of the properties of the estate and an unregistered partnership is created when the heirs invested the common properties and income and placed them under a single management. However, the co-ownership is not converted into a partnership where the transactions of the co-owners intended to liquidate the co-ownership are few or isolated, and the element of habituality is not present. The intention of the co-owners to establish a partnership should also be considered.

CO-OWNERSHIP DUE TO DEATH OF DECEDENT

1. **Before partition of property-** in general, co-ownerships are not treated as separate taxable entities. The income of a co-ownership arising from the death of a decedent is not subject to income tax, if the activities of the co-owners are limited to the preservation of the property and the collection of the income therefrom. In which case, each co-owner is taxed individually on his distributive share. Before the partition and distribution of the estate of the deceased, all the income thereof belongs commonly to all the heirs.

2. **After partition of property-** should the co-owners invest the income of the co-ownership in any income-producing properties after the extrajudicial partition of the estate, they would be constituting themselves into an unregistered partnership which is consequently subject to income tax as a corporation.

   The co-ownership of inherited properties is automatically converted into an unregistered partnership the moment the said common properties and/or incomes derives therefrom are used as a common fund with intent to produce profits for the heirs in proportion to their respective shares in the inheritance as determined in a project partition either duly executed in an extrajudicial settlement or approved by the court in the corresponding testate or intestate proceeding. From the moment of such partition, the heirs are already entitled to their respective definite shares of the estate and the income thereof, for each of them to manage and dispose of the property as exclusively his own without the intervention of the other heirs. Accordingly the heirs become liable individually for all taxes in connection with his co-heirs.

   If after such partition, he allows his shares to be held in common with his co-heirs under a single management to be used with the intent of making profit thereby in proportion to his share, there can be no doubt that, even if no document or instrument were executed for the purpose, at least an unregistered partnership is formed for tax purposes **[Ona vs. Commission, 45SCRA74]**

ISOLATED TRANSACTION OF UNIMPROVED PROPERTIES- NOT A TAXABLE UNREGISTERED PARTNERSHIP

Φ Petitioners bought two parcels of land in 1985; however, they did not sell the same nor make any improvements thereon. In 1966 they bought another three parcels of land. It was only in 1968 that they sold the two parcels of land after which they did not make any additional purchases. The remaining three parcels of land were sold in 1970. Commissioner assesses them corporate income taxes on the ground that petitioners established an unregistered partnership engaged in real estate transactions.

The SC ruled that no unregistered partnership was formed. The sharing of returns does not itself establish a partnership whether or not the persons therein have a joint or common right or interest in the property. There must be clear intent to form a partnership, the existence of which creates a juridical personality different from the individual partners, and removes the freedom of each party to transfer, sell, or assign the properties.

In this case, there was no showing of intent to form a partnership. The transactions were isolated; therefore, the character of habituality peculiar to business transactions engaged for the purpose of gain was not present. **[Pascual vs. Commissioner, October 18, 1988]**

TRANSFER OF LAND TO CHILDREN- NOT A TAXABLE UNREGISTERED PARTNERSHIP

Φ The father sold his rights over two parcels of land to his four children so that they can build their residence, but the latter after one year sold the said land and paid the capital gains. The Commissioner, acting on the theory that the children had formed an unregistered partnership or joint venture within the meaning of Sections 24a and 84b of the tax Code, required the siblings to pay corporate income tax.

Φ SC held that the petitioners should not be treated as having formed an unregistered partnership and tax corporate income tax on the sale and dividend income tax on shares of the profits from the sale. Their original purpose was to divide the lots for residential purposes. The later on found that it is not feasible to build their residences on the lots because of the high cost of construction, then they had no choice but to resell the same to dissolves the co-ownership. The division of the profit was merely incidental to the dissolution of the co-ownership which was in the nature of things in a temporary state.**[Obillos Jr. vs. CIR, October 29, 1985]**

TAXABILITY OF A TRUST

Taxable Trust- irrevocable trust

- Φ *Irrevocable as to property but not to income-* trustor is the taxpayer
- Φ *Irrevocable as to income but revocable as to property-* trustee liable for tax in the income
- Φ *Irrevocable as to income and property-* trustee in representation of the trust is the taxpayer.

Non-taxable trusts are:

1. **Revocable Trust-**The income here will be taxed in so far as the recipient of the same is concerned.
   - Φ As to income and property- taxpayer is the trustor.

2. **Employee's Trust.** If an employer establishes a pension trust for the benefit of the employees, that pension trust is not taxable.

