## Notes on Taxation Law[[1]](#footnote-1)

## Table of Contents

## General Principles . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 02

**Inherent Limitations of Power of Taxation . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 13**

**Constitutional Limitation on the Power to Tax . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 15**

**Means of Avoiding or Minimizing the Burden of Taxation . . . . . . . . . . . . . . . . . . . . . . . . . . 20**

**Sources, Application, Interpretation and Administration of Tax Laws . . . . . . . . . . . . . . . . 25**

**General Principles on Income Taxation . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 28**

**Classes of Income Taxpayers . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 31**

**Situs of Taxation . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 35**

**Determination of Gross Income . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 39**

* **Source of Income . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 40**
* **Accounting Periods . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 41**
* **Exclusions from Gross Income . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 43**
* **Gross Income from Compensation and Other Benefits. . . . . . . . . . . . . . . . . . . . . . . 48**
* **Taxability of Passive Income . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 52**

**Deduction from Gross Income . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 57**

**Special Treatment of Gains and Losses from Dealing in Property . . . . . . . . . . . . . . . . . . . . 77**

**Taxation Income of Individual Taxpayer . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 86**

**Deductions Allowed only to Individual Taxpayers . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 90**

**Corporate Income Tax . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 97**

**Payment of Tax . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 108**

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| GENERAL PRINCIPLES |

**TAXATION**

* **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***]

**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:

1. 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.

1. Taxes are proportional in character, since taxes are based on one’s ability to pay.
2. 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.

**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.:
   1. Imposition of tariffs on imported goods to protect local industries.
   2. The adoption of progressively higher tax rates to reduce inequalities in wealth and income.
   3. The increase or decrease of taxes to prevent inflation or ward off depression.

#### *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.

### 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.
* 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 duty, and countervailing duty, promote the non-revenue or sumptuary purpose of taxation.

### 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 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**

### LIFEBLOOD DOCTRINCE

* 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.
* By enforcing the tax lien, the BIR availed itself of the most expeditious way to collect the tax. *Taxes are the lifeblood of the government and their prompt and certain availability is an imperious need,* ***[CIR v. Pineda, 21 SCRA 105].***
* The government is not bound by the errors committed by its agents. In the performance of its governmental functions, the State cannot be estopped by the neglect of its agents and officers. Taxes are the lifeblood of the nation through which the government agencies continue to operate and with which the state effects its functions fro the welfare of its constituents. The errors of certain administrative officers should never be allowed to jeopardize the government’s financial position, ***[CIR v. CTA, 234 SCRA 348].***
* The BIR is authorized to collect estate tax deficiency through the summary remedy of levying upon the sale of real properties of a decision without the cognition and authority of the court sitting in probate over the supposed will of the decedent, because the collection of the estate tax is executive in character. As such, the estate tax is exempted from the application of the statute on non-claims, and this is justified by the necessity of government funding, immortalized in the maxim “*Taxes are the lifeblood of the government and should be made in accordance with law, as any arbitrariness will negate the very reason for government itself,* ***[Marcos II v. CA, 273 SCRA 47].***
* *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 to 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 an 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.*

1. **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.*
* In return for his contribution, the taxpayer receives the general advantages and protection which the government affords the taxpayer and his property. One is compensation or consideration for the other; protection for support and support for protection.
* 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.”*

**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].***

**When is taxation considered as an implement 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.”
* In ***Tio v. Videogram Regulatory Board, 151 SCRA 208,*** the levy of a 30% tax under PD1987, was imposed primarily for answering the need for regulating the video industry, particularly the rampant film piracy, the flagrant violation of intellectual property rights, and the proliferation of pornographic videotapes, and is therefore valid. While the direct beneficiaries of the said decree are the movie industry, the citizens are held to be its indirect beneficiaries.

**What is the concept of fiscal adequacy?**

* That the sources of revenues must be adequate to meet government expenditures, ***[Chavez v. Ongpin, 186 SCRA 331]***.

### DEFINATION AND DIFFERENTION 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 used 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 form 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, unreasonable, 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.

### 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].***

***Philex Mining Corp. v. CIR, 294 SCRA 687 [1998]***

* 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:*** 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

In the case of ***Republic v. Ericta, [173 SCRA 623],*** The SC allowed taxes due from the taxpayer to be considered paid through the delivery of certificates of indebtedness. It held that: “*In effect, while judgment shall be rendered in favour of the Republic against Sampaguita for unpaid taxes, judgment ought at the same time issue for Sampaguita commanding payment to it by the Republic of the same sum representing the face value of the certificate of indebtedness assigned to it and for recovery of which it had specifically prayed in its counterclaim.”*

***\*This can be construed as an exemption.***

In ***CIR v. Esso Standard, [172 SCRA 364],***  the SC allowed the overpaid income tax of 1959 to be considered tax credit against the deficiency income tax of 1960. It held that “*The obligation to return the money mistakenly paid arises from the moment the payment is made, and not from the time that the payee admits the obligation to reimburse. The obligation of the payee to reimburse an amount paid to him results from the mistake, not from the payee’s confession of the mistake or recognition of the obligation to reimburse.*”

**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.

### SURVEY OF PHILIPPINE TAXES

* 1. Internal Revenue taxes imposed under the NIRC
  2. Income tax
  3. Transfer taxes
  + Estate tax
  + Donor’s tax

**3.** Percentage taxes

* + - * 1. Value Added Tax
        2. Other percentage taxes

**4.** Excise taxes

**5.** Documentary stamp tax

**B.** Local/Municipal Taxes

**C.** Tariff and Customs duties

1. 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.

1. **Property tax**

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

1. **Excise tax**

* A charge imposed upon the performance of an act, the enjoyment of a privilege, or the engagement in a 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.

1. **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.

1. **Indirect tax**

* An indirect tax is demanded from a person in the expectation and intension 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.

1. **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.

1. **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.

1. **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.

1. **Regressive tax**

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

**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

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].***

1. ***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.”*

1. ***Administrative feasibility***

It means that tax laws should be capable of convenient, just and effective administration.

### 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.

1. 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.

