Rousing the Partnership — The Tax Stimulus

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I. INTRODUCTION

> *Esa idea del beneficio o de la ganancia se deriva de la misma naturaleza del contrato de sociedad, cuya razón de existencia, así como su fundamento jurídico, esta en la propia identidad humana y en la impotencia del esfuerzo individual.*
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> - *Manresa*[1]

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Cite as 55 ATENEO L.J. 294 (2010).

1. 9 D. JOSE MARÍA MANRESA Y NAVARRO, CÓDIGO CIVIL ESPAÑOL 283 (1950). (The quotation translates as: "That idea of the benefit or the gain derives itself from the very nature of the *contrato de sociedad*, whose reason for existence, as

More often than not, the subject of taxation of partnerships is glossed over by tax jurisprudents. Indeed, the very subject of partnership is treated by many legal scholars with an almost dismissive attitude, relegating the study of partnerships to something akin to the study of dinosaurs. Yet a check with the Securities and Exchange Commission (SEC) reveals that a fifth of active companies registered with it as of 20 April 2010 are partnerships.[2] There are, in fact, 77,654 active partnerships registered with SEC today.[3] These numbers should merit the subject of taxation of partnerships, at the very least, a brief study.

II. THE PHILIPPINE PARTNERSHIP LAW — A HYBRID OF TWO LEGAL SYSTEMS

The law on partnership in the Philippines is a hybrid of the American and the Spanish law on partnership.[4] There are now 101 articles in the Philippine Civil Code[5] devoted to partnership divided into four chapters: General Provisions, Obligations of Partners, Dissolution and Winding Up, and Limited Partnerships.[6] From Spain, the *Código Civil* (Spanish Civil Code)[7] contributed, in whole or in part, some 31 articles,[8] and the *Código de*

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well as its juridical foundation, is in its own human identity and in the impotence of individual effort.").

2. *See* Annex A containing data generated by the Management Information System of the Economic and Research Information Department of the Securities and Exchange Commission (SEC), in response to a request for information made for this Article (on file with the Author).

3. *Id.*

4. HECTOR S. DE LEON & HECTOR M. DE LEON, JR., COMMENTS AND CASES ON PARTNERSHIP, AGENCY, AND TRUSTS 5-6 (8th ed. 2010).

5. An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386 (1950).

6. *Id.* arts. 1767-1867.

7. CÓDIGO CIVIL ESPAÑOL 1889 [CÓDIGO CIVIL] (Spain) (Spain's Civil Code, which by Royal Decree of July 24, 1889, was ordered for publication and published in the Gaceta de Madrid on July 25, 1889, and was extended to the Philippines by Royal Decree of July 31, 1889.). *See* CÓDIGO CIVIL DE LA PENÍNSULA, CUBA, PUERTO RICO Y FILIPINAS XVIII (1913), *available at* http://civil.udg.edu/normacivil/estatal/CC/RD25071889.htm (last accessed Aug. 31, 2010).

8. The following articles of the CIVIL CODE can be traced from the CÓDIGO CIVIL: 1767; 177-71; 1773; 1775-79; 1781-84; 1786; 1788; 1789; 1792-1804; 1827; 1830.

Comercio (Spanish Code of Commerce)[9] contributed four articles,[10] all in the first three chapters of the law on partnership. The remaining articles of the first three chapters are provisions lifted from the Uniform Partnership Act (UPA)[11] and the entire fourth chapter was lifted from the Uniform Limited Partnership Act (ULPA) of the United States of America (U.S.).[12] This is because the Code Commission[13] found the provisions of the Code of Commerce on limited partnerships[14] "too meager and inadequate to govern this juridical institution."[15] Thus, Philippine partnership law is one-third Spanish and two-thirds American.

As a consequence, it is useful in the understanding of partnership law to know how the entity is perceived by both legal systems. While a mere statistical reckoning of the provisions will trace the greater number of the provisions of partnership to the American uniform codes, these provisions were grafted on the foundation of the Spanish *sociedad*.

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9. CÓDIGO DE COMERCIO 1885 [CÓDIGO DE COMERCIO] (Spain) (Spain's Code of Commerce of 1885 was extended to the Philippines by the Royal Decree of Aug. 6, 1888 and took effect in this jurisdiction on Dec. 1, 1888.). *See* 1 AGUEDO AGBAYANI, COMMENTARIES AND JURISPRUDENCE ON THE COMMERCIAL LAWS OF THE PHILIPPINES 2-3 (1992).

10. The following four articles of the CIVIL CODE can be traced to the CÓDIGO DE COMERCIO: art. 1772 (registration); art. 1787 (appraisal on goods contributed as capital); art. 1789 (prohibition against industrial partner engaging in business for himself); and art. 1808 (mirror provision on capitalist partner on engaging business for their own account).

11. Uniform Partnership Act [UNIF. P'SHIP ACT], 6 U.L.A. 125 (1914) (amended 1997).

12. Uniform Limited Partnership Act [UNIF. LTD. P'SHIP ACT], 6 U.L.A. 305 (1916) (amended 2001).

    See generally 5 ARTURO M. TOLENTINO, COMMENTARIES AND JURISPRUDENCE ON THE CIVIL CODE OF THE PHILIPPINES 320–95 (1992).

13. Office of the President, Creating the Code Commission, Executive Order No. 48, 43 O.G. 792 (Mar. 20, 1948). The Code Commission was created under Executive Order No. 48 signed by President Manuel A. Roxas to address "the urgent need for immediate revision of all existing substantive laws of the Philippines." Prior to this, a Code Committee was created under An Act Creating a Code Committee, Commonwealth Act No. 628 (1941), but the committee was not able to complete its work due to the outbreak of World War II.

14. *See* CÓDIGO DE COMERCIO, arts. 145–150, governing the *sociedad en comandita*.

15. REPORT OF THE CODE COMMISSION ON THE PROPOSED CIVIL CODE OF THE PHILIPPINES 149 (1951). (This published version is with footnote annotations by Napoleon R. Malolos and Teodorico C. Martin cross-referencing the provisions discussed in the report with article numbers of the current CIVIL CODE.).

III. THE *SOCIEDAD*

The term *sociedad* has been conveniently, but rather inaccurately, translated as "partnership" in various writings found in our jurisdiction. The *sociedad*, however, has a broader scope. The fundamental notion of the *sociedad* is that in it is the recognition of the limitations of the nature of man who needs his peers to achieve his goals, as not all men have the same aptitudes, some with privileged intelligence but without capital, and others with capital but without sufficient knowledge. All this provides the basis for the contract of the *sociedad* which is for the purpose of securing a union of forces in an enterprise which no one could achieve individually.[16] Hence, Manresa considered as the most important provision of the relevant chapter in the *Código Civil* the proviso which describes the *sociedad* as a contract by which two or more persons oblige themselves to put in common money, property or industry with the intent of dividing among themselves the gains.[17] The *sociedad* contemplated two classes, one the civil, governed principally by the Spanish Civil Code, and the other the mercantile, governed by the Spanish Code of Commerce. The object of a *sociedad mercantil* is industry or commerce. This categorization means, quite confusingly for today's Filipino legal scholar, that such pursuits as agriculture or fishing are excluded from this classification, relegating the latter to the *contrato civil de sociedad*.[18] In our jurisdiction, a steam laundry was considered in the realm of a *sociedad civil*,[19] and so was operating an entire sugar plantation.[20] In another case,[21] our Supreme Court ruled that a general engineering company engaged in the business of raising sunken Spanish ships was deemed a *sociedad industrial civil*, which was described as a *sociedad civil* of mercantile form.[22] The distinction between civil and mercantile would therefore appear to us today as awkward

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16. 56 ENCICLOPEDIA UNIVERSAL ILUSTRADA 1283 (1927).

