

# A CRITIQUE OF THE PROPOSED SYSTEM OF GROSS INCOME TAXATION

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## I. INTRODUCTION

"Of all the powers conferred upon government, that of taxation is most liable to abuse. Given a purpose or object for which taxation may be lawfully used and the extent of its exercise, is in its very nature unlimited. It is true that express limitation on the amount of tax to be levied or the things to be taxed may be imposed by the constitution or statute but in most instances for which taxes are levied, as the support of government, the prosecution of war, the national defense, any limitation is unsafe. The entire resources of the people should in some instances, be at the disposal of the government.

"The power to tax is, therefore, the strongest, the most pervading of all the powers of government, reaching directly or indirectly to all classes of the people. x x x This power can as readily be employed against one class of individuals and in favor of another, so as to ruin the one class and give unlimited wealth and prosperity to the other, if there is no implied limitation of the uses for which the power may be exercised.

"To lay, with one hand, the power of the government on the property of the citizen, and with the other bestow it upon favored individuals to aid private enterprises and build up private fortunes, is nonetheless a robbery because it is due under the forms of law and is called taxation. This is not legislation. It is a decree under legislative forms."<sup>1</sup> (Emphasis supplied).

<sup>1</sup> Citizens Savings & Loan Association of Cleveland, Ohio City of Toledo, 20 Wall. (U.S.) 665, 663, 22 Law. Ed. 455 (1875).

There have been enormous agitations to adopt the system of gross income taxation in lieu of the present system which is based on net income, although the proponents have not advanced a concrete proposal relative thereto. No less than the President/Prime Minister Ferdinand E. Marcos himself has called the attention of the members of the Batasang Pambansa to the "proposals that we now adopt the gross income tax in place of the net income tax."<sup>2</sup> Moreover, in a cautious modification of a previous stand, the Acting Commissioner of the Bureau of Internal Revenue, Efren I. Plana, has signified that he is in favor of the adoption of a scheme which would reduce the area of discretion of collection agents."<sup>3</sup>

These declarations were predicated on the public outcries against the alleged graft and corruption in the enforcement of tax laws committed by some BIR personnel in collusion with some tax evading taxpayers. These ignited a major revamp in the Bureau of Internal Revenue and termination of many officers and employees thereof.<sup>4</sup>

This article attempts to present our view on the issue of whether or not we should adopt the system of gross income taxation in lieu of the present system of net income taxation.

## II. BASIC CONCEPTS ON INCOME TAXATION

Before discussing the issue, it is but appropriate to describe some basic concepts which are relevant.

Taxation is defined as the power of the sovereign to impose burdens or charges upon persons, property or property rights for use and support of government in order to enable it to discharge its appropriate functions.<sup>5</sup> A tax, as can be gleaned from the definition of taxation, is the burden or charge imposed upon person, property or property rights in the exercise of the state's taxing power for public use. According to Webster's Dictionary, a tax is a rate

<sup>2</sup> 75 O.G., No. 44, pg. 8803.

<sup>3</sup> Bulletin Today, October 6, 1979 issue.

<sup>4</sup> Ibid, October 9, 1979 and subsequent issues.

<sup>5</sup> Santos, Outline of Taxation, 1976 ed., p. 5, citing Des Moines Union Reg. Co. v. Chicago Great Western Reg. Co. 188 Iowa, 1019, 177 N. W. 30 (1920).

or sum of money assessed on the person or property of a citizen by the government for use of the nation or state.<sup>6</sup>

Income in the broad sense means all wealth which flows into the taxpayer other than a mere return of capital.<sup>7</sup> It is defined for income tax purposes as the amount of money coming to a person or corporation within a specified time whether as payment for services, interest or profits from investments.<sup>8</sup> In *Madrigal v. Rafferty*,<sup>9</sup> the Supreme Court cited with approval the classical distinction between income and capital as follows:

"The essential difference between capital and income is that capital is a fund, income is flow. A fund or property existing at an instant of time is called capital. A flow of services rendered by the capital, by the payment of money from it or any other benefit rendered by fund or capital in relation to such fund through a period of time is called income. Capital is wealth, while income is the service of wealth".