### POWER TO TAX, POLICE POWER, POWER OF EMINENT DOMAIN

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|  | **TAXATION** | **POLICE POWER** | **EMINENT DOMAIN** |
| **DEFINITION** | Power of the State to demand enforced contributions for public purposes. | Power of the State to enact such laws in relation to persons and property as may promote public health, safety, morals, and the general welfare of the public. | Power of the State to take private property for public use upon paying to the owner a just compensation to be ascertained according to law. |
| ***Authority exercising the power*** | Only the government or its political subdivisions. | Only the government and its political subdivisions. | May be granted to public service or public utility companies. |
|  | **TAXATION** | **POLICE POWER** | **EMINENT DOMAIN** |
| Purpose | Enforced contribution is demanded for the support of the government. | Use of property is regulated for the purpose of promoting the general welfare. | Property is taken for public use. |
| Persons affected | Operates upon a community, a class of individuals or their property. | Operates upon a community, a class of individuals or their property. | Operates on an individual as the owner of a particular property. |
| Effect | Money contributed in the concept of taxes becomes part of public funds. | No transfer of ownership of the property seized, at most there is restraint on the injurious use of the property. Restraint on the exercise of a right. | There is transfer of ownership or a lesser right (e.g. lease), of the property. |
| Benefits received | Presumed that the taxpayer receives the equivalent of what he contributed in the form of protection from the government, and the enjoyment of living in a civilized society. | Persons affected receives no direct benefit but only as such as may arise from the maintenance of the healthy economic standard of society. | Person affected receives just compensation for the property taken from him. |
| ***Amount of imposition*** | Generally no limit as to the amount of tax to be imposed. | Amount imposed should not be more that that sufficient to cover the cost of the license and the necessary expenses of regulation. | No amount imposed, since it is property which is taken. |
| ***Relationship to the Constitution*** | Subject to certain Constitutional limitations | Relatively free from Constitutional limitations and is superior to the non-impairment provisions. | Subject to certain Constitutional limitations (e.g. inferior to the non-impairment of contracts clause). |

**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.

**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.

**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.

**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 no to encroach upon it.

**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.

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| **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:
  1. For the support of the government.
  2. For some of the recognized objects of the government; or
  3. To promote the welfare of the community.

**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 form 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 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.
* 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]***.

***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.

***REASON FOR EXEMPTING GOVERNMENTAL ENTITIES***

* Government will be taxing itself to raise money for itself;
* Immunity is necessary on order that the governmental functions will not be impeded.

***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)

***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.

***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]***.

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| **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
    1. Grant of tax exemption
    2. Veto of appropriation, revenue, tariff bills by the President
    3. Non-impairment of the SC jurisdiction
    4. Revenue bills shall originate exclusively from the House of Representatives
    5. Infringement of press freedom
    6. Grant of franchise

### DUE PROCESS OF LAW

* There must be a valid law
* Tax measure should not be unconscionable and unjust as to amount to confiscation of property
* Tax statute must not be arbitrary as to find no support in the Constitution

***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]***.

### 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, gran 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***

* In the case of Ormoc Sugar Company v. The treasurer of Ormoc City, 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.
* 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.

### 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].*

**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 exemption in favour of property used exclusively for charitable or educational purpose is not limited to property actually indispensable therefore, but extends to facilities which are incidental to and reasonably necessary for the accomplishment of said purpose. [*Abra Valley College v. Aquino, 162 SCRA 106].*
* 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].*

**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 a non-stock, non-profit educational institutions.
* Note however the last paragraph of Sec. 30, which states: “*Notwithstanding the provisions in the preceding paragraphs, the income of whatever kind and character of the foregoing organizations form any of their property, 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.”*

***Department of Finance Order 145-85***

* Non-stock, non-profit educational institutions are exempt form 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 form 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.
* 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.

***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.

***CIR v. CA, 298 SCRA 83 [1998]***

* The Young Men’s Christian Association of the Philippines, Inc. (YMCA), was established as a “*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 form real and property taxes- not from income taxes.

### 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].
* Under Sec. 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 are subject to different tax rates.

***When is a property tax exempt for being “used exclusively for educational purposes”***

* The test of exemption is the use of the property for the purposes mentioned in the Constitution. The exemption extends to facilities which are incidental to and reasonably necessary for the accomplishment of the main purposes, such as, in the case of hospitals: a school for training nurses, a nurses’ home, property used to provide housing facilities for interns, resident doctors, superintendents, and other members of the hospital staff, *[Herrera v. QC Board of Assessment Appeals, 3 SCRA 186]*.
* In *Abra Valley College V. Hon. Aquino 162 SCRA 106,* The use of the second floor for residential purposes of the Director and his family was held to incidental to the purpose of education, while the lease of the first floor to a corporation is not, and therefore considered taxable.

**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].

1. **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]

1. **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:
* 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:
* 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].

1. **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]
* 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]*

1. **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.

1. **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

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| **MEANS OF AVOIDING OR MINIMIZING THE BURDEN OF TAXATION** |

### Six basic forms of minimizing or escape from taxation

1. Shifting
2. Capitalization
3. Evasion
4. Exemption
5. Transformation
6. Avoidance

**Note**: With the exception of evasion, all are legal means of escape.

### 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.

***Taxes that can be shifted***

* 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.

1. **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.

1. 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 us 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.

### 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*].
* **Example:** Deliberate failure to report a taxable income or property; deliberately reduction of income that has been received.

***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 underdeclaration 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.

***Is an affidavit executed by revenue officers a tax assessment?***

* An affidavit executed by revenue officers stating the tax liabilities of a taxpayer and attached to a criminal complaint for tax evasion, is not an assessment that can be questioned before the CTA, *[CIR v. PASCOR, 309 SCRA 402]*

***State the principle laid down in the case of UNGAB v. CUSI 97 SCRA 877***

* Remedies for the collection of deficient taxes may be by either civil or criminal action. In case of failure to file a return, the tax may be assessed or a proceeding in court may be begun without an assessment. An assessment is not necessary before a taxpayer may be prosecuted if there is prima facie showing of wilful and deliberate attempt to file a fraudulent return with the intent to evade and defeat tax. A criminal complaint is instituted not to demand payment, but to penalize the taxpayer for violation of the Tax Code, *[Ungab v. Cusi]*

### 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.

### 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 lawmaking 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 therefore.