17. MANRESA, *supra* note 1, at 18. (Referring to Article 1665 of the CÓDIGO CIVIL, the original reads: "*Artículo 1665. La sociedad es un contrato por el cual dos o más personas se obligan a poner en común dinero, bienes o industria, con ánimo de partir entre sí las ganancias.*").

    The current version of this provision is found in the first paragraph of Article 1767 of our CIVIL CODE, to wit: "By the contract of partnership two or more persons bind themselves to contribute money, property or industry to a common fund, with the intention of dividing the profits among themselves."

18. 56 ENCICLOPEDIA UNIVERSAL ILUSTRADA 1291 (1927).

19. *See* Dietrich v. Freeman, 18 Phil. 341 (1911).

20. *See* Co-Pitco v. Yulo, 8 Phil. 544 (1907).

21. *See* Mead v. McCullough, 21 Phil. 95 (1911).

22. *Id.* at 105. In this case, the company being examined was a *sociedad anónima*.

and unwieldy, but it was an important distinction then as it determined which set of rules would be primarily used, either the *Código Civil* or the *Código de Comercio*. However, even the *sociedad* under the Spanish Civil Code can adopt any of the forms recognized in the Spanish Code of Commerce, and the provisions of the latter code will be applicable insofar as these are not inconsistent with the provisions of the former.[23]

There are three forms of the *sociedad* prescribed in the Spanish Code of Commerce that was then in force in the Philippines, the *sociedad colectiva*, the *sociedad anónima*, and the *sociedad en comandita*, which are best viewed in this order. The *sociedad colectiva* is where all the members[24] in a firm, under a business name, bind themselves to participate, in the proportion they may establish, in the same rights and obligations, with unlimited and solidary liability.[25] The *sociedad colectiva* is therefore the equivalent of today's general partnership. On the other hand, the *sociedad anónima* is considered as the predecessor of our corporation today. The *sociedad anónima* is where its members constitute a common fund which can be divided into a number of parts called shares, and administered and represented by agents with revocable authority without any of the members liable beyond the funds they have contributed or bound themselves to contribute. What is predominant in a *sociedad anónima* is the material element over the personal, being a company of capital more than of persons.[26] Finally, the *sociedad en comandita* is seen as a mixture of the elements of the *sociedad colectiva* and the *sociedad anónima* because it has members with the unlimited liability of a *sociedad colectiva,* referred to as the *socios colectivos*, and members with the limited liability of a *sociedad anónima,* referred to as the *socios comanditarios*, with the administration solely resting with the former, that is, the *socios colectivos*.[27] Hence, the *sociedad* is seen as a contract capable of existing in three forms, these three with a kinship to one another.

IV. AMERICAN CONCEPTS OF PARTNERSHIP AND THE ENTITY-AGGREGATE DICHOTOMY

We then proceeded to eject all these forms from our system, but leaving intact certain key provisions of the *sociedad* on which our Code Commission

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23. CÓDIGO CIVIL, art. 1670. ("*Las sociedades civiles, por el objeto a que se consagren, pueden revestir todas las formas reconocidas por el Código de comercio. En tal caso, les serán aplicables sus disposiciones en cuanto no se opongan a las del presente Código.*").

24. The Spanish term used is "*socio*" which is often translated as "partner" in our jurisdiction. For purposes of greater clarity "*socio*" is translated in this Article as "member."

25. CÓDIGO DE COMERCIO, arts. 122 (1) & 127.

26. *Id.* arts. 122 (3) & 153; 56 ENCICLOPEDIA UNIVERSAL ILUSTRADA 1295 (1927).

27. 56 ENCICLOPEDIA UNIVERSAL ILUSTRADA 1298 (1927). *See* CÓDIGO DE COMERCIO, arts. 122 (2) & 148.

rested much of the provisions from the American uniform codes of partnership.

We have the uniform law movement in the U.S. to thank for two-thirds of our law on partnership. The movement began in the second half of the 19th century to address the complexities created by the existence of a variety of state laws on the same subject matter.[28] In 1889, the American Bar Association decided to work towards the uniformity of laws.[29] Thence, the National Conference of Commissioners on Uniform State Laws (NCCUSL) was created with its first meeting in 1892 marked by lawyers representing the participating states working together to draft uniform codes for the guidance of state legislatures who may wish to adopt some or all of these uniform codes, which in essence are proposed model laws.[30]

A uniform law on partnership was first raised in 1902, and the early drafts had, similar to our partnership law, adopted the "entity" theory of partnerships, but later drafts adopted the common-law "aggregate" theory. The Uniform Partnership Act, described as having embodied aspects of both theories, was approved by the NCCUSL in 1914.[31] The UPA on the whole is not only applicable to general partnerships but is also intended to apply to limited partnerships except where there is an inconsistency with the relevant statute on limited partnerships.[32] Two years later, or in 1916, the Uniform Limited Partnership Act was promulgated.[33] It is from the ULPA that the provisions of Chapter Four on partnership in our Civil Code were drawn from. Meanwhile, the UPA was spliced into the Spanish provisions found in the first three chapters of our Civil Code provisions on partnership.

While the development of the various forms of the *sociedad* in the Spanish system is relatively intertwined, American law tends to treat

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28. *See* Uniform Law Commission, History of the National Conference of Commissioners on Uniform State Laws (NCCUSL), *available at* http://www.nccusl.org/Update/DesktopDefault.aspx?tabindex=0&tabid=11 (last accessed Aug. 31, 2010).

29. *Id.*

30. *Id.*

31. *Id.*

32. UNIF. P'SHIP ACT, Prefatory Note, *available at* http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/upa97fa.htm (last accessed Aug. 31, 2010). *See also* UNIF. P'SHIP ACT § 6 (2) *in* ALEXANDER HAMILTON FREY, CASES AND MATERIALS ON CORPORATIONS AND PARTNERSHIPS 1362 (1951).

33. *See* Uniform Law Commission, Summary of the Uniform Limited Partnership Act (2001), *available at* http://www.nccusl.org/Update/uniformact_summaries/uniformacts-s-ulpa.asp (last accessed Aug. 31, 2010).

partnership as a class on its own. The debate on whether a partnership is an entity or an aggregate, that is, a mere aggregation of partners, was in fact left unresolved by the UPA. It has been observed that some provisions reflect the aggregate theory while others reflect the entity theory. In any case, the American law of partnership "exhibits much less tendency to treat partnerships as entities separate and distinct from their owners than does corporate law."[34] There appears to be a dispute as to whether partnership in the UPA refers to an entity or to an aggregate ownership of property.[35] Apparently, as a result, there is a tendency to reify corporations as opposed to partnerships,[36] an attitude which the Author believes appears to have been carried over into our jurisdiction.

While during the drafting of the UPA, the debate raged as to whether partnership should rely on the theory of the entity or that of the aggregate, it was observed that with respect to the taxation of partnerships in America, it began almost purely on the aggregate concept in 1913, although some entity components later appeared.[37] The result is that partnerships are given a flow-through tax treatment where the partnership is not taxed on its income as an entity but the partners are taxed individually on the share of the partnership income that has "flowed through" to them. In the meantime, U.S. tax authorities applied a multi-factor test to determine whether or not to give a business organization a flow-through tax treatment. Simultaneously, the development of the statute on business organizations saw further evolution on partnership laws and hybrid entities such as the limited liability companies, a cross between partnerships and corporations. The evolution of these hybrid business organizations was driven by the need seen by state legislators to avoid corporate taxes for unincorporated businesses. The result is the comment that "the tax laws became the tail that wagged the dog"[38]

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34. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 69 (2007).

35. Bradley T. Borden, *Aggregate-plus Theory of Partnership Taxation*, 42 GEO. L.J. 717, 736 (2009), *also available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1015&context=brad_borden (last accessed Aug. 31, 2010).

