This just proves a point often pointed out in my lectures that the corporate entity is meant primarily to attract investors to place their money in the hands of professional managers (a divorcing of ownership from control) and that most corporate doctrines were intended for such a set-up. Close supervision of one's investment should be more compatible with other forms of media such as partnership and sole proprietorship. In fact, the Corporation Code has given a special type of vehicle for investors who wish to actively manage their investments: the close corporations, which have been termed as incorporated partnership and for which intervening stockholders are made personally liable for corporate debts and obligations.[133]

[133] *See* Sec. 100, CORPORATION CODE.

PRESCRIPTION AS A DEFENSE IN TAX CASES

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INTRODUCTION

This short article is intended as a guide towards the better understanding and application of one of the most common defenses against tax liability: prescription. There are instances when the government assesses a deficiency or collects on an assessment after the prescriptive period for assessment or collection has elapsed. Prescription as a valid means of resisting the government gains added lustre when it is recalled that usual injunctive remedies do not generally apply in tax cases.[1] Set-off is, likewise, not available as an option.[2]

Why does prescription exist? If the power to tax has been characterized as the very "lifeblood of the nation," why does the legislature allow prescription to exist as a defense against its exercise? In the cogent language of Justice Labrador, the rationale for its existence is that:

> The law prescribing a limitation of actions for the collection of the income tax is beneficial both to the government and to its citizens;

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[1] EXECUTIVE ORDER No. 273, Sec. 219, NATIONAL INTERNAL REVENUE CODE, as revised [hereinafter NIRC]. The only exception to this occurs in cases where the Court of Tax Appeals feels that the collection of taxes may jeopardize either the interest of the government or of the taxpayer. In such a case, it may issue an injunction only in aid of its appellate jurisdiction under Sec.1 of Republic Act 1125.

[2] A claim for taxes is not such a debt, demand, contract or judgement as is allowed to be set-off under the statutes of set-off x x x The reason on which the general rule is based, is that taxes are not in the nature of contracts between the party and party but grow out of duty to, and are the positive acts of, the government to the making and enforcing of which, the personal consent of individual taxpayers is not required x x x *Francia v. Intermediate Appellate Court*, 162 SCRA 753 at 758-59, year furthering citing *Republic v. Mambulao Lumber Co.*, 4 SCRA 622 (1988).

> to the government because tax officers would be obliged to act promptly in the making of (an) assessment, and to citizens because after the lapse of the period of prescription citizens would have a feeling of security against unscrupulous tax agents who will always find an excuse to inspect the books of taxpayers, not to determine the latter's real ability, but to take advantage of every opportunity to molest peaceful, law-abiding citizens.[3]

It seems that very little has change from the 1960's to the present. To see how prescription works today, it is necessary to examine the procedure by which taxes are assessed, collected, and enforced.

I. TAX ASSESSMENT

Provisions of the National Internal Revenue Code prescribe the following procedure in assessing taxes against a taxpayer:

1. If the tax payers files a return, the Bureau has three (3) years within which to assess the taxpayer.[4]
2. However, if no return is filed, or the return is false or fraudulent with intent to defraud, then the Bureau has ten (10) years from discovery of the failure to file a return or from discovery of the fraud to make an assessment,[5] to file the suit for collection.[6]
3. The period for making the assessment may be extended when the taxpayer and the government enter into written waiver of the original prescriptive period.[7]
4. The proper prescriptive period may be suspended when the government is prohibited from making the assessment or from filing a collection suit, and for sixty (60) days thereafter.[8] The phrase "when the government is prohibited from making an assessment" has been held to include the execution of a chattel mortgage to the government to cover a taxpayer's tax deficiencies, persuading the government to postpone collection, under the doctrine of estoppel.[9] It does not, however, comprehend a case of partial payment.[10]

[3] *Republic of the Philippines v. Albaza*, 108 Phil 1108 1960).

[4] NIRC, Sec. 203.

[5] See H. DE LEON, COMPREHENSIVE REVIEW OF TAXATION 376 (1987). This assessment of deficiency taxes is otherwise known as a deficiency assessment. Hector de Leon defines it as an assessment made by the Commissioner of Internal Revenue or by any authorized officer after an examination and inspection of the taxpayer's return or records or after an independent investigation where a deficiency is found.

[6] NIRC, Sec. 223, subparagraph. (a), It must be noted that under Sec. 203 and Sec. 223 subparagraph (c) of the Code, there is general three-year prescriptive period for collection, which should not be confused with the three-year prescriptive period for assessment.

[7] NIRC, Sec. 233, subparagraph (b). The case of *Collector of Internal Revenue v. Pineda*, 2 SCRA 401 (1961), is illustrative of the rule.

II. TAXPAYER'S PROTEST VIA ADMINISTRATIVE PROCEEDINGS

Administrative proceedings commence once a final assessment has been made. Upon final assessment, the taxpayer must protest the assessment by filing a motion for reinvestigation or reconsideration with the Bureau within thirty (30) days, transforming the final assessment into a disputed assessment. Otherwise, the assessment becomes final and unappealable.[11] This protest is vital and cannot be overemphasized. To omit this vital step would mean the foreclosure of all possible defenses based on the validity of the assessment, under the doctrine of exhaustion of administrative remedies.

In *Aguinaldo Industries v. the Commissioner of Internal Revenue*,[12] petitioner corporation, in its corporate tax return for the year 1957, claimed as a business deduction the sale of a parcel of land in Muntinlupa, Rizal. This deduction was disallowed by the examiner on the ground that the deduction was paid to the officers of the corporation as a