***Nature of tax exemption***

* + - 1. It is a mere personal privilege of the grantee.
      2. It is generally revocable by the government unless the exemption is founded on a contract which is protected from impairment.
      3. 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.
      4. 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.

1. **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.

1. **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.
* 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.

***Tax amnesty, tax condonation, and tax exemption***

* 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. Unlike a tax exemption, however, a tax amnesty has limited applicability as to cover a particular taxing period or transaction only
* There is tax condonation or remission when the State desists or refrains from exacting, inflicting or enforcing something as well as to restore what has already been taken. 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 expressed in law.
* Tax exemption, on the other hand, 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. Tax exemption is not favored and is construed *strictissimi juris* against the taxpayer.

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| **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:

* + 1. Philippine Institute of Certified Public Accountants
    2. Integrated Bar of the Philippines
    3. Philippine Chamber of Commerce and Industry
    4. American Chamber of Commerce
    5. Federation of Filipino-Chinese Chamber of Commerce; and
    6. Japanese Chamber of Commerce and Industry in the Philippines.

***\*however, other persons or entities may request a copy of the said issuances.***

* 1. 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.
  2. 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.

### EFFECTIVITY AND VALIDITY OF A TAX ORDINANCE

***Tuazon v. CA, [212 SCRA 739]***

* 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.

### 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.

***Hilado v. CIR, [100 Phil 288]***

* 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.

***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.

***Republic v. Oasan, [99 Phil 934]***

* 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.

### 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.

1. **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.

1. **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.

***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.
* 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

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| **GENERAL PRINCIPLES OF INCOME TAXATION** |

**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.

**Meaning of Income**

* 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 in its broad sense means all wealth which flows into the taxpayer other than as a mere return of capital. It also means accession to wealth, gain of flow of wealth.
* 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 Philppines, 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)*.

**Stock Dividends**- cannot be subject of income tax

***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*).

**CAPITAL CONTRA INCOME**

* Capital is the tree, income is the fruit.
* 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*).

**Test Applied in Determining the Existence of Income**

1. ***Severance test/ Realization test***

* As capital or investment is not subject to tax, the gain or profit derived from the exchange or transection of said capital by the taxpayer for his separate use, benefit and disposal is income subject to tax.

1. ***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 sane 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.

1. ***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 is considered as income.

1. ***Tax Benefit Rule and Economic Benefit Test***
2. ***Claim of Right Doctrine***
3. ***Income whatever source***

**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.

**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.

**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

**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.

1. 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

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| **CLASSES OF INCOME TAXPAYERS** |

**Basis of classification of taxpayers**

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

**Classes of Income Tax Payers**

1. ***Individuals***
2. Resident citizens
3. Non-resident citizens
4. Resident aliens
5. Non-resident aliens-
6. Engaged in trade or business in the Philippines.
7. 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.

1. ***Corporations***
2. Domestic corporations
3. Resident foreign corporations
4. Non-resident foreign corporations
5. ***Special***
6. Proprietary educational institutions and hospitals that are non-profit
7. Insurance companies
8. General Professional Partnerships
9. Estates and Trusts- estates and trust are treated as individual taxpayers.

**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 hi 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).
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.

**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
3. Resident foreign corporation- the term applies to a foreign corporation engaged in trade or business within the Philippines.
4. 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 are deemed constructively received by the partners [Sec. 73 (d), NIRC].

**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.

**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 would be constituting themselves into a partnership taxable as a corporation.

**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.
* As stated, a joint venture is not taxed as a corporation, just like a general professional 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.
* Accordingly, a pool of individual real property owners dealing in real estate business was considered a corporation for tax purposes (*Afisco Insurance Corporation vs. CA, 302 S 1*).

**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.

**CASES:**

**Obillos Jr. vs. CIR, 139 S 438**

* 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.
* 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.

**Ona vs. CIR, 45 S 74 (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.

**Sena vs. Commissioner**

* The heirs inherited the properties from their deceased mother. The property was under administration of an administrator. The administrator of the property was authorized to sell these properties for profit, or lease properties for profit and to engage in income producing activities.

The SC held that when these heirs inherited the property from their deceased mother, the co-ownership began. At this stage it is still exempt from tax, however when the heirs decided to invest such property in income producing activities, such co-ownership was converted to a taxable unregistered partnership.

**Gatchalian vs. Collector, 102 P 140**

* Plaintiffs contributed money to buy a sweepstakes ticket, which subsequently won. The SC held that hey formed an unregistered partnership. Plaintiffs formed a partnership of a civil nature since each of them contributed money to a common fund for the sole purpose of dividing equally the prize money.

**Pascual vs. Commissioner**

* 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.

**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.

**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.

**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.

***Recovery of amounts written off***

* Considered as income.

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| **SITUS OF TAXATION** |

**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.
* The determination of the situs of taxation depends on various factors including the:

1. Nature of the tax;
2. Subject matter thereof (e.g. persons, property, act or activity)
3. Possible protection and benefit that they may accrue both to the government and the taxpayer;
4. Residence or citizenship of the taxpayer; and
5. Source of income.

**What is the situs of taxation on persons (poll tax)?**

* 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 situs of tax on real property?**

* 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*.

**What is the tax situs for tangible personal property?**

* It is taxable in the state where it has actual situs although the owner resides in another jurisdiction.

**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 riles 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.

**CASES:**

**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.

### THEORIES RE: 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.

1. ***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.

1. ***Source law***

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

### SITUS OF INCOME TAX IN THE PHILIPPINES

* The situs is where the income is derived.
* 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 income is derived from an activity within the Philippines. In ***BOAC***’*s* case, the sale of tickets in the Philippines is the activity that produces the income. The tickets exchanged hands here and payments for fares were also made in the Philippines. The flow of wealth proceeded from and occurred in the 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.
* The absence of flight operations to and from the Philippines is not determinative of the source of income or the situs of income taxation. The test of taxability is the source of the income or the situs of income taxation. The test of taxability is the source of the income and the source is that activity which produced the income. Even if the tickets sold covered the transport of passengers and cargo to and from foreign cities, it cannot alter the fact that income from the sale of the tickets was derived from the Philippines. The word “source” conveys one essential idea, that of origin, and the origin of the income is here in the Philippines, [*Commissioner v. BOAC, 149 SCRA 395].*
* Situs of tax on interest income is the residence of the borrower who pays the interest, irrespective of the place where the obligation was contracted. If the borrower is a resident of the Philippines, the interest payment paid by him can have no other source than within the Philippines.