36. KLEIN & COFFEE, *supra* note 34, at 68 & 117.

37. Borden, *supra* note 35, at 722 & 741.

38. ALAN R. PALMITER, CORPORATIONS 31-34 (2006). The multi-factor test refers to the Kintner test, where the Internal Revenue Services looked into whether the firm exhibited three of the four classic corporate characteristics: (1) continuity of life; (2) centralized management; (3) liability for business debts limited to corporate assets; and (4) free transferability of interests. In 1996, all this changed with the "check the box," which allowed the unincorporated business organization to choose whatever organizational attributes best suited to its needs to assure the flow-through tax status. (The Kintner test was derived from the case of United States v. Kintner, 216 F.2d 418 (9th Cir. 1954)).

Id. at 33.

due to the desire for a form of unincorporated business organization that has the corporate characteristic of limited liability but, in order to avoid the double tax on corporate income, is treated as a partnership for purposes of federal income taxation.[39]

V. FLOW-THROUGH TAXATION OF THE PHILIPPINE PARTNERSHIP UNDER THE 1939 TAX CODE

The question now is how to determine the underlying features of our current hybrid Hispano-American partnership law for purposes of studying how partnerships are taxed in our jurisdiction. If we were to juxtapose American analytical tools with the aggregate-entity dichotomy on Philippine partnership law, it will be safe to conclude that the Philippine law on partnership has both before and after the current Civil Code operated on the theory that the partnership is an entity. Prior to the current Civil Code, the legal personality of the *sociedad* was expressly recognized by the Spanish Civil Code[40] and the Spanish Code of Commerce, albeit registration was required under the latter.[41] Our Civil Code today provides an express recognition of the juridical personality of the partnership separate and distinct from each of the partners, even in case of failure to comply with the requirements of registration.[42] No equivalent provisions can be found in the UPA.[43] Nevertheless, certain elements[44] that can be recognized as characteristic of the aggregate theory can be found in our partnership law. These include the *delectus personae* provisions which grants partners the right to deny or admit persons as partners even in the event when a former partner has sold or encumbered his interests in the partnership,[45] and the rules on mutual agency.[46]

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39. KLEIN & COFFEE, *supra* note 34, at 103.

40. CÓDIGO CIVIL, art. 35.

41. CÓDIGO DE COMERCIO, arts. 116 & 119.

42. CIVIL CODE, art. 1768.

43. *See* FREY *supra,* note 32, at 1361-76.

44. *See* Borden *supra,* note 35, at 738-39.

45. CIVIL CODE, arts. 1804 & 1813, to wit:

> Article 1804. Every partner may associate another person with him in his share, but the associate shall not be admitted into the partnership without the consent of all the other partners, even if the partner having an associate should be a manager. (1696)
>
> Article 1813. A conveyance by a partner of his whole interest in the partnership does not of itself dissolve the partnership, or, as against the other partners in the absence of agreement, entitle the assignee, during

While the basis of the flow-through taxation on partnerships is the aggregate theory, prior to the enactment of the current Civil Code, the duly registered *sociedad colectiva,* the precursor of the general partnership, was earlier subject to a flow-through taxation scheme despite the clear recognition of its separate and distinct juridical personality under our legal tradition. Thus, under the National Internal Revenue of 1939 (1939 Tax Code),[47] which is the earliest attempt at codifying our tax laws:

> Persons carrying on business in general co-partnership (*compañía colectiva*) duly registered in the mercantile registry shall be liable for income tax only in their individual capacity, and the share of the profits of the registered general co-partnership (*compañía colectiva*) to which any taxable partner would be entitled, whether divided or otherwise, shall be returned for taxation and the tax paid in accordance with the provisions of this Title.[48]

The 1939 Tax Code also specifically excluded duly registered general co-partnerships (*compañías colectivas*) from the corporate income tax provided therein.[49] This provision survived the introduction of new concepts of partnership under the current Civil Code when the Supreme Court in 1957 ruled that, under this tax regime, even a *sociedad civil* organized as a *sociedad colectiva* does not necessarily cease to be a civil partnership but can nevertheless enjoy this tax exemption of a *sociedad colectiva.*[50] The key,

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> the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled. However, in case of fraud in the management of the partnership, the assignee may avail himself of the usual remedies.
>
> In case of a dissolution of the partnership, the assignee is entitled to receive his assignor's interest and may require an account from the date only of the last account agreed to by all the partners. (n) (This article is from the UNIF. P'SHIP ACT, § 27.).

46. *See* CIVIL CODE, arts. 1803, 1818, 1821, 1822 & 1823. In particular, articles 1818, 1821, 1822, & 1823 were lifted from sections 9, 12, 13 & 14 of the UNIF. P'SHIP ACT, respectively.

47. An Act to Revise, Amend and Codify the Internal Revenue Laws of the Philippines [NATIONAL INTERNAL REVENUE CODE OF 1939], Commonwealth Act No. 466 (1939).

48. *Id.* § 26. The word "*compañía*" is interchangeable with the word "*sociedad,*" hence, "*compañía colectiva*" and "*sociedad colectiva*" refer to the same type of general partnership.

49. *Id.* § 24, ¶ 1.

50. *See* Collector of Internal Revenue v. Isasi, 101 Phil. 247, 253-54 (1957).

apparently, was that to be exempt, the entity must be *duly registered* as a general co-partnership.

However, under the 1939 Tax Code, as originally enacted, all other partnerships, no matter how created or organized, were treated as corporations by way of definition, and as a result, should be taxed accordingly, [51] although this was later amended to exempt general professional partnerships (GPPs),[52] and subsequently, joint ventures formed for the purpose of undertaking construction projects.[53] The inclusion of partnerships by definition into the meaning of the word "corporation" for the purpose of taxation has generated a study in itself of unregistered partnerships. In a case [54] involving a deemed partnership, albeit an unregistered one, where three sisters, all surnamed Evangelista, borrowed funds from their father to purchase real estate, had their brother manage these, and subsequently, habitually leased these out for 12 years, the High Tribunal found that this enterprise is subject to the same taxes as a corporation.[55] Thus, the Court had occasion to explain that:

> To begin with, the tax in question is one imposed upon 'corporations,' which, strictly speaking, are distinct and different from 'partnerships.' When our Internal Revenue Code includes 'partnerships' among the entities subject to the tax on 'corporations,' said Code must allude, therefore, to organizations which are not necessarily 'partnerships,' in the technical sense of the term. Thus, for instance, section 24 of said Code exempts from the aforementioned tax 'duly registered general partnerships,' which constitute precisely one of the most typical forms of partnerships in this jurisdiction. Likewise, as defined in section 84(b) of said Code, 'the term corporation includes partnerships, no matter how created or

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51. NATIONAL INTERNAL REVENUE CODE OF 1939, §§ 24 & 84 (b). Section 84 (b) provides that "[t]he term 'corporation' includes partnerships, no matter how created or organized, joint-stock companies, joint accounts (*cuentas en participación*), associations or insurance companies, but does not include duly registered general co-partnerships (*compañías colectivas*)."

52. An Act Amending Sections Twenty-Four, Twenty-Six, Twenty-Nine, Thirty-Two, Forty-Nine, Fifty-Three, Fifty-Four and Eighty-Four (b) of the National Internal Revenue Code, as Amended, Republic Act No. 5431 (1968). (Sections 1, 2 & 8 amended Sections 24, 26 & 84 (b) of the NATIONAL INTERNAL REVENUE CODE OF 1939.).

53. Amending Subparagraph (b) of Section 84 and Section 191 of the National Internal Revenue Code, as Amended, Presidential Decree No. 929, (1976). (Section 1 amended Section 84 (b) of the NATIONAL INTERNAL REVENUE CODE OF 1939.).

54. Evangelista v. Collector of Internal Revenue, 102 Phil. 140 (1957).

55. *Id.* at 148.