The trust is revocable if the power to revest the title to the property of the trust is vested:

1. In the grantor or in conjunction with other person who does not have the substantial adverse interest in the disposition of the property.
2. In any person who does not have substantial adverse interest in the disposition of the property.
   - Φ In irrevocable trust, you cannot transfer or revest the title of the property.
   - Φ "No substantial interest in the disposition of the property" – he must not be the beneficiary.
   - Φ If the properties of the estate are not invested in a business, so ten heirs are just co-owners of the property that is not taxable because co-ownership as a rule is not taxable.
   - Φ If the heirs decide to continue the business, such that the administrator may manage the same, that will become an unregistered taxable partnership.
   - Φ Estate and trust may be taxed on the same manner and on the same basis as in the case of individual taxpayers. So, they may claim the deductions under Section 34 as long as these deductions were paid or incurred in connection with the business of that estate or trust.

EXCEPTION FROM TAXATION OF TRUSTS

- Φ Employee's trust which forms part of a pension, stock bonus or profit-sharing plan of an employer for the benefit of some or all of his employees shall be exempt from income tax:
  1. If contributions are made to the trust by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and the principal of the fund accumulated by the trust in accordance with such plan; and

  2. If under the trust instrument, it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus or income to be used for or diverted to purposes other than for the exclusive benefit of the employees.

- Φ However, any amount actually distributed to any employee or distributee shall be taxable to him in the year in which so distributed to the extent that it exceeds the amount contributed by such employee or distributee.

SPECIAL DEDUCTIONS [THIS CAN BE AVAILED OF ONLY BY ESTATE AND TRUST]:

1) In the case of intestate, the executor, or administrator may deduct the income distributed to the heirs during the particular year when such estate is still under settlement.

2) In the case of a trust, the income may be distributed to the beneficiaries during that year may also be deducted. The trustee or fiduciary may distribute the income or accumulate the income. The trustee has the discretion whether to distribute the income to the beneficiaries during the taxable year or to accumulate the same and distribute such income after the lapse of certain period of time or year. In the event that income of the trust is distributed to the beneficiary, this particular amount may also be claimed as deductions.

Note: The deductions allowed above shall not be allowed in case of a trust administered in a foreign country.

Questions: If there are two (2) trust created by one trustor or grantor, how do we tax the income of that trust?

Answer: Under the law, the taxable income of these two (2) trust must be consolidated. That trust should be taxed as if they constitute one trust.

Situation:

Grantor X created 2 trust. One is A trust created and the other is B trust. There is only one beneficiary named Y.

Let us assume that the taxable income of trust A is P10,000. The taxable income of B trust is P20,000. The total taxable income is P30,000. We will tax these 2 trust separately but through consolidation.

In paying the tax after applying the applicable tax rate to the taxable income of P30,000, the tax due should be apportioned to trust A and B.

So, for purposes of income tax, the taxable income of these 2 trusts should be consolidated, but for purposes of paying the tax, the tax due should be apportioned.

Fiduciary returns- Guardians, trustees, executors, administrators, receivers, conservators and all persons or corporations acting in any fiduciary capacity shall render a return of the income of the persons, trust or estate for whom or which they act, and be subject to all the provisions of this Title, which apply to individuals in case such person, estate or trust has a gross income of twenty thousand pesos (P20, 000) or over during the taxable year.

Such fiduciary or person filing the return for him or it, shall take oath that he has sufficient knowledge of the affairs of such person, trust or estate to enable him to make such return and that the same is, to the best of his knowledge and belief, true and correct, and be subject to all provisions of this Title which apply to individuals.

Fiduciaries indemnified against claims for taxes paid- Trustees, executors, administrators and other fiduciaries are indemnified against the claims or demands of every beneficiary for all payments of taxes which they shall be required to make under the provisions of this Title, and they shall have credit for the amount of such payments against the beneficiary or principal in any accounting which they make as such trustees or other fiduciaries.

CASE: Ona vs. CIR, May 25, 1972 [Unregistered Partnership]- Although the CFI already approve the project of partition of the estate of Julia Bernales among her surviving spouse, Lorenzo Ona, and her 5 children, no attempt was made to divide the properties left by the decedent. Instead the properties remained under the management of Lorenzo Ona, who used said properties in business by leasing or selling them and investing the income derive therefrom and the proceeds from the sales thereof in real property and securities. The said incomes are recorded in the books of account kept by Lorenzo, where the corresponding shares of the heirs in the net income for the year are also found.

Based on these facts, the commissioner ruled that the heirs formed an unregistered partnership which is thus subject to corporate income tax. The CTA and the SC affirmed the decision.

For tax purposes, the so-ownership of inherited properties is automatically converted into an unregistered partnership the moment the said common properties and/or the incomes derived therefrom are used as a common fund with intent to produce profits for the heirs in proportion to their respective shares in the inheritance as determined in a project of partition either duly executed in an extrajudicial settlement or approved by the court in the corresponding testate or intestate proceeding.