The Supreme Court of Georgia expressed the thought in the following figurative language:

"The fact is that the property is a tree, income is the fruit, labor is a tree, income the fruit; capital is tree, income the fruit".<sup>10</sup>

Hence, income tax is a tax on income. This tax may either be based on net or gross income.

Under the law, gross income is defined as follows:

"Gross income includes gains, profits and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interests, rents, dividends, securities, or the transactions or any business carried on for gains or profits and income derived from any source whatever."<sup>11</sup>

<sup>6</sup>Citizens Savings & Loan Association of Cleveland, Ohio v. City of Topeka, *supra*, at p. 461.

<sup>7</sup>Section 36, Revenue Regulation No. 2.

<sup>8</sup>Fisher v. Trinidad, 43 Phil. 973 (1922)

<sup>9</sup>38 Phil. 414 (See Fisher's, The Nature of Capital and Income).

<sup>10</sup>Warring v. City of Savannah (1878), 60 Ga., 93

<sup>11</sup>Section 29, the National Internal Revenue Code of 1977 as amended.

On the other hand, net income is simply defined as:

"Net income means gross income computed under Section 29 less deductions allowed by Section 30."<sup>12</sup>

### III. GROSS INCOME TAX SYSTEM ANALYZED

Although the distinction between a tax on net income and one on gross income is not always clear and there is no rigid meaning for the term "net income" since laws differ considerably in the allowances of exemptions and deductions,<sup>13</sup> it is apparent under the above definition of net income that the difference between net income and gross income lies in the allowance of deductions. The proponents of gross income taxation, therefore, seek the Batasang Pambansa to eliminate the present statutory deductions for the purpose of computing income tax. Although it has been held that allowance of deductions rests upon the sound discretion of the lawmakers,<sup>14</sup> this discretion must be exercised subject to the constitutional provisions delimiting the taxing power of the estate,<sup>15</sup> namely:

"The rule of taxation shall be uniform and equitable. The National Assembly shall evolve a progressive system of taxation."<sup>16</sup>

<sup>12</sup>Section 28, *supra*, Under Sec. 30, *supra*, the deductions allowed are: ordinary and necessary business expense, entertainment expenses, medical care, basic tuition fees, interest, taxes, losses, bad debts, depreciation, depletion, charitable and other contributions, contribution to pensions trusts, optional standard deduction and standard deductions for working wife. Other deduction allowed are elsewhere provided for in the Tax Code.

<sup>13</sup>Atlantic Coast Line R. Co. v. Daughton, 262 U.S. 413, 67 L. ed. 1051, 43 S. Ct. 620, cited in 27 Am. Jur. 312.

<sup>14</sup>New Colonial Ice Co. v. Helvering, 292 US 435; 54 S. Ct. 788 (1934), affg. 66F 2nd 480 (2d. Cr., 1933). It was said that "there is no constitutional objection to a provision of an income tax statute permitting proper deductions to be made from gross income for expenses, losses, and other charges incurred by taxpayers in carrying on the business activities by which the income is produced, the legislature having broad powers to determine deductions (which) may be allowed." (See 61 C.J. 1563).

<sup>15</sup>A noted professor of constitutional law has written that the power of taxation, like police power and eminent domain, is an inherent power of government, thus Section 17 is not a grant of power but limitations on the inherent power. (I Bernas, 262, Notes and Cases on 1973 Philippine Constitution). Furthermore, it was held in *McAhrens v. Bradshaw* (57 Ariz. 342, 113 P. 2d, 932 (1941) that "it is a cardinal rule that the legislature may adopt any method or mode of taxation so long as what is adopted is not in conflict with the constitution."

<sup>16</sup>Section 17 (1) Article III, New Constitution of the Philippines.