> organized.' This qualifying expression clearly indicates that a joint venture need not be undertaken in any of the standard forms, or in conformity with the usual requirements of the law on partnerships, in order that one could be deemed constituted for purposes of the tax on corporations. Again, pursuant to said section 84(b), the term 'corporation' includes, among others, 'joint accounts (*cuentas en participación*)' and 'associations,' none of which has a legal personality of its own, independent of that of its members. Accordingly, the lawmaker could not have regarded that personality as a condition essential to the existence of the partnerships therein referred to. In fact, as above stated, 'Duly registered general co-partnerships' — which are possessed of the aforementioned personality — have been expressly excluded by law (sections 24 and 84 [b]) from the connotation of the term 'corporation'. It may not be amiss to add that petitioners' allegation to the effect that their liability in connection with the leasing of the lots above referred to, under the management of one person — even if true, on which we express no opinion tends to increase the similarity between the nature of their venture and that of corporations, and is, therefore, an additional argument in favor of the imposition of said tax on corporations.[56]

The *Evangelista* case became a landmark ruling of sorts for the taxation of partnerships, and was repeatedly cited and applied in several other instances. Thus, in another case,[57] a "Joint Emergency Operation" was undertaken by two bus corporations who purchased 56 buses from the American army in the aftermath of World War II, and operated these buses under a sole management. In this instance, citing the ruling in the *Evangelista* case, the "Joint Emergency Operation" was deemed a joint venture, and hence, a partnership within the meaning of the 1939 Tax Code, and was subject to corporate taxes.[58] Again in another case,[59] a father and son purchased a lot and building known as the Gibbs Building, wherein father and son shared in the payments to the vendor and the mortgage obligation they assumed from the vendor of the lot and building, hiring an administrator to manage the property, and dividing equally the income from the rentals. The taxpayers in this case claim that the purpose of acquiring the building was to house their various enterprises and to effect division after 10 years.[60] The Court, however, noted that the building was held for lease for 15 years, and declared that "the petitioners' efforts to avoid the controlling force of the *Evangelista* ruling cannot be deemed successful."[61] In still another case,[62] the

56. *Id.* at 146-47.

57. Collector of Internal Revenue v. Batangas Trans. Co., et al., 102 Phil. 822 (1957).

58. *Id.* at 827-31.

59. Reyes v. Commissioner of Internal Revenue, 24 SCRA 198 (1968).

60. *Id.* at 201 & 203.

61. *Id.* at 204.

husband and five children of a deceased woman, after partitioning the estate among themselves, left the estate under the management of the widower, who used the properties in business by leasing or selling them, and investing the income derived therefrom in other real estate property and securities, a situation which continued from the point of partition in 1949 to the year 1956, which was subject of an assessment by the Bureau of Internal Revenue (BIR).[63] In this instance, the Court ruled that, while it is logical that in cases of inheritance, there should be a period when the heirs can be considered as co-owners rather than unregistered co-partners:

> [F]or tax purposes, the co-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 partition either duly executed in an extrajudicial settlement or approved by the court in the corresponding testate or intestate proceeding. The reason for this is simple. From the moment of such partition, the heirs are entitled already to their respective definite shares of the estate and the incomes thereof, for each of them to manage and dispose of as exclusively his own, without the intervention of the other heirs, and accordingly, he becomes liable individually for all taxes in connection therewith. If after such partition, he allows his 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 the purpose, for tax purposes, at least, an unregistered partnership is formed.[64]

VI. THE 1977 TAX CODE — NARROWING THE FLOW-THROUGH TAXATION OF PARTNERSHIPS

The second codification of our tax laws in 1977 (1977 Tax Code)[65] eliminated the special treatment of the duly registered *sociedad colectiva*. In its place, only the general professional partnership enjoyed the flow-through tax scheme. The general rule that partnerships, no matter how created or organized, will be subject to corporate income tax was emphasized by including this rule in the section providing for the rates of income taxes for

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62. Oña v. Commissioner of Internal Revenue, 45 SCRA 74 (1972).

63. *Id.* at 76-81.

64. *Id.* at 82-83.

65. A Decree to Consolidate and Codify All the Internal Revenue Laws of the Philippines [NATIONAL INTERNAL REVENUE CODE OF 1977], Presidential Decree No. 1158, § 24 (1977).

corporations[66] while maintaining that partnerships are included in the definition of corporations.[67] However, the 1977 Tax Code included in the definition of corporations "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."[68] It also defined "general professional partnerships" as "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."[69]

The Supreme Court had occasion to apply these principles to cases involving allegations of unregistered partnerships. In one case[70] decided under the 1977 Tax Code, the two petitioners purchased two parcels of land in 1965 and left it idle. The following year, they bought three parcels of land. It was only in 1968 that they sold the first two parcels and in 1979 the remaining three were sold.[71] The BIR deemed the transactions as undertaken by an unregistered partnership, and taxed the petitioners as a corporation.[72] The petitioners protested claiming that they availed of a tax amnesty under Presidential Decree No. 23.[73] The Bureau of Internal Revenue ruled that the availment of the tax amnesty only relieved petitioners of their individual income tax liabilities but did not relieve them of the tax liabilities arising from their unregistered partnership.[74] On appeal, the Commissioner of Internal Revenue invoked the tried and tested *Evangelista* ruling.[75] However, the Supreme Court deemed the transactions in this case as isolated and without the character of habituality peculiar to business transactions for the purpose of gain.[76] The Court distinguished the *Evangelista* case from the instant case, to wit:

> In the present case, there is no evidence that petitioners entered into an agreement to contribute money, property or industry to a common fund, and that they intended to divide the profits among themselves. Respondent commissioner and/or his representative just assumed these conditions to be

66. *Id.* § 24.
67. *Id.* § 20 (b).
68. *Id.*
69. *Id.*
70. Pascual v. Commissioner of Internal Revenue, 166 SCRA 560 (1988).
71. *Id.* at 561-62.
72. *Id.* at 562.
73. *Id. See also* Proclaiming a Tax Amnesty, Subject to Certain Conditions, Presidential Decree No. 23 (1972).
74. *Id.*
75. *Id.* at 563.
76. *Pascual,* 166 SCRA at 568.

> present on the basis of the fact that petitioners purchased certain parcels of land and became co-owners thereof.
>
> In *Evangelista*, there was a series of transactions where petitioners purchased twenty-four (24) lots showing that the purpose was not limited to the conservation or preservation of the common fund or even the properties acquired by them. The character of habituality peculiar to business transactions engaged in for the purpose of gain was present.
>
> ...
>
> The sharing of returns does not in itself establish a partnership whether or not the persons sharing therein have a joint or common right or interest in the property. There must be a clear intent to form a partnership, the existence of a juridical personality different from the individual partners, and the freedom of each party to transfer or assign the whole property.
>
> In the present case, there is clear evidence of co-ownership between the petitioners. There is no adequate basis to support the proposition that they thereby formed an unregistered partnership. The two isolated transactions whereby they purchased properties and sold the same a few years thereafter did not thereby make them partners. They shared in the gross profits as co-owners and paid their capital gains taxes on their net profits and availed of the tax amnesty thereby. Under the circumstances, they cannot be considered to have formed an unregistered partnership which is thereby liable for corporate income tax, as the respondent commissioner proposes.[77]

VII. TAX TREATMENT OF THE PARTNERSHIP TODAY — A FEW RULES TO CONSIDER

The current tax code (1997 Tax Code)[78] carries with it virtually unchanged the tax treatment of partnerships found in the 1977 Tax Code. Partnerships currently have two types of tax treatment: first, those partnerships which are treated as corporations; and second, those allowed a flow-through taxation scheme. The latter applies to general professional partnerships and includes certain types of joint ventures and consortiums.

A. Partnerships are Generally Taxed in the Same Manner as Corporations

The prevailing rule now is that, without considering general professional partnerships and certain types of joint ventures and consortiums, partnerships, no matter how created or organized, are included in the

77. *Id.* at 566-68.