The reason is simple, from the moment of such partition, the heirs are entitled already to their respective definite shares of the estate and incomes thereof for each of them to manage and dispose of as exclusively his own without the intervention of the other heirs, and accordingly, each becomes liable individually for all taxes in connection therewith. If after such partition, they allow their share to be held in common with his co-heirs under a single management to be used with the intent of making profit thereby in proportion to his share, there can be no doubt that, even if no document or instrument were executed, for tax purposes, at least, an unregistered partnership is formed.

Note: The income derived from inherited properties may be considered as individual income of the respective heirs only as long as the inheritance or estate is not distributed or, at least partitioned, but the moment their respective known shares are used as part of the common assets of the heirs to be used in making profits, it is but proper that the income of such shares be considered as part of the taxable income of an unregistered partnership.

BAR 1997- Mr. Santos died intestate in 1989 leaving his spouse and five children as the only heirs. The estate consisted of a family home and a four doo-door apartment which was being rented to tenants. Within the year, an extra-judicial settlement of the estate was executed from the heirs, each of them receiving his/her due share. The surviving spouse assumed administration of the property. Each year, the net income from the rental property was distributed to all, proportionately on which they paid respectively, the corresponding income tax.

In 1994, the income tax returns of the heirs were examined ad deficiency income tax assessments were issued against each of them for the years 1989 to 1993, inclusive as having entered into an unregistered partnership. Were the assessments justified?

Suggested answer: Yes, the assessments were justified because for income tax purposes, the co-ownership of inherited property is automatically converted into an unregistered partnership from the moment the said properties are used as a common fund with intent to produce profits for the heirs in proportion to their shares on the inheritance.

From the moment of such partition, the heirs are entitled already to their respective definite shares of the estate and the income thereof, for each of them to manage and dispose of as exclusively their own, without the intervention of the other heirs, and accordingly, he becomes liable individually for all taxes in connection therewith. If after such partition, he allows his shares to be held in common with his co-heirs under a single management to be used with the intent of making profit thereby in proportion to his share, there can be no doubt that, even if no document or instrument were executed for the purpose, for tax purposes, at least, an unregistered partnership is formed [Ona vs. CIR]

BAR 1994- Noel Langit and his brother, Jovy, bought a parcel of land which the registered in their names as pro indiviso owers [Parcel A]. Subsequently, they formed a partnership, duly registered with SEC, which bought another parcel of land [Parcel B]. Both parcels of land were sold, realizing a net profit of 1M for Parcel A and 500K for parcel B.

The BIR claims that he sale of parcel A should be taxed as a sale by an unregistered partnership. Is the BIR correct? – the BIR is not correct, since there is no showing that the acquisition of the property by Noel and Jovy Langit as pro indivisio owners, and prior to the formation of the partnership, was used, intended for use, or bears any relation whatsoever to the pursuit or conduct of the partnership business. The sale of parcel A shall therefore not be treated as a sale by an unregistered partnership, but an ordinary sale of a capital asset, and hence will be subject to the 6% capital gains tax and documentary stamp tax n transfers of real property, said taxes to be borne equally by the co-owners.

The BIR also claims that the sale of parcel B should be taxed as a sale by a corporation. Is the BIR correct? – the BIR is correct, since a 'corporation' as deemed under section 22(b) of the Tax Code includes partnerships no matter how created or organized except GPP. The business partnership in the instant case shall therefore be tax in the same manner as a corporation on the sale of parcel B. the sale shall thus be subject to the creditable withholding tax on the sale of parcel B, and the partnership shall report the gain realized from the sale when it files its income tax return.

BAR 1991- Roberto Ruiz and Conrado Cruz bought 3 parcels of land from Rodrigo Sabado on May 4 1976. Then on July 1977, thy bought 2 parcels of land from Miguel Sanchez. In 1988, they sold the first 3 parcels of land to Central Realty Inc. In 1989, they sold the 2 parcels to Jose Guerrero. Ruiz and Cruz realized a net profit of 100K for the sale in 1988 and 150K for the sale in 1989. The corresponding capital gains taxes were individually paid by Ruiz and Cruz.

On 20 September 1990, however, Ruiz and Cruz received a letter from the CIR assessing them deficiency corporate income taxes for the years 1988 and 1989 because according to the Commissioner, during said years they, as co-owners in the real estate transactions, formed an unregistered partnership or joint venture taxable as a corporation and that the unregistered partnership was subject to corporate income tax, as distinguished from profits derived from the partnership by them, which is subject to individual income tax.

Are Robert Ruiz and Conrado Cruz liable for deficiency corporate income tax?

Suggested answer: Roberto Ruiz and Conrado Cruz are not liable for corporate income tax. Evidently abandoning the Gathchalian ruling, the SC in a recent ruling in Pascual vs. CTA, GR No. 78133 [1988] held that isolated transactions by 2 or more persons do not warrant their being considered as mere-owners; no corporate income tax is due on mere co-ownerships. It was, therefore, correct for Ruiz and Cruz to merely pay their individual income tax liabilities on the gain from sale of real estate transactions.