"No person shall be deprived of life, liberty, or property without due process of law, nor shall any person be denied equal protection of the laws."<sup>17</sup>

It is clear from the foregoing that the lawmakers are mandated to enact uniform and equitable tax laws, and to evolve or adopt a progressive system of taxation. Furthermore, since the power of taxation also involves "taking" of property, the "taking" must not deprive persons of property without "due process of law", nor shall any person be denied "equal protection of the laws".

Uniformity in taxation means that all taxable articles of the same class shall be taxed at the same rate.<sup>18</sup> It does not mean, however, that lands, chattels, income, privileges, etc. shall be taxed at the same rate since these things belong to different classes.<sup>19</sup> The constitutional provision requiring uniformity of taxation imposes the duty upon the State directly to lay its burden uniformly and evenly upon all persons belonging to the same class. Therefore, a tax can be assailed for lack of uniformity if it is not laid upon all members of the same class.<sup>20</sup>

A tax law enacted in violation of the "uniformity rule" is equally derogatory of the "equal protection clause" for both constitutional provisions require valid and reasonable classification.<sup>21</sup> The "equal protection clause" does not mean exact equality of taxation. It does not require equal rates of taxation for different classes of property nor prohibit unequal taxation so long as the inequality is not based upon arbitrary classification. It merely requires that all persons subjected to such legislation shall be treated alike under the cir-

cumstances and conditions both in the privilege conferred and in the liabilities imposed.<sup>22</sup>

The legal requirements of "due process of law" may include all that is connoted by "equal protection of the laws."<sup>23</sup> Thus, one who is injured by arbitrary or class legislations and thereby deprived of "equal protection of the laws" may justly claim that he is likewise deprived of his property without "due process of law". In other words, "due process of law" involves prohibition of arbitrary class legislation.<sup>24</sup> The U.S. Supreme Court said that the two guarantees, "due process of law, and "equal protection of the laws" are secured if the laws operate on all alike and do not subject an individual to an arbitrary exercise of the power of government.<sup>25</sup>

In view of the foregoing criteria, it is submitted that the proposed gross income taxation scheme is of questionable validity because it may result in the imposition and collection of the same amount of tax upon taxpayers who do not belong to the same class. Taxpayers who are not in the position or are less able to pay taxes are required to pay the same amount of taxes as those who are well able to pay, for "gross income does not necessarily indicate the possession of available surplus."<sup>26</sup> Furthermore, taxpayers earning the same amount of gross income do not necessarily incur or sustain the same cost of earning such income. This is due to circumstantial factors peculiar to the taxpayer, among which are the nature of industry, location and stage of operations without however considering the efficiency or inefficiency of the operator. This viewpoint finds support in a statement made by Commissioner Plana, before an open forum with the members of the Philippine Institute of Certified Public Accountants (PICPA), in which he indicated his reservation against the adoption of the system of gross income taxation and pictured its concurrent inequities as follows:

<sup>22</sup> Rivera, *Taxation Self Taught*, p. 121, citing many cases.

<sup>23</sup> The requirements of "due process of law" are as follows: First, that there shall be a law prescribed in harmony with the general powers of the legislative department of the government; Second, that the law shall be reasonable in its operation; Third, that it shall be enforced according to the regular method of procedure prescribed; and Fourth, that it shall be applicable alike to all the citizens of the state or all of a class. (Story on the Constitution 5th ed., secs. 1943-1945; Principle Constitutional Law, Cooley, 434). From these requisites, it is apparent that there are two classes of "due process", namely substantive and procedural due process of law. (See also I Bernas, p. 90 *supra*)

<sup>24</sup> *Supra* note 22 at p. 124, citing Sheppard v. Johnson, 2 Humphrey 285, Sutton v. Hate, 96 Tenn. 710.

<sup>25</sup> Connolly v. Union Sewer Pipe Co. 184 U.S. 540; 46 L. ed. 679 (1902)

<sup>26</sup> Redfield v. Fisher, 284 U.S. 617; 76 L. ed. 526.

<sup>17</sup> Section 1, Article IV, *supra*.