78. An Act Amending the National Internal Revenue Code, as Amended, and for Other Purposes [TAX REFORM ACT OF 1997], Republic Act No. 8424 (1997).

definition of a "corporation."[79] In fact, the term "share of stock" includes units of participation in a partnership.[80] Correspondingly, the term "shareholder" includes a holder of a unit of participation in a partnership.[81] The consequence is that the income of a partnership is subject to taxes twice in the same way as a corporation. First, at the level of the partnership, a partnership is subject to the 30% corporate income tax on all taxable income from all sources within and without the Philippines.[82] Second, on the level of the partner, a final tax of 10% is imposed on the share of an individual partner in the distributable net income after the tax on the partnership.[83]

The Supreme Court, deciding under the current tax code, applied the *Evangelista* ruling on unregistered partnerships on a pool of 41 domestic insurance corporations forming a "clearing house" to contract with a non-resident foreign insurance corporation with respect to reinsurance.[84] The Court of Tax Appeals gave no heed to the fact that the pool does not retain any profit or income; instead, it noted that the pool was indispensable to the business of the insurance companies involved.[85] The finding of the Court of Tax Appeals was held to be apt by the Supreme Court who declared that:

> Article 1767 of the Civil Code recognizes the creation of a contract of partnership when 'two or more persons bind themselves to contribute money, property, or industry to a common fund, with the intention of dividing the profits among themselves.' Its requisites are: '(1) mutual contribution to a common stock, and (2) a joint interest in the profits.' In other words, a partnership is formed when persons contract 'to devote to a common purpose either money, property, or labor with the intention of dividing the profits between themselves.' Meanwhile, an association implies associates who enter into a 'joint enterprise ... for the transaction of business.'
>
> In the case before us, the ceding companies entered into a Pool Agreement or an association that would handle all the insurance businesses covered under their quota-share reinsurance treaty and surplus reinsurance treaty

79. *Id.* § 22 (b).

80. *Id.* § 22 (l).

81. *Id.* § 22 (m).

82. An Act Amending Sections 27, 28, 34, 106, 107, 108, 109, 110, 111, 112, 113, 114, 116, 117, 119, 121, 148, 151, 236, 237 and 288 of the National Internal Revenue Code of 1997, as Amended, and for Other Purposes [Reformed VAT Law], Republic Act No. 9337 (2005). (Section 1 states that the corporate income tax shall be imposed on every corporation as defined in the cited Section 22 (b) of the TAX REFORM ACT OF 1997.).

83. TAX REFORM ACT OF 1997, § 24 (b) (2).

84. Afisco Insurance Corporation v. Court of Appeals, 302 SCRA 1 (1999).

85. *Id.* at 14.

> with Munich. The following unmistakably indicates a partnership or an association covered by Section 24 of the NIRC [1997 Tax Code]:
>
> (1) The pool has a common fund, consisting of money and other valuables that are deposited in the name and credit of the pool. This common fund pays for the administration and operation expenses of the pool.
>
> (2) The pool functions through an executive board, which resembles the board of directors of a corporation, composed of one representative for each of the ceding companies.
>
> (3) True, the pool itself is not a reinsurer and does not issue any insurance policy; however, its work is indispensable, beneficial and economically useful to the business of the ceding companies and Munich, because without it they would not have received their premiums. The ceding companies share 'in the business ceded to the pool' and in the 'expenses' according to a 'Rules of Distribution' annexed to the Pool Agreement. Profit motive or business is, therefore, the primordial reason for the pool's formation.[86]

B. The Remaining Flow-Through Tax Treatment For Partnerships

Partnerships with a flow-through tax treatment under the current tax code are the formal general professional partnerships which retained their definition from the 1977 Tax Code in that these are defined as "partnerships formed by persons for the sole purpose of exercising their common profession."[87] Consequently, the GPP, unlike an ordinary business, is tax exempt, provided that no part of its income is used for trade or business, the partnership being devoted solely to the practice of a common profession.[88] By common profession, there is an opinion that the professionals in a general professional partnership must be of the same profession. Thus, where a professional partnership is formed consisting of architects and engineers, this was perceived as a partnership made up of different and distinct professionals. While it is true that it is capable of providing integrated services to the varied disciplines required in the construction business, it is a full service firm rather than a group of professionals practicing a common profession and as such, cannot be exempt from income tax.[89]

Persons engaging in business as partners in a GPP shall be liable for income tax only in their separate and individual capacities. But the partners

86. *Id.* at 13-14.

87. NATIONAL INTERNAL REVENUE CODE OF 1977, § 20 (b).

88. TAX REFORM ACT OF 1997, §§ 22 (b) & 26.

89. Bureau of Internal Revenue, VAT Ruling No. 116-99 (Dec. 7, 1999).

themselves will be taxed on their share of the net income of the partnership, whether actually or constructively received. Such distributive share in the net income of the general professional partnership shall be reported by each partner as part of his or her gross income.[90]

For purposes of computing the distributive share of the partners, the net income of the partnership shall be computed in the same manner as a corporation.[91] As such, the general professional partnership, like a corporation, may claim itemized deductions allowed under the tax code[92] or opt to avail of the optional standard deduction (OSD) of 40% of its gross income, the optional standard deduction being in lieu of the itemized deductions.[93] The net income determined after either claiming the itemized deductions or the optional standard deduction from the gross income of the general professional partnership is, consequently, the net income from which the share of each partner is to be determined. In this manner, the general professional partnership is not a taxable entity but is a flow-through or pass-through entity where the income is ultimately taxed on the partners comprising it.[94]

Partners of a general professional partnership who received taxable income may still deduct expenses which are ordinary and necessary and incurred and paid for the practice of the profession, apart from the expenses claimed by the general professional partnership in determining net income. However, partners to a general professional partnership must observe the following rules:

> (1) If the general professional partnership has already availed of the itemized deductions, its partner cannot claim the same expenses that have already been claimed by the partnership. Moreover, the *partners are not allowed to claim the optional standard deductions* from their share in the net income because the optional standard deduction 'is a proxy for all the items of deductions allowed in arriving at taxable income.'[95]

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90. TAX REFORM ACT OF 1997, § 26.

91. *Id.*

92. *Id.*, § 34 (a) - (j).

93. An Act Amending Sections 22, 24, 34, 35, 51, and 79 of Republic Act No. 8424, as Amended, Otherwise Known as the National Internal Revenue of 1997, Republic Act No. 9504, § 3 (2008).

94. *See* Bureau of Internal Revenue, Amendment to Revenue Regulations No. 16-2008 with Respect to the Determination of the Optional Standard Deduction (OSD) of General Professional Partnerships (GPPs) and the Partners Thereof, as well as the Manner and Period for Making the Election to Claim OSD in the Income Tax Returns, Rev. Reg. No. 2-2010 (Feb. 18, 2010).