***Multiplicity of suit***

* 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. The 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:
  1. Provide exemptions or allowance of deduction or tax credit for foreign taxes; or
  2. 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.

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

**GROSS INCOME VS. GROSS RECEIPTS/ SALES**

**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. Interestes. *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*
   1. Received from domestic corporation – This is income purely within.
   2. 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%
4. Annuities. *SITUS* – Place where the contract was made
5. 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.
6. Pensions. *SITUS* – Place where this may be given on account of services rendered.
7. Partner’s distributive shares from the net income of the general professional partnership. *SITU*S – place where the exercise of profession is undertaken.

**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.

**Sources of taxation**

1. Income from sources within the Philippines
2. Income from sources without the Philippines
3. Income from sources partly within and partly without the Philippines

**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 form 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]

**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:

1. If no such method of accounting has been so employed; or
2. 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.

1. **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.

1. **Mixed/Hybrid**

* Combination of the cash and accrual method.

1. Any other method which clearly reflects the income

**Cash v. accrual method of accounting**

* Gains, profits and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him.

**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. Percentage of completion basis
2. Completed contract 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.”*

* 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.
* Installment 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**

* 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 be emanate from the mutual fund.
    * + 1. **“PROCEEDS OF LIFE INSURANCE”**

***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, P1 M less P500, 000.

***Problem:***

* A obtained a life insurance policy for B. B is the president of A’s corporation. 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.

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

***Answers:***

1. 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.*

1. *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.

1. *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.*

* + - 1. **“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

===================================

P 200, 000. 00 – taxable amount

* + - 1. **“GIFTS, BEQUESTS and DEVISES”**
* **Rationale:** What is contemplated here are donations which are *purely gratuitous in character* in order that it may be excluded.
* *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.

* + - 1. **“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*

*But as regards damages representing loss of anticipated income, this is the one that 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)

\*\*\* *All damages awarded are tax-exempt* ***except*** *damages of representing loss of income.*

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

**Answer:** Qualify your answer. With regards to damages awarded on account of loss of earnings of the contracting party, it is taxable.

* *An award for unrealized profit or earnings would only be taxable if such amounts are due to loss or damage to property.*
  + - 1. **“INCOME EXEMPT UNDER TREATY”**
* **Reason for the Exclusion:** *Treaty has obligatory force of contract*.
* ***General rule:*** excluded
* ***Exception:*** As may be provided for in the treaty.
  + - 1. **RETIREMENT BENEFITS, PENSIONS, GRATUITIES, ETC.**
* *Such 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 form 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 form 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.

##### **Requisites for exclusion of retirement benefits**

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. 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.

##### **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]

##### **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.
   * + 1. **INCOME BY THE PHILIPPINE GOVERNMENT**
4. Income derived from any public utility or from the exercise of any essential governmental function.
5. Accruing to the Government or to any political subdivision thereof.
   * + 1. **“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 this 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 ofte employee.
  + - 1. **“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.
3. The recipient is not required to render substantial future services as a condition to receiving the prize or award.

##### **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.

**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.

**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**
   1. If it is not discounted, it is the face value of the promissory note.
   2. 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:
   1. It may account to taxable compensation income if the indebtedness has been cancelled in consideration of the services rendered.
   2. It may account to taxable gift or donation of the indebtedness has been cancelled without any consideration at all.
   3. 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.
   1. It is a taxable compensation income if the beneficiary designated is the heirs of the employee or his family. Deductible expense
   2. 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:

1. Beneficiary is the wife of the President of a close corporation.
2. 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

* Applicable to managerial and supervisory employees only
* A final tax of 32% effective 01 January 2000 is imposed 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.
* The fringe benefit tax is paid by the employer.
* Grossed-up monetary value is acquired by dividing the actual monetary value of the fringe benefit by 68% effective 01 January 2000.

### FRINGE BENEFIT

* ***General rule:*** it is taxable on the part of the employee. Deductible from GI [grossed-up monetary value] provided FBT is paid.
* 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:*** 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.

1. Expense account;
2. Vehicle of any kind;
3. Household personnel, such as maid, driver and others;
4. Interests on loan at less than market rate to the extent of the difference between the market rate and actual rate granted;
5. 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

1. Holiday and vacation expenses;
2. Educational assistance to the employee or his dependents; and;

* ***General rule:*** taxable on the part of employee or dependent.
* ***Exception:***
  + 1. 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.
    2. Not taxable on the dependent- non-taxable if he acquired the educational benefits though a competitive scheme under a scholarship program.

1. Life or health insurance and other non-life insurance premiums or similar amounts in excess of what the law allows.

### 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.

### DE MINIMIS BENEFITS

* 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:*

1. Monetized unused vacation leave credits not exceeding ten (10) days during the year;
2. Medical cash allowance to dependents of employees not exceeding P750 per semester or P125 per month;
3. Rice subsidy of P1, 5000. 00 per month or 50 kgs/month;
4. Uniforms in the amount of P5, 000. 00/ year;
5. Medical benefits in the amount of P10, 000. 00/ year;
6. Laundry allowance of P300 per month;
7. 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;
8. Christmas and major anniversary celebrations for employees and their guests in the amount of P5, 000. 00;
9. Company picnics and sports tournaments in the Philippines and are participated in exclusively by employees; and
10. Flowers, fruits, books or similar items given to employees under special circumstances on account of illness, marriage, birth of a baby, etc.
11. Daily meal allowance for overtime work of 25% of the basic wage.

**SEPARATION PAYMENTS**

* Separation pay is non-taxable if-
  1. Employee was separated beyond his control
  2. Employee’s heir had received the separation benefits by the employer.