<sup>18</sup> Tan Kim Kee v. Court of Tax Appeals, L-18080, April 22, 1963.

<sup>19</sup> De Villata v. Stanley, 32 Phil. 541. Perfect uniformity is a baseless dream (Head Money Cases, 112 U.S. 580).

<sup>20</sup> De Villata v. Stanley, *supra*. There is authority to the effect that uniformity in taxation also involves geographical uniformity.

<sup>21</sup> The requisites for valid and reasonable classification are as follows: (1) classification should be based on substantial distinction which makes real differences, (2) these are germane to the purpose of the law, (3) the classification applies not only to present conditions, but also to future conditions which are substantially identical to those of the present, and (4) classification applies to those who belong to the same class. (Ormoc Sugar Co. v. Treasurer of Ormoc City, citing Filura vs. Salas case L-23794, Feb. 17, 1968). If the classification is capricious or arbitrary and does not rest upon reasonable classification, it is usually offensive to "equal protection" provision of the constitution. (See 13 Williams v. City of Richmond, 177 Va. 477, SE 2nd, 287, 292).

"Gross income taxation is not really such a simple matter. So far as we know, no country in the world except as to very few classes of income had adopted the pure system of gross income taxation because of the inequity that inevitably would come in and the inequity will arise perhaps in two major areas of fixing tax rate and classification of the enterprises."

"A mere general industry classification may not be sufficient. Even within each general class, there may be a need for sub-classification because different industries within the same general class may vary in the cost of producing the same amount of income, due to factors or circumstances inherent to the industries and not due to the efficiency of one enterprise over the other."<sup>27</sup>

Before the same PICPA open forum, Commissioner Plana, citing examples, "pointed at two different enterprises with different costs of production such as logging and mining. Placing them in the same class and imposing the same tax rate on them may result in unfairness to the industry whose cost of production is higher by its very nature. In the same way, a uniform tax rate cannot be applied to a general class of industry made up of several groups as in the case of instructured contractors. One may contract only for labor in view of changing cost of materials. Necessarily, their costs of producing the same amount of gross income will differ, and it **might** be unfair to place them in the same category and to tax them at the same rate."<sup>28</sup>

He continued by saying that "classification by its very nature includes generalization of some sort because even identical things are not exactly alike. That is why you have to go to general interview in grouping these companies. But you cannot make exceptions at every turn, because instead of achieving simplicity in the system, the system will become even more complex than before."<sup>29</sup>

The theory of net income taxation is that it places the burden of governmental maintenance upon those best able to bear it. Thus it is an equitable method of distributing burdens of government.<sup>30</sup> On the other hand, the concept of gross income taxation would present a patent departure from a generally accepted centuries old principle in taxation, i.e. "from each according to his ability to pay."

<sup>27</sup> PICPA Newsette, April 1977. It was held in one case, *supra*, that economic reasons which sustain tax on net income do not sustain tax on gross income.

<sup>28</sup> *Supra*.

<sup>29</sup> *Supra*.

<sup>30</sup> *New York Rapid Transit Corp. v. New York*, 303 U.S. 573; 82 L. ed. 1584 58 S. Ct. 939.

staunchly advocated by Adams Smith in 1776 in his famous book entitled **Wealth of Nations**. This principle is not without place in our jurisprudence for the Supreme Court in a case<sup>31</sup> involving allowance of exemptions said:

"The Income Tax Law of the United States extended to the Philippine Islands, is the result of an effect on the legislators to put into statutory for this canon of taxation and social reformer. The aim has been to mitigate the evils arising from the inequalities of wealth by a progressive scheme of taxation which places the burden on those best able to pay."<sup>32</sup>

Since the proposed scheme of gross income taxation departs from the ability-to-pay principle, it would thus be abrasive to the social justice concept zealously nurtured by the framers of the constitution and fittingly enshrined in our fundamental law of the land. The pertinent provision of the constitution provides:

"The State shall promote social justice to ensure the dignity, welfare and security of all the people. Towards this end, the State shall regulate the acquisition, ownership, use, enjoyment and disposition of private property and equitably diffuse property ownership and profits."<sup>33</sup>