95. Rev. Reg. No. 2-2010, § 2. This rule reverses the prior rule found in Bureau of Internal Revenue, Implementing the Provisions of Section 34 (L) of the Tax Code of 1997, as Amended by Section of Republic Act No. 9504, Dealing on

> The optional standard deduction is in lieu of *both* the items of deduction of the general professional partnership and the items of deduction claimed by the partners, and is not available when the general professional partnership claims itemized deductions.[96]
>
> (2) If the general professional partnership avails of the optional standard deduction in computing its net income, the partners can no longer claim further deduction from their share in the said net income. The reasons for these are:
>
> i. The partners' distributive share in the general professional partnership is treated as his gross income and not his gross sales/receipts, and the 40% optional standard deduction allowed to individuals is specifically mandated to be deducted not from the partner's gross income but from his gross sales/receipts; and,
>
> ii. The optional standard deduction being in lieu of the itemized deductions allowed in computing taxable income as defined under Section 31 of the Tax Code, it will answer for both the items of deduction allowed to the general professional partnership and its partners.[97]
>
> (3) As a rule, the type of deduction chosen by the general professional partnership must be the same as the one chosen by its partners. This is because one layer of income tax is imposed on the income of the general professional partnership and the individual partners where the law had placed the statutory incidence of the tax in the hands of the latter. Accordingly, if the general professional partnership claims itemized deductions, all items of deduction allowed under Section 34 can be claimed both at the level of the general professional partnership and at the level of the partner in order to determine the taxable income. On the other hand, *should the general professional partnership opt to claim the optional standard deduction, the individual partners are deemed to have availed also of the optional standard deduction* because the optional standard deduction is in lieu of the itemized deductions that can be claimed in computing taxable income.[98]

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the Optional Standard Deduction (OSD) Allowed to Individuals and Corporations in Computing Their Taxable Income, Rev. Reg. No. 16-2008, § 6 (Nov. 26, 2008), to wit: "If the GPP availed of the itemized deduction in computing its net income, the partners may still either claim itemized deduction or OSD from said share, provided, that, in claiming itemized deductions, the partner is precluded from claiming expenses already claimed by the GPP." (emphasis supplied).

96. *Id.*

97. *Id.*

98. *Id.* (emphasis supplied).

(4) If the partner also derives other gross income from trade, business or practice of profession apart and distinct from his share in the net income of the general professional partnership, the deduction that he can claim from his other gross income would follow the same deduction availed of from his partnership income as explained in the foregoing rules. Provided, however, that if the general professional partnership opts for the optional standard deduction, the individual partner may still claim 40% of its gross income from trade, business or practice of profession but not to include his share from the net income of the general professional partnership.[99]

The foregoing set of rules issued this year significantly changes a regulation issued just 15 months earlier to implement the new provisions on optional standard deductions, to wit:

> The GPP and each of the partners are entitled to their own election of deductions to claim during the taxable year thereby resulting to four possibilities, namely: (1) the GPP may claim itemized deductions in computing net income and a partner may also claim itemized deductions in computing his taxable income; or (2) the GPP may claim OSD in computing net income while a partner may claim itemized deductions in computing his taxable income; or (3) the GPP may claim itemized deductions in computing net income while a partner may claim OSD in computing his taxable income; or (4) the GPP may claim OSD in computing net income and a partner may also claim OSD in computing his taxable income.[100]

The most radical revision introduced by the new regulation is the fundamental shift on the treatment of optional standard deductions. The new rules effectively preclude, *in toto*, the application of the optional standard deduction on the income that a partner receives from the general professional partnership. Also deserving of harsh criticism is the new rule that now prohibits a partner from claiming itemized deductions after the GPP has applied the optional standard deduction to arrive at the distributable net income of the partnership.[101] The basis of the rule is apparently the "pass-through" nature of the taxation of the general professional partnership.[102] On the surface, this may be justified as the pass-through taxation rests on the aggregate theory. However, two points weigh heavily against this approach.

First, the statute on optional standard deduction makes no specific exception as to bar partners of a general professional partnership from applying the optional standard deduction on the income they received from the partnership. In the same vein, the law makes no mention of the effect of

99. *Id.*

100. Rev. Reg. No. 16-2008, § 6.

101. Rev. Reg. No. 2-2010, § 2.

102. *Id.*

the use of the OSD by a general professional partnership so as to prevent a partner from using the itemized deductions thereafter. The law provides that the optional standard deduction is an option available to any individual subject to tax on his or her gross receipts or gross sales.[103] The OSD should be seen as a way to simplify the tax system. It is therefore dismaying to find a set of regulations that complicates a system that has been introduced for the purpose of simplifying tax administration. The new regulations can only create more incidents where the tax bureaucracy can vex the taxpayer.

Second, we cannot ignore the entity characteristics of our partnership law as manifested by the unequivocal declaration that a partnership has a juridical personality separate and distinct from each of the partners, even in case of the absence of registration.[104] Hence, the rationale given in the rules for barring partners from applying the optional standard deductions, or for that matter, the itemized deductions in case the partnership has claimed for the optional standard deduction, is a complete failure in logical analysis.[105]

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103. Republic Act No. 9504, § 3. This amends Section 34 (L) of the TAX REFORM ACT OF 1997 as follows:

> (L) Optional Standard Deduction. — In lieu of the deductions allowed under the preceding Subsections, an individual subject to tax under Section 24, other than a nonresident alien, may elect a standard deduction in an amount not exceeding forty percent (40%) of his gross sales or gross receipts, as the case may be. In the case of a corporation subject to tax under Sections 27(A) and 28(A)(1), it may elect a standard deduction in an amount not exceeding forty percent (40%) of its gross income as defined in Section 32 of this Code. Unless the taxpayer signifies in his return his intention to elect the optional standard deduction, he shall be considered as having availed himself of the deductions allowed in the preceding Subsections. Such election when made in the return shall be irrevocable for the taxable year for which the return is made: Provided, That an individual who is entitled to and claimed for the optional standard deduction shall not be required to submit with his tax return such financial statements otherwise required under this Code: Provided, further, That except when the Commissioner otherwise permits, the said individual shall keep such records pertaining to his gross sales or gross receipts, or the said corporation shall keep such records pertaining to his gross income as defined in Section 32 of this Code during the taxable year, as may be required by the rules and regulations promulgated by the Secretary of Finance, upon recommendation of the Commissioner.

104. CIVIL CODE, art. 1768.

105. Reference is to the revisions made by Rev. Reg. No. 2-2010 to Section 6 of Rev. Reg. No. 16-2008.

The fact that there is only one layer of income tax, as stated in the new regulations, does not and can in no manner obliterate the fact that the partners are natural persons separate and distinct from the juridical person of the general professional partnership. Hence, while the flow-through taxation has been specifically provided by law, it does not follow that either the optional standard deduction or the itemized deduction, *as systems of deduction from gross income*, can be only applied on one layer. What can only be applied once is the specific item of expense for deduction, for instance the depreciation of a car used in the practice of profession or law books purchased for the purpose of the practice of law. But the reason for this is not because of the one-layer pseudo-theory as posed by the new regulation, but because the principle of unjust enrichment should preclude a deduction on the exact same expense to be claimed twice.

Moving to another point, the discussion on GPPs cannot be complete without mentioning the latest rules on withholding taxes. Accordingly, it should be noted that any income payments made periodically or at the end of the taxable year by a general professional partnership to the partners is subject to a withholding tax of 15% if the income payments to the partner for the current year exceeds ₱ 720,000.00; and 10%, if it does not exceed ₱ 720,000.00. Drawings, advances, shares, allowances, stipends and the like paid to partners are all considered income from the partnership subject to the expanded withholding tax.[106]

Also included in the flow-through taxation scheme are joint ventures and consortiums formed for undertaking construction projects or energy operations "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

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106. Bureau of Internal Revenue, Amending Further Pertinent Provisions of Revenue Regulations No. 2-98, as Last Amended by Revenue Regulations No. 17-2003, and Revenue Regulations No. 8-98, as Amended, Providing for the Imposition of Final Withholding Tax on the Sale, Exchange or Other Disposition of Real Property Classified as Capital Assets by Nonresident Aliens, Increasing the Withholding Tax Rates on Certain Income Payments, Inclusion of Certain Income Payments, Sanctions to be Imposed on Payees Who Refuse the Withholding of Tax on Their Income/Receipts, and for Other Purposes, Rev. Reg. No. 30-03 (Nov. 12, 2003). Section 3 provides that Section 2.57.2 (H) of Rev. Reg. No. 2-98, as amended, is further amended to read as follows:

> (H) Income payments to partners of general professional partnerships. Income payments made periodically or at the end of the taxable year by a general professional partnership to the partners, such as drawings, advances, sharings, allowances, stipends, etc. — Fifteen percent (15%), if the income payments to the partner for the current year exceeds P720,000; and Ten percent (10%), if otherwise.