**LEAVE BENEFITS**

**SSS/GSIS BENEFITS**

**SSS/GSIS/ PHILHEALTH/ PAG-IBIG/ UNION DUES**

**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***

### 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:
   1. ***Obligation of the lessor assumed by the lessee.***The following are obligations which may be assumed by the lessee: [**R.I.D.I.O.**]

***a.*1**. Real property taxed on leased premises

**a.2** Obligation to pay insurance premium on the insured leased premises.

**a.3.** If the lessor is a corp., the obligation to distribute Dividends to its stockholders

**a.4.** Obligation to pay interest on the bonds issued by the lessor.

**a.5.** Other obligations of the lessor which may be assumed by the lessee.

* 1. ***Value of permanent improvements on leased premises.*** This may be reported through:

**b.1.** **Outright method** at the time of permanent is completed, he may report that as additional rent income – FMV of the building or permanent improvement.

**b.2.** **Spread out method** by allocating the depreciation among throughout the remaining term of the leased.

* 1. ***Advanced rentals***

**c.1.** If in the nature of the prepaid rentals ***without restriction*** on the use of the amount, it is *taxable*.

**c.2.** 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.

**c.3.** If it is in the ***nature of a loan*** to the lessor, it is not taxable.

**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:
  1. Rentals [income]- to lessee and lessor [income to the corporation]
  2. Dividend from the lessor corporation- as far as the shareholders is concerned.

**Rule if the contract is rent to own**

* **Who pays the tax?** Lessee because he will eventually become the owner of the property upon expiration of the contract.

**TAXABILITY OF PASSIVE 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 – 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*

* + 1. Other winnings, except PCSO and Lotto, derived from sources within the Philippines – 20%

1. 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 funds and similar arrangements – 20%
        2. 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%
        3. Interest income from long term deposit or investment evidenced by certificates prescribed by BSP:
  1. Exempt, if investment is held for more than 5 years
  2. 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

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|  | **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% |

### INCOME FROM DIVIDENDS

##### ***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**

* 1. 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***
  2. 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
2. Stock dividend/stock rights
3. Property dividend
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. If there is a change in the stockholder’s interest in the net assets of the corporation;
  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.
  1. Redemption of stock dividend;
  2. 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:

|  |  |  |
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| **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.

**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]

**CAPITAL GAINS DERIVED FROM THE SALE OF REAL PROPERTY**

* The real property involved must be considered CAPITAL ASSET.

A capital asset is property held by the taxpayer whether or not connected in his trade or business except:

* 1. Stock in trade or other property of any kind which would be included in the inventory of the taxpayer if on hand at the end of the taxable year.
  2. Property primarily held for sale to customers in the ordinary course of trade or business.
  3. Property used in trade or business subject to depreciation.
  4. Real property used in trade or business.
* **General rule**: A final tax of six percent (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***: 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, the portion of the gain presumed to have been realized from the sale or disposition shall be subject to capital gains tax.

* ***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*.
* This cover not only “sale” of property; it also covers conditional sale of real property including the so-called **pacto de retro sale** under Art. 1620 of the NCC, or disposition of property located in the Philippines.
* ***Alternative taxation in case of sale to government***: If the sale is made to the government nor 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 six percent (6%) of gross selling price or fair market value, whichever is higher, or the schedular tax rate of 5% up to P125,000 + 32% of excess of over P500,000.

***Is capital gains tax, a tax on the buyer 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 fro0m transferring the tax to the buyer in the contract of sale.

**CAPITAL GAIN DERIVED FROM SALE OF SHARES OF STOCK**

* ***Listed and traded through local stock exchange-*** 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.*
* 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**

* 1. ***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, 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
  + 1. ***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

**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.
* *What if the initial payment exceeds 25% of the selling price?* What do you call the transaction? You must pay the whole tax. It is called deferred sale.

**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.

**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 sake 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.
  + 1. Income from Long- term Construction projects

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| **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.

##### **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.

##### **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.

##### **Time within which to claim deduction**

1. As a rule, if a taxpayer does not, within a year, deduct certain of his 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 form 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.

1. Non-resident aliens not engaged in trade or business in the Philippines
2. Non-resident foreign corporations

### DEDUCTIONS FROM GROSS INCOME

### BITE DeDe LOSS

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.
2. ***Optional standard deduction*** which is available to individual [not to corporations] taxpayers only, except a non-resident alien.
3. ***Special deductions*** which is available, in addition to the itemized deductions, to certain corporations, i.e. insurance companies and propriety educational corporations.

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| **Rule on Optional Standard Deduction**   * No substantiation requirements [such as receipts] * Once availed it is considered as irrevocable for that taxable period.   **Itemized Deductions** |

**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

### ORDINARY AND NECESSARY BUSINESS EXPENSES

##### **Business expense v. capital 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 and necessary expenses**

* 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.
* 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.

**ORDINARY & NECESSARY EXPENSES**

* When we speak of ORDINARY, this simply refers to the expenses which are normal, usual or common to the business, trade or profession of the taxpayer. This may not be recurring.
* *Example*: 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- It is one which is useful and appropriate in the conduct of the taxpayer’s trade or profession.
* 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.

**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 expenses |
| 7. | Supplies and materials |

**Note:** There is no need to prove that these expenses as ordinary and necessary. All you have to pove is that 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]

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| * 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.

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| * 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. |

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| **Option to Private Educational Institutions**  * **General rule:** 36 A (2) and 36 A (3) expenditures for capital outlays not deductible as business expense. * **Exception:** Private 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; 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. |

### 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.

1. ***Promotional expenses***

* Same advertising expense

1. ***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.

1. **BAD DEBTS**

* Bad debts are debts due to the taxpayer which are actually ascertained to be worthless and charged off within the taxable year.
* 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:
   1. Between members of the family;
   2. Between an individual who owns more than 30% of outstanding capital stock of a corporation and that corporation;
   3. Between two corporation more than 50% of the outstanding capital stock of which is owned by or for the same individual;
   4. Between a grantor and fiduciary of any trust;
   5. Between two fiduciaries of two trusts who has the sae grantor;
   6. Between a fiduciary of a trust and above fiduciary of such trust.