We can readily perceive the injustice which the proposed system might bring upon a taxpayer with the following set of circumstances: Taxpayer (T), during the taxable year, earns P50,000 in commissions. Using said commissions, T constructs a small house during the said year. Before the end of the said year, T's house, which is uninsured, gets burned. Under the existing law, T has to include his P50,000 worth of commissions in his income tax return as part of his income and claim the loss as a deduction before arriving at his net taxable income. Under the proposed gross income taxation scheme, T must report his P50,000 worth of com-

<sup>31</sup> *Madrigal v. Rafferty, supra*.

<sup>32</sup> Smith propounded the principle in this wise: "The subject of every state ought to contribute towards the support of the government, as nearly as possible in proportion to their ability, that is, in proportion to the revenue which they respectively enjoy under the protection of the States." (Under-scoring supplied). This principle was adopted by the Philippine Joint Legislative - Executive Tax Commission which evolved the net income taxation scheme as embodied in our present Tax Code.

<sup>33</sup> Sec. 6, Art. II, *supra*. In the words of the late Pres. Magsaysay, social justice means "those who have less in life must have more in law."

missions as part of his gross taxable income but cannot deduct the fire loss therefrom. In effect, T would be taxed on his lost earnings.<sup>34</sup> Thus, instead of extending a helping hand to extricate the taxpayer from his predicament by allowing him a renewed lease on life which would enable him to again become a future source of government revenue, the state would take pleasure in "adding insult to injury" and in making it difficult for him to join the ranks of responsible citizens sharing the burdens of government maintenance.

Under Section 30(f) (1) of the Tax Code, depreciation expense is deductible as "a reasonable allowance for deterioration of property arising out of its use or employment in business or trade or out of its not being used." However, although the law says "allowance for deterioration", it is in fact the proportionate allocation of capital expenditures over the economic life of depreciable assets.<sup>35</sup> Hence, taxing income without deducting depreciation expense would result in taxing a "mere return of capital" because it is capital used up to earn income. The same effect is true in the case of wasting assets where deduction of depletion expense is allowed.<sup>36</sup> Practically, therefore, all necessary, ordinary and reason-

<sup>34</sup> Under Section 30(d) of the Tax Code, losses actually sustained during the taxable year and not compensated by insurance under conditions mentioned therein are deductible from gross income. Together with this type of deduction, bad debts actually written off during a taxable year can be grouped whether the debt charged off is connected in business or not as can be implied under Section 30(e) (2) *supra*. This section limits the deductibility of debts charged off by non-resident aliens and foreign corporations to those connected with business. Under the accrual method of accounting, which is acceptable for tax purposes, income generated from products sold or services rendered may be taxed even if the same is still uncollected in the meantime. Now if this income would later prove uncollectible under the present law, the taxpayer is allowed to recoupe the tax paid by way of deducting the amount charged off from his taxable income which may not altogether be possible if in the year of charging off he has no taxable income. If this were not the case, he would be taxed on income he never earned and realized. Thus, it presents a case of taxing paper income.

<sup>35</sup> Under Section 31, *supra*, capital expenditures are not deductible, per se, but may be so thru depreciation accounting. Depreciation accounting is patterned after generally accepted accounting principles. It is described by the American Institute of Certified Public Accountants as a system "which aims to distribute the cost or other basis value of tangible capital assets, less salvage value (if any, over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner." (Accounting Terminology Bulletin No. I "Review and Resumé" (New York: AICPA, 1953), par. 56). Depreciable assets include buildings, furniture, equipment and machineries.

<sup>36</sup> Section 30(g), *supra*.

able expenses incurred in generating income are expenditures doled out from capital invested by the taxpayers, such expenditures when recouped partly to the extent of the tax which would otherwise be due thereon, are but "mere return of capital". Otherwise, if such expenditures were not considered as "mere return of capital" then income of taxpayers would be nothing but illusory.