with the Government."[107] The most common application of this provision is in land development agreements, where one party contributes real estate such as land, and the other party develops the property into a condominium or subdivision, ascribing to each party the obligation to contribute development and/or construction funds, and thereafter, each contributing party is entitled to a share of the condominium units and parking slots or lots as the case may be. In such cases, the BIR has consistently ruled that such transactions do not give rise to a taxable joint venture. Key aspects in the transaction were deemed non-taxable events such that taken as a whole, even if a joint venture or an unregistered partnership was indeed formed, the enterprise will be tax exempt, to wit:

> (a) That the contribution of each party to the joint venture is not a taxable event that will give rise to the payment of regular income tax, creditable income tax or capital gains tax as the parties did not convey or transfer their ownership or interest over their real properties when they contributed the aforesaid parcels of land to the joint venture but merely pooled their resources into a common fund and this constituted the parties capital contribution to the joint venture project. The transfer was also deemed not subject to value added taxes since that transfers are not in the course of business but are capital contributions.
>
> (b) The allocation and distribution of saleable lots or condominium units and parking slots, as the case may be, in accordance with, or in consideration of, the parties' respective contributions are not subject to income tax or any withholding tax because the allocation is a mere return of capital that each party has contributed. Furthermore, the allocations are not subject to documentary stamp taxes for want of consideration. However, the subsequent disposition by the parties of the lots or units allocated to them will subject the gains realized therefrom to the regular corporate income tax rate.[108]

It was noted that the exclusion of joint ventures undertaking construction projects from the definition of taxable corporations was intentional on the part of the legislator because:

> (1) Local contractors contribute substantially to the development program of the country; (2) Local contractors are at a disadvantage in competitive bidding with foreign contractors in view of limited capital and financial resources; (3) In order to be able to compete with big foreign contractors,

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107. TAX REFORM ACT OF 1997, § 22 (b). This section merely carries over the exact provisions of Section 20 (b) of the NATIONAL INTERNAL REVENUE CODE OF 1977.

108. *See generally* Bureau of Internal Revenue, BIR Ruling No. DA-(JV-007) 015-10 (Jan. 28, 2010), BIR Ruling No. DA-(JV-006) 014-10 (Jan. 26, 2010), and BIR Ruling No. DA-(JV-005) 012-10 (Jan. 26, 2010).

> it may be necessary for them to enter into joint ventures to pool their limited resources in undertaking big construction projects; (4) To assist them in achieving competitiveness with foreign contractors, the joint ventures formed by them should not be considered an additional income tax lien.[109]

On the other hand, in several cases, favorable rulings were secured from the BIR finding a non-taxable joint venture or partnership for the purpose of undertaking a construction project under the following scheme:

> To begin the Project, each Client entered into a Contract to Manage and Execute the Construction of Kensington Place Condominium (the Contract). In said Contract, each Client undertook to collectively develop the Project and to put up his/her respective construction funding contributions for the same. In return for such participation and as part of his/her interest in the Project, each Client was assigned specific condominium units and parking units in the Project (the Condominium Units and Parking Units). In addition, each Client was to have a proportionate undivided interest in the common areas of the Project, which common areas include the Subject Land (the Common Areas).
>
> For its part GW [G&W Architects, Engineers and Project Development Consultants] was given a mandate to manage and execute the development of the Project and in connection thereto, to execute acts on behalf of and for the collective benefit of the Clients. GW, however, did not and does not assume the role of developer and hence, has not made any representation that it is, in its own capacity, selling the units comprising the Project.
>
> Under the terms of the Contract, each Client agreed that prior to the actual division of the Project into individual units, their respective interests in the Project would consist in a pro-indiviso, pro-rata share, held collectively with the other Clients. Realizing, however, that it would be cumbersome and administratively difficult for all the Clients to be named as owners of the Subject Land and the Project, the Clients appointed GW, as Trustee, for the purpose of allowing the Trustee to hold title to the Subject Land and the Project. GW was thus instructed under the Contracts, to purchase and hold title to the Subject Land for the collective benefit of the Clients and in proportion to their respective interests in the Project.[110]

However, after issuing a series of favorable rulings for this type of real estate development agreement, the tax authorities found that the transaction

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109. *See* Bureau of Internal Revenue, BIR Ruling No. DA-(JV-006) 014-10 (Jan. 26, 2010) and BIR Ruling No. DA-(JV-005) 012-10 (Jan. 26, 2010).

110. Bureau of Internal Revenue, BIR Ruling No. DA-455-07 (Aug. 17, 2007). The ratio in this ruling is found also in BIR Ruling No. DA-056-2003 (Feb. 24,2003), BIR Ruling No. DA-0624-2004 (Dec.10, 2004), BIR Ruling No. DA-410-2007 (July 26, 2007), and BIR Ruling No. DA-409-2007 (July 26, 2007).

is actually a scheme of build-to-own, build-your-own and similar concepts where the developer makes it appear that it merely manages the construction of the condominium project. In which case, the funds as contributed by the individual investors/co-developers are pooled in a bank with the developer. The developer, on the other hand, as project manager, receives only a project management fee. The delivery of the units to the individual investors/co-developers represented as a non-taxable event, the ruling previously issued will be *nullified* as it effectively results in the non-payment of income taxes and value-added taxes on the gross project amount. There are several recent incidents where the Bureau of Internal Revenue found the need to nullify previously issued rulings on joint venture real estate development in favor of developers and their co-parties based on the above grounds.[111]

VIII. ARMING PARTNERSHIP WITH THE FLOW-THROUGH TAX TREATMENT — A TOOL FOR THE DEVELOPMENT OF THE FILIPINO ENTREPRENEUR

When reviewing the statistics on the registration of partnerships in the last 50 years, one will notice that partnerships comprised an average of nine percent of the total registrations of both corporations and partnerships. From 1960 until 1984, the percentage of registered partnerships has been hovering at a one percent of the total registered partnerships and corporations and thereafter, partnerships increased to a little better than 10%.[112] Compare this

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111. Bureau of Internal Revenue, Revenue Memorandum Circular No. 55-2010 (June 28, 2010). It declares all the rulings in the next preceding footnote null and void. Bureau of Internal Revenue, Revenue Memorandum Circular No. 20-2010 (March 9, 2010) also declared BIR Ruling No. DA-245-05 (June 7, 2005) null and void for the same reasons. Bureau of Internal Revenue, Revenue Memorandum Circular No. 54-2010 (June 28, 2010) likewise declared null and void BIR Ruling No. DA-(C-322) 789-09 (Dec. 17, 2009), which has similar facts but where the BIR ruling is based on a trust relationship.

112. *See* Annex B of this Article. Data in Annex B was generated by the Management Information System of the Economic and Research Information Department of the SEC in response to a request for information made for this article (on file with the Author). For this Annex, while the raw data provided in the first four columns are data provided by the SEC, the totals and percentages found in the last three right most columns were computed by the Author. Compare the percentages in Annex B with the figure of 19.19% provided in Annex A as the total number of active partnership maintaining its registration with the SEC, the remaining balance consisting of corporations. Based on this, it appears that there has been a dramatic decline in the registration of partnerships in the last 50 years.

with the figures given for the U.S. indicating that there are 1.7 million partnerships as against 4.6 million corporations in the U.S.[113] This means that partnerships in the U.S. comprise 27% of the combined figures for partnerships and corporations. It is then apparent that the use of partnerships in the Philippines compares poorly with its usage in the U.S., an interesting fact considering that we share to a large degree with the U.S. the use of the same model laws for partnerships.