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| 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. |

### 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.

##### **Back-to-back interest**

* ***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)].
* ***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 Bank deposit

Interest 100K earned interest: 100K

* 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 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.

### 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.

**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 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.

##### **Optional treatment of interest expense**

* At the option of the taxpayer, ***interest incurred to acquire property*** used in trade, business or exercise of a profession may be allowed as a deduction or treated as a capital expenditure.

##### **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 [PARCAPU]**

* + 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 paid in ADVANCE
    6. Interest on obligation to finance PETROLEUM EXPLORATION
    7. Interest on UNCLAIMED SALARIES of the employees

***Related taxpayers****:*

1. *Members of the same family which includes:*
2. spouses
3. brothers and sisters
4. descendants and ascendants
5. *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.
6. *Between a corp. and an individual; that individual owns or controls more than 50% of the outstanding capital stock of the such corp.*
7. *parties to a trust*;
8. grant of fiduciary
9. fiduciary of one trust and fiduciary of another trust but there is only one grantor
10. Beneficiary and fiduciary.

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| 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 the 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.

P200, 000.00

- 41,000.00

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P159, 000.00

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*.

* 1. 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.
  2. Interest on deficiency income tax can also be claimed as deductible interest expense because taxes here are considered ordinary obligations.

1. **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.

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| **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 the improvement of a parcel of land.
2. *Income tax***-** This includes foreign income tax.In this regard, the so-called 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 he claims that as tax credit, he can no longer claim the same as deduction.
3. Taxes which are not connected with the trade, business or profession of the taxpayer.
4. Estate tax, donor’s tax.

**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 ration 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.

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| 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. * ***Purpose:*** to counteract the effects of double taxation.  **Tax deduction v. Tax Credit**  * In the former, the taxes are deducted from the gross income in computing the net income, while in the latter; the taxes are deducted from Philippine income tax itself. * In the former, all taxes as a general rule are allowed as deductions with some exemptions (enumerated above), while in the latter, only foreign income taxes may be claimed as credits against Philippine income tax.  **What are the proof 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 form sources without the Philippines taxable under this Title bears to his entire taxable income for the same taxable year.  Mercury Drug Case  * Involves the question whether the discounts given to senior citizens be claimed as deductions or tax credit. * SC held that discount claimed by senior citizens shall create tax credit and must be deducted at the bottom of the formula.   **Problem:**   1. Suppose you paid 100K net Income tax to US, can you claim as a deduction the whole 100K? What is the formula?    * + - 1. Formula   **Step 1:**  Net income tax: Gross Income from sources within  Gross Income from entire world  **Step 2:** quotient x Rate= mount which can be claimed as deduction.   * + - * 1. 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].  1. Suppose you are a Resident Citizen, you pay Net Income Tax to US, will you be able to deduct to claim it as as a tax deduction?    * 1. Generally, you can claim it as tax credit.      2. 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. |

### LOSSES

* The term implies an unintentional parting with something of value.
* 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.

1. It must not be compensated for by insurance or other forms of indemnity.
2. 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.
3. Not claimed as deduction for estate tax purposes [the law will not allow double deduction].

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| **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.

**Note:** Capital losses and securities becoming worthless are governed by rules on loss from the sale or exchange of capital assets.

**Kinds of Losses**

##### **Casualty loss**

* This must be reported to the BIR earlier than 30 days but not later than 45 days following the date of loss.
* Loss arises from fires, storms, shipwreck, or other casualties, or from robbery, theft or embezzlement.

##### **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.

##### **Losses Securities becoming worthless**

1. Securities become worthless during the taxable year
2. Securities are capital assets
3. Losses are considered as losses from the sale or exchange, on the last day of such taxable year, of capital assets.

##### **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.

##### **Wagering losses**

* 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

***SPECIAL LOSSES*** – ***include the following****:*

##### **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.
  + - 1. **Loss arising from voluntary removal of buildings as an incident to renewal or replacement**

**Problem:**

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| 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 value of a court order because the gov’t considered this as a fire hazard, loss of useful value of property or capital asset. |

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| **NET OPERATING LOSS CARRY-OVER (NOLCO)**   * It means the excess of allowable deduction over gross income of the business in a taxable year. * 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.   **Rule:**   * 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. * Such loss shall be allowed as a deduction if it had not been previously offset as deduction from gross income. * 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 * 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:  1. 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 2. 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. |

### DEPRECIATION

* 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.

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| **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:* 
  + - * 1. Personal property not used in trade, business or profession of the taxpayer;
        2. Inventoriable stocks and securities;
        3. Land;
        4. Mining and other natural **r**esources;

1. The allowance for depreciation must be reasonable;
2. The method in computing the **a**llowance 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.

1. 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.

***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.

### 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.

### CHARITABLE AND OTHER CONTRIBUTIONS

* *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.
* *What if the done is not one of those mentioned under the law, can the donor claim a deduction?* No!

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| **Note:**   * Done 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 done is the Government, what is the requirement?***   * It must be made exclusively for public purposes.   ***What if the done is a province?***   * There must be a qualification that it is for public purpose.   ***If the done 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:
   * 1. Another non-profit domestic corporation organized for similar purpose;
     2. To the state for public purpose;
     3. 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.

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| **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:   + - 1. Sports and development, science and invention;       2. Health and human settlement;       3. Educational and economic development * No conflict with partial deduction because they have different requirement;   + - * 1. Partial deduction- donated for exclusively public purposes;         2. Full deduction- donation is used in undertaking priority activities of NEDA.  1. 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.  1. Accredited NGO  * NGO means non-profit domestic corporation which are formed and organized for any of the following purposes: [CHERS]   + - * 1. Research         2. Health         3. Education         4. Charitable, cultural, character building         5. Sports development and social welfare. |

**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

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| **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. |

**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.

### RESEARCH AND DEVELOPMENT

* A taxpayer may treat research and development expenditures which are paid or incurred by him during the taxable year in connection with his trade, business or profession, as ordinary expenses and necessary expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as deduction during the taxable year when paid or incurred.