Furthermore, partners of government in providing charitable and educational services and in developing scientific advances would "fast fade in the misty past" for contributions thereto not being deductible, would have a downward trend.<sup>37</sup> Taxpayers would be discouraged to avail of housing, real estate, educational and other similar loans because the interest expense<sup>38</sup> thereon would no longer be deductible under the proposed system. The same is true as regards employers who grant liberal fringe benefits to their employees by way of decent salary increases, bonuses, profit sharing and the like not only because the latter deserve them but also because these are deductible from the former's taxable income under the present law. Loss of the employers' incentive to grant such benefits to its employees would thus militate against the states policy to equitably diffuse property ownership and profits.<sup>39</sup>

The proposed system would facilitate the "passing on" or shifting of the tax burden from one intended by law to bear the same to another. This is the primary characteristic of an indirect tax. Direct taxes are so called because they strike directly at the taxpayer from whose income they are supposed to be taken.<sup>40</sup> Thus,

<sup>37</sup> See Section 30(h), *supra*.

<sup>38</sup> Under the present law, interest expense is deductible whether incurred in connection with business or not. (Se. 30(b) *supra*. As a business expense, it is also in effect a "mere return of capital". To illustrate: A taxpayer borrows ₱100,000 at an interest rate of 10% p.a. deducted in advance. The loan is supported by a promissory note with a face value of ₱100,000 but with net proceeds of ₱90,000 (₱100,000) — (100,000 x .10). Assuming that at the end of the year after investing the proceeds it is now worth ₱110,000, under the proposed system the amount subject to tax would be ₱20,000 (₱110,000 — 90,000). Under the present system, it would only be ₱10,000 (₱110,000 — (90,000 plus 10,000)). Indeed, the ₱10,000 interest deducted in advance is part of the returned capital.

<sup>39</sup> Sec. 7, Art. II, *supra*, provides: "The State shall establish, maintain and ensure adequate social services in the field of education, health, housing, employment, welfare and social security to guarantee the enjoyment by the people of a decent standard of living".

<sup>40</sup> See 61 C.J. pg. 74. Moreover, a tax is called direct when it is assessed upon the person who has to bear the burden of it, as income tax. A tax on a consumer article as salt is called an indirect tax because though paid by the producer in the first instance, it really falls on the consumer. (W. McMordie, 1975 ed., pg. 57).

those who control production and services could easily avoid income taxation.<sup>41</sup>

The proponents of the proposed gross income taxation asserts that graft and corrupt practices are likely to be committed in the exercise of discretion allowing or disallowing deductions. This assertion raises two assumptions. First, it assumes that those who implement and enforce the tax laws are generally not qualified, willing and effective enough to do so. Second, it assumes that those in the revenue service are pitifully corrupt. The latter is indeed contrary to the legal presumption, although disputable that public officials regularly perform their duties<sup>42</sup> and that they obey the laws.<sup>43</sup> It even runs counter to the constitutional exhortation that public office is a public trust.<sup>44</sup> Assuming deductions are eliminated and applying the two assumptions discussed above, what assurance can we get that in the determination of correct gross income no collusion between the tax collector and the tax evading taxpayer would take place? Thus, following its logical conclusion, gross income taxation would precipitate underdeclaration of income. This is made possible because taxpayers would no longer report income payments nor withhold the tax thereon as required by Section 30(m) of the Tax Code. Besides, the Anti-graft and Corrupt Practices Act,<sup>45</sup> is biting enough to punish violators of tax laws. Thus, the problem lies in the implementation of tax laws rather than in the system.

<sup>41</sup> Suppose a top caliber executive's asking salary is ₱100,000 per year, net of income tax. Suppose further that the rate of tax based on gross income is 30%. He would thus ask for ₱142,857.00 (₱100,000 ÷ 70) to net or take home ₱100,000. Obviously, this kind of arrangement could not be availed of by low income earners. The same mathematical computation could be applicable to manufacturers or producers who shift income tax to consumers. Thus, the cliché "the rich become richer while the poor become poorer" could come to life.