It is unfortunate that partnerships are relegated to the less preferred of business organizations. There is much to say in its favor for the Filipino entrepreneur. On the other side of the coin, too much credit has been given to the absence of the limited liability available to the shareholders of a corporation. But the more extensive liability that a partner is exposed to should be viewed not as a bane of partnerships but as the key to allowing one to enjoy the advantages of a partnership organization. For one, the unity of ownership and control in partnerships allows for direct management by the proponents of a partnership enterprise which is not shared in the same degree by shareholders of a corporation. Also, because of the rules on *delectus personae*, a partnership allows the partners an absolute say as to who will be intimately entwined with them in their economic endeavors. Furthermore, a partnership will have lower transaction and agency costs as it has no board of directors, and is not subject to complex corporate governance rules. Thus, for the entrepreneur who is at the early or initiatory stage of his or her business enterprise or whose business or operations is too small or whose available personnel is too few, the partnership is an ideal choice as a business organization.

There can be no doubt then that the partnership vehicle can provide the much needed tool to develop Filipino entrepreneurship. It is ready and available for use as it is not in dire need of new laws for its creation. It has in existence a stable set of statutory and jurisprudential rules, and hence, does not need the creation of an implementing agency or the development of a new set of implementing rules and regulations. Marketed as a way for single proprietors and business proponents to combine their capital, property, industry, skills and talent to a common business undertaking, the partnership can be easily understood.

Consequently, to treat partnerships in the same manner as corporations for tax purposes is an incongruity. By giving partnerships a complex set of financial rules applicable to corporations, a business organization that can be utilized to develop those of lesser sophistication is obliged to acquire the sophistication necessary to run the multi-layered corporate organization.

It is on this note that the proposal is made that the flow-through tax scheme already available to general professional partnerships and certain types

113. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 1 (2002).

of joint ventures should be made available to all types of partnerships, both registered and unregistered, as well as to all types of joint ventures.

In the case of joint ventures, there does not appear to be any real economic or scientific basis why the flow-through tax scheme should apply only to the construction industry or energy projects. For instance, a joint venture engaged in food production or the export of goods could not possibly be less deserving of the simplification provided by the flow-through taxation than the real estate developers mentioned in this article. Moreover, a joint venture, which is the identical twin of the partnership as it is governed by the rules of partnerships,[114] allow for two or more corporations with large capital and capabilities to bind themselves to a business venture which they would not have otherwise been able to do alone.

The entrepreneurship that can be stimulated by partnerships and the combinations of big business that can be motivated by the joint venture are good grounds to expand the flow-through tax scheme. The realities that the Filipino taxpayer is confronted with in dealing with our tax bureaucracy likewise call for the flow-through tax in order to simplify taxation and minimize the necessity for more regulations. The essence of this proposal is to rouse the partnership from its slumber, and with its aid, to overcome the frailties and impotence of a single individual's effort by creating an environment where capital, talent and industry from many can be galvanized into vigorously coalescing to form a single enterprise.

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114. *See* Philex Mining Corporation v. Commissioner of Internal Revenue, 551 SCRA 428, 439 (2008) (citing Aurbach v. Sanitary Wares Manufacturing Corp., 180 SCRA 130, 146-47 (1989)).

IX. ANNEX A

Number of Registered Corporations and Partnerships as of 30 April 2010

	NUMBER OF FIRMS		% TO TOTAL
A. Total Active and Inactive Companies[115]	709,191		100.00%

		NUMBER OF FIRMS	% TO TOTAL ACTIVE	% TO TOTAL ACTIVE & INACTIVE
B. Active Companies		404,615	100.00%	57.05%
1. Corporations		326,961	80.81%	46.10%
1.1 Stock	217, 264		53.70%	
1.2 Non-Stock	109,697		27.11%	
2. Partnerships		77,654	19.19%	10.95%

	NUMBER OF FIRMS	% TO TOTAL ACTIVE	% TO TOTAL ACTIVE & INACTIVE
C. Inactive Companies	304,576	100.00%	42.95%
1. Revoked	269,763	88.57%	38.04%
2. Cancelled	548	0.18%	0.08%
3. Dissolved	15,651	5.14%	2.21%
4. Expired	15,365	5.04%	2.17%
5. Others	3,249	1.07%	0.46%

115. All registered firms as of 30 April 2010, including domestic corporations and partnerships and foreign companies licensed to do business in the Philippines.

X. ANNEX B[116]

Number of Registered Corporations/Partnerships

YEAR	CORPORATIONS ★	GENERAL PARTNERSHIP ★	LIMITED PARTNERSHIP ★	PARTNERSHIPS IN TOTAL	ALL ENTITIES	PERCENTAGE OF PARTNERSHIPS
1960	1,805	224	5	229	2,034	11.26%
1961	1,924	185	5	190	2,114	8.99%
1962	2,174	10	-	10	2,184	0.46%
1963	2,196	13	-	13	2,209	0.59%
1964	2,129	3	-	3	2,132	0.14%
1965	2,070	9	-	9	2,079	0.43%
1966	2,867	21	-	21	2,888	0.73%

116. While the raw data provided in the first four columns are data provided by the SEC, the totals and percentages found in the last three right most columns were computed by the Author. Compare the percentages in Annex B with the figure of 19.19% provided in Annex A as the total number of active partnership maintaining its registration with the SEC, the remaining balance consisting of corporations. Based on this, it appears that there has been a dramatic decline in the registration of partnerships in the last 50 years.

1967	2,887	19	-	19	2,906	0.65%
1968	3,117	20	-	20	3,137	0.64%
1969	2,887	17	-	17	2,904	0.59%
1970	3,023	17	-	17	3,040	0.56%
1971	3,264	20	-	20	3,284	0.61%
1972	788	29	-	29	817	3.55%
1973	16,243	30	1	31	16,274	0.19%
1974	1,510	21	-	21	1,531	1.37%
1975	9,851	22	-	22	9,873	0.22%
1976	6,278	13	-	13	6,291	0.21%
1977	6,042	11	-	11	6,053	0.18%
1978	6,532	10	-	10	6,542	0.15%
1979	6,703	14	-	14	6,717	0.21%
1980	6,618	484	53	537	7,155	7.51%
1981	5,948	866	85	951	6,899	13.78%
1982	6,772	10	-	10	6,782	0.15%

1983	9,314	29	3	32	9,346	0.34%
1984	6,091	28	2	30	6,121	0.49%
1985	6,509	931	97	1,028	7,537	13.64%
1986	7,138	871	90	961	8,099	11.87%
1987	13,578	955	95	1,050	14,628	7.18%
1988	11,423	1,078	96	1,174	12,597	9.32%
1989	14,541	1,220	126	1,346	15,887	8.47%
1990	15,833	1,410	169	1,579	17,412	9.07%
1991	14,615	1,160	1	1,161	15,776	7.36%
1992	17,588	1,667	205	1,872	19,460	9.62%
1993	20,231	2,125	274	2,399	22,630	10.60%
1994	21,859	2,221	357	2,578	24,437	10.55%
1995	22,957	2,424	387	2,811	25,768	10.91%
1996	23,170	2,589	533	3,122	26,292	11.87%
1997	25,989	2,913	1,247	4,160	30,149	13.80%

1998	20,933	2,694	1,177	3,871	24,804	15.61%
1999	22,244	2,998	672	3,670	25,914	14.16%
2000	21,168	2,678	290	2,968	24,136	12.30%
2001	22,797	2,501	134	2,635	25,432	10.36%
2002	22,452	2,374	77	2,451	24,903	9.84%
2003	19,607	1,997	150	2,147	21,754	9.87%
2004	23,109	2,560	218	2,778	25,887	10.73%
2005	20,672	2,226	230	2,456	23,128	10.62%
2006	19,774	2,087	233	2,320	22,094	10.50%
2007	22,382	2,096	243	2,339	24,721	9.46%
2008	22,581	2,093	243	2,336	24,917	9.38%
2009	12,052	860	122	982	13,034	7.53%
22-JUN-10	8,575	919	115	1,034	9,609	10.76%
TOTAL	592,810	51,772	7,735	59,507	652,317	9.12%