**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.

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| **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]. |

### 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.

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| * *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. |

1. **OTHER FORMS OF DEDUCTIONS [Section 37 NIRC]**
2. Special deductions allowed to insurance companies
3. Mutual insurance companies
4. Mutual marine insurance companies
5. Assessment insurance companies
6. Estates and trust
7. 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.

**SPECIAL INCOME TAX TREATMENT OF GAINS AND LOSSES FROM DEALING IN PROPERTY**

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| 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]**.**

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| **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 | * All properties not used in trade or business are considered capital asset. * 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.
  1. **Shares of stock of domestic corporation**

1. Stocks not listed, or sale not effected through the stock exchange:
   * 1. 5% of first P100,000
     2. 10% of excess of P100,000
2. Listed and traded in the stock exchange:

* ½ of 1%, regardless of the resulting gain or loss

1. Initial public offering
   * + 1. 4% if 25% of stocks is offered
       2. 2% if over 25% to 33%
       3. 1% if over 33%
   1. **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.

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| **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***
   1. Exchange of property where the property received is not substantially different from the property disposed of. [Section 140, Reg. No.2]
   2. Exchange of property solely in kind in pursuance of corporate mergers and consolidations. Stock for stock.
   3. 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***
   1. Transactions between related taxpayers
   2. Illegal transactions
   3. Wash sales by non-dealers by securities and when not subject to the stock transfer tax
   4. Sales and exchanges that are not in arm’s length
   5. Exchanges of property, not solely in kind, in pursuance of corporate mergers and consolidations

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| **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.   1. **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.  1. **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.   1. **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**

### CAPITAL LOSS LIMITATION RULE

* + meaning, capital losses are deductible only to the extent of capital gain
  + So, it follows that there is no capital gain, there is no deductible losses.
  + Capital loss cannot be deducted from capital gain
  + Ordinary loss is deductible from ordinary gain.

**N.B.:** 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.

* Losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges.

1. **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.

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| **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. |

1. **NET CAPITAL LOSS CARRY-OVER**

* This rule applies only o individual taxpayers.
* If any taxpayer, other than a corporation, sustains in any taxable year a net capital loss, such loss (in an amount not in excess of the net income for such year) shall be treated in the succeeding taxable year as a loss from the sale or exchange of a capital asset held for not more than 12 months.

**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.

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| **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**.** |

**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

1. **Failure to exercise option to buy**
2. No exercise or the right- rule on capital gain/loss applicable
3. 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.

1. **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.

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| **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. |

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| **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. |

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| **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:   Selling price exceeds P1, 000. 00  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.

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| **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 and Cash**  **Property: P50,000**  **Cash: P50,000**  **Corp. A Corp. B Total: P100,000**    **Stock 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”.**
2. 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:**

**Property**

**Corp. A Corp. B**

**Stock**

1. 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:**

**Security or Stock**

**Stockholder --------------Corp. 1. Stock for Stock**

**Security or Stock 2. Securities for stock**

**3. Securities for Securities**

**\*\*** Sometimes, we call the above-mentioned transactions as **“Transactions solely in kind”** or **“Tax Exempt Transactions”.**

1. 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.

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| **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. |

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| **TAXATION INCOME OF INDIVIDUAL TAXPAYERS** |

**How are individuals taxed?**

* An individual citizen, bot 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.

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| ***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**

* + - * 1. **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*

1. Other winnings, except PCSO and Lotto, derived from sources within the Philippines – 20%
2. 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%
3. Interest income from long term deposit or investment evidenced by certificates prescribed by BSP:
   1. Exempt, if investment is held for more than 5 years
   2. 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

1. Cash and/or property dividends

***10% final tax, by January 1, 2000, on the following:***

* 1. 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.
  2. 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
  3. 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

1. Cash rewards for informants – 10%

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|  | **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% |

**Capital gains from the sale of shares of stock not traded in the stock exchange**

1. Not over P100,000 - 5%
2. Over P100,000 - 10%

**Capital gains derived from the sale of real property**

* The real property involved must be considered CAPITAL ASSET.

A capital asset is property held by the taxpayer whether or not connected in his trade or business except:

* 1. Stock in trade or other property of any kind which would be included in the inventory of the taxpayer if on hand at the end of the taxable year.
  2. Property primarily held for sale to customers in the ordinary course of trade or business.
  3. Property used in trade or business subject to depreciation.
  4. Real property used in trade or business.
* **General rule**: A final tax of six percent (6%) is imposed on the gross selling price **or** current fair market value, whichever is higher, for every sale or exchange of real property.
* ***Optional***: If the sale is made to the government nor 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 six percent (6%) of gross selling price or fair market value, whichever is higher, or the schedular tax rate of 5% up to P125,000 + 32% of excess of over P500,000.
* ***Exception***: The sale or disposition of the principal residence of natural persons is exempt from capital gains tax if certain conditions are met.

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| **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, the portion of the gain presumed to have been realized from the sale or disposition shall be subject to capital gains tax.  * ***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*. * This cover not only “sale” of property; it also covers conditional sale of real property including the so-called **pacto de retro sale** under Art. 1620 of the NCC, or disposition of property located in the Philippines.   **Is this a tax on the buyer 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 fro0m transferring the tax to the buyer in the contract of sale. |

**CAPITAL GAIN DERIVED FROM SALE OF SHARES OF STOCK**

* ***Listed and traded through local stock exchange-*** 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.*
* 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.
  + - * 1. **TAX ON NON-RESIDENT ALIEN INDIVIDUAL**

***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.
  + - * 1. **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 20% for citizens and resident aliens, the rate is 10% since year 2000.
  + - * 1. **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 sale 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.

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| **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.*** |

* + - * 1. **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

**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 ore 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.

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| **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:
   * + - 1. Living with the taxpayer
         2. Dependent upon the taxpayer for chief support;
         3. Unmarried;
         4. Not gainfully employed;
         5. 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:**

* + 1. Living with the taxpayer;
    2. Dependent upon the taxpayer for chief support;
    3. Unmarried;
    4. Not gainfully employed
    5. Not more than 21 years old except if physically or mentally incapacitated.

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| **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 may 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.* |

* + - * 1. **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.
* In the case of legally separated spouses, it may be claimed only by the spouse who has custody of the child or children.
  + - * 1. **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.*

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| 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*

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|  | **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
   * 1. Any amount paid out for new buildings or for permanent improvements, or betterments made to increase the valued of any property or estate
     2. 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**
   * 1. Any amount paid out for new buildings or for permanent improvements, or betterments made to increase the value of any property or estate.
     2. Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made
     3. Cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense
     4. The amount expended for architect’s services is part of the cost of the building
     5. 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
     6. 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.*

1. **RELATED TAXPAYERS**
2. Between members of a family (which shall include only his brothers and sisters, spouse, ancestors and lineal descendants)
3. 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
4. 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
5. Between the grantor and the fiduciary of a trust
6. Between the fiduciary of a trust and the fiduciary of another trust if the same person is a grantor with respect to each trust
7. 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.
   * + - 1. **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.

1. 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.

1. An individual whose sole income has been subjected to a final withholding tax.
2. 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.

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| **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.

**KINDS OF CORPORATE TAXPAYER**

### RATES OF INCOME TAX ON DOMESTIC CORPORATIONS

**In General**

* 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 are 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 form all sources does 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
5. Not over P100,000 – 5%
6. Over P100,000 - 10%
7. 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.***

1. Intercorporate dividends – exempt
2. 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)**

* Applicable only to Domestic Corporations and Resident Foreign Corporations.
* ***Concept:*** A minimum corporate income tax of 2% of the gross income as of the end of the taxable year is hereby imposed on a corporation subject to income tax beginning 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.
* The rates provided for the payment of income tax of corporate taxpayers are not applicable if the amount corresponding to the rates are lower than 2% of the gross income of such corporate income taxpayer. This is called the “***Minimum Corporate Income Tax”.***
* ***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 is 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.
* 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.
* ***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 year 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.

**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**

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|  | 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:   * 1. Salaries and employee benefits of personnel, consultants and specialists directly rendering the service and,   2. 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).

1. **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.
* ***Tax rates in General***
* 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 are 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.

1. Tax on branch profits remittances – 15% of total profits applied or earmarked for remittance without deduction for the tax component thereof.
2. Regional or area headquarters shall not be subject to income tax
3. 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.

**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.
      + 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]***.

**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.

**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.

1. 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.

1. Capital gains from sale of shares of stock not traded in the stock exchange
   * + 1. Not over P100,000 – 5%
       2. Over P100,000 – 10%
2. 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.
3. **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 distributor**

* 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.

* 1. 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.

* 1. Capital gains from sale of shares of stock not traded in the stock exchange
     1. Not over P100,000 – 5%
     2. Over P100,000 – 10%

### TAX SPARING RULE

* Involves inter-corporate dividends received by a **non-resident foreign corporation** from a domestic corporation
* Only 15% final withholding tax on cash and/or property dividends is imposed
* Provided the country in which the non-resident foreign corporation is domiciled shall allow a credit against the tax due form the non-resident foreign corporation taxes deemed to have been paid in the Philippines, which is 32% by 2000 [Sec. 28, (B) (5) (b)]

### TAX SPARING CREDIT RULE

**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 form 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 fila 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 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.

### EXEMPTION OF CERTAIN ORGANIZATIONS

##### **Exemption from tax on corporations**

* If they have real property and lease it to another, the rent income is subject to tax
* If they have deposit in a bank, the interest income on the same is subject to tax
* If they 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 alter 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. 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***

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| **PAYMENT OF TAX** |

**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

1. 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.

**WITHOLDING OF TAX AT SOURCE**

**Two kinds of withholding**

1. Withholding of final tax on certain incomes
2. Withholding of creditable tax at source

**Fund withheld held in trust by withholding agent**

* The taxes deducted and withheld by the withholding agent shall be held as a special fund in trust for the government until paid to the collecting officers.
* All taxes withheld pursuant to the NIRC and its implementing rules and regulations are hereby considered trust funds and shall be maintained in a separate account and not commingled with any other funds of the withholding agent.

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| **ESTATE AND TRUST** |

**Taxation of estates and trusts**

* Income tax imposed upon individuals shall also apply to the income of estates or of any kind of property held in trust.
* The tax shall be computed upon taxable income of the estate or trust and shall be paid by the fiduciary.
* Its status is dependent on the status of the decedent immediately prior to his death.

**Parties to a Trust:**

1. **Trustor or grantor** - one who created the trust
2. **Trustee or fiduciary** – one who may hold the property for the benefit of other person known as **beneficiary.** Sometimes, the fiduciary is also the beneficiary**.**
3. **Beneficiary**
   * Estate may be the subject to tax, if it is under your administration. It may only be under administration or settlement if the properties of the decedent are settled under judicial settlement.
   * If the estate is 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.
   * When we speak of judicial settlement, this may include estate or intestate proceedings.
   * **Trust may be subject to tax if the trust is irrevocable**.

**Non-taxable trust are:**

* 1. **Revocable Trust.** The income here will be taxed in so far as the recipient of the same is concerned.
  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.
  + In irrevocable trust, you cannot transfer or revest the title of the property.
  + “No substantial interest in the disposition of the property” – he must not be the beneficiary.
  + 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.
  + If the heirs decide to continue the business, such that the administrator may manage the same, that will become an unregistered taxable partnership.
  + 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.
  + Estate and trust are entitled to personal exemptions P20,000.

**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.

**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 trust should be consolidated, but for purposes of paying the tax, the tax due should be apportioned.

**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.

**Exception from taxation of estates or trusts**

* 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.

* 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.

**Taxable income of estates or trusts**

* The taxable income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual.
* However, there shall be allowed as a deduction in computing the taxable income of the estate or trust the amount of the income of the estate or trust for the taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the taxable income of the beneficiaries, whether distributed or not.
* In the case of income received by estates or deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the taxable income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir or beneficiary, but the amount so allowed as a deduction shall be included in computing the taxable income of the legatee, heir or beneficiary.
* The deductions allowed above shall not be allowed in case of a trust administered in a foreign country.

**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.

**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.

1. Culled from the Tax Code, Sababan’s Magic Notes and others… [↑](#footnote-ref-1)