<sup>42</sup> Section 5(m) Rule 131 of the Rules of Court.

<sup>43</sup> Section 5(ff) *supra*.

<sup>44</sup> Section 1, Art. III, New Constitution of the Philippines.

<sup>45</sup> Republic Act 3019 (1960) as amended.

#### IV. CONCLUSION

The present system is fair enough to allow a healthy and rewarding atmosphere. Hence, the government's avowed paramount consideration, i.e., the welfare of the nation or of the greater portion of its population, should take precedence in the evolution of the tax laws.

"The power of taxation is sometimes called also the power to destroy.<sup>46</sup> Therefore, it should be exercised with caution to minimize injury to proprietary rights of a taxpayer. It must be exercised fairly, equally, and uniformly lest the collectors kill the hen that lays the golden egg."<sup>47</sup>

Therefore, in view of all the foregoing, it is strongly urged that the present system of net income taxation should be retained.

#### V RECOMMENDATIONS

We, however, offer the following recommendations to improve the present system of net income taxation:

a) All individual taxpayers whether or not engaged in business, and required to file income tax returns should attach to said returns a statement of assets and liabilities<sup>48</sup> similar to those being filed by government officers and employees. This would facilitate tax investigation on the basis of the net worth method.<sup>49</sup>

<sup>46</sup> Chief Justice Marshall in his historical statement said, "the power of taxation involves the power to destroy." (See *McCullock v. Maryland*, 4 L. ed. 579 (1819), 4 Wheat, 316); In the case of *Nicol v. Ames*, 173 U.S. 509, 515, it was tersely observed that taxation does not only involve the power to destroy but also the power to keep alive. Furthermore, the court said in *Austin v. Alderman* (1868), 7 Wall., 694, "the right of taxation where it exists is necessarily unlimited in its nature. It carries with it inherently the power to embarrass and destroy." (See also *Sarasola v. Trinidad*, 40 Phil. 252).

<sup>47</sup> *Roxas v. Court of Tax Appeals*, 32 SCRA 276; To quote the dissenting opinion of Justice Holmes in *Panhandle Oil Company v. State of Mississippi*, 277 U.S. 218, "the power to tax is not the power to destroy while this court sits."

<sup>48</sup> This requirement is embodied in R.A. 3016, *supra*, the constitutionality of which had gone under attack but ultimately upheld in the case of *Morfe v. Mutuc*, G.R. No. L-20387, January 31, 1968.

<sup>49</sup> The legality of this method was affirmed in the case of *Perez v. Court of Tax Appeals* G.R. No. L-10507, May 30, 1958.

b) All forms of representation, entertainment and similar expenses<sup>50</sup> should be limited to a fixed maximum rate as in the case of individual taxpayers who receive compensation income. This is intended to eliminate the temptation to use these accounts to disguise "improper payments" as tax deductible expenses.

c) Commissions or rebates granted by taxpayers to secure government contracts should be disallowed because of the inherent temptation to include therein "improper payments". Government costs of procuring goods and services would then be at arms-length.

d) Tax investigation of the income tax returns of BIR officers and employees should be undertaken by an independent government agency under the control and supervision of the Minister of Finance. This could preclude any accusation of collusion among BIR officers and employees to evade payment of their own taxes.

e) The existing personal and additional exemptions<sup>52</sup> should be revised to cope with abruptly changing economic conditions. An across-the-board increase thereto would in reality be more beneficial to taxpayers belonging to higher income groups, which is already the case under the present law. To illustrate: Suppose A is married with four children who are qualified dependents. Suppose further that B is likewise married with four children who are also qualified dependents. During the taxable year A earns P15,000 while B earns P514,000. Let us assume that both A and B avail of the optional standard deduction. Their income tax returns would reflect the following:

	A	B
Gross income (GI)	P10,000	P514,000
Less: Optional Std. Deduction (10% of GI or 5,000 whichever is lower)	1,000	5,000
Net income before personal and additional deductions	9,000	509,000
Less: Personal and additional deduction (P1,000 per dependent and P3,000 for married person)	7,000	7,000
Amount subject to tax	<u>P 2,000</u>	<u>P502,000</u>
Tax due (see table at Sec. 21, <i>supra</i> )	<u>P 60</u>	<u>P306,640</u>

Effectively A's tax credit on his personal and additional exemptions is P680 (i.e. tax due on P9,000 which is P740 less tax due on the first P2,000 which is P60) while that of B is P4,900 (i.e. tax due on P509,000 which is P311,540 less tax due on P502,000 which is P306,640).

The exemptions should be transformed into a direct tax credit system. Under this proposal, the tax credit would be computed by determining the number of exemptions multiplied by a fixed amount of tax credit per exemption. However, the tax credit should not exceed the amount of tax before tax credit. To illustrate this proposal we use the same information at paragraph (e), *supra*. Furthermore, we assume that tax credit per exemption is P115. Exemption is per capita, i.e., for single individual or separated spouse or a widow or widower not being a head of the family, the exemption is one (1); for married persons who file joint returns or head of the family, two (2); and for each dependent child, one (1). Hence for both A and B their number of exemptions is six (6).

<sup>50</sup>See Section 30 of the Tax Code.

<sup>51</sup>For this matter, other government agencies such as Bureau of Customs may be included in the scope of the proposed agency's authority.

<sup>52</sup>Section 23(a), (b) and (c) of the Tax Code.

	A	B
Net income subject to tax	₱9,000	₱509,000
Tax due	740	311,540
Less: Tax Credit (6 x ₱115)	690	690
Tax still due	₱ 50	₱310,850

Under this illustration while A's tax due is reduced by ₱10, B's tax due is increased by ₱4.210.

The figures used are for illustration purposes only. To arrive at more realistic figures statistical study could be resorted to. This would allay the fear of Commissioner Plana that an increase in personal and additional exemptions would erode the tax base and that due to consequent loss of revenue, the government might resort to taking by the left what was given by the right hand.<sup>53</sup>

The same tax credit system recommended in paragraph (e), *supra*, should be utilized in adjusting the deductible tuition fees and medical care expenses. At present, these are pegged at the maximum amount of exemptions multiplied by a fixed amount of ₱1,000 and ₱2,000, respectively.<sup>54</sup>

f) Finally, the ostentatious display of wealth by some government official as well as the unnecessary expenditures in the government should be avoided. This would prevent the normal tendency of channelled to some personal end and encourage them to pay voluntarily the correct amount of taxes.

<sup>53</sup> See unnumbered BIR ruling dated February 16, 1976. This is a pro-forma letter of the Commissioner to those seeking increase in personal and additional deductions.

<sup>54</sup> See Section 30(a)(2)(A) and (B) of the Tax Code.

## SUPREME COURT DOCTRINES

Compiled by:

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JOSE VICTOR V. OLAGUERA, LI.B. '84

### CIVIL LAW

#### AUTHORITY OF DIRECTOR OF LANDS TO ENTER INTO A CONTRACT OF LEASE

The Director of Lands acted within his power and authority as head of the Division of Landed Estates when he entered into the contract of lease for a period of 10 years renewable for a like period, at the lessee's options.

The Director of Lands was not acting merely as an agent in the sense that he still needed a special power of attorney to lease the real property to another person for more than one year under Article 1878 (8) of the Civil Code. After the war, administration of the Crisostomo Estate was turned over to the Rural Progress Administration by Administrative Order No. 36 issued by President Manuel Roxas, and thereafter, on November 28, 1950, administration reverted to the Bureau of Lands, particularly in the latter's newly created division of Landed Estates. When the Director of Lands, therefore, leased the property to defendant, he did so as a public officer and he represented the government and stood for it as an "arm of the state." He acted by virtue of an authority vested in him by law and needed no further delegation of power. He was clothed with some part of the sovereignty of the state. He acted as a "vice principal" defined as "one vested with the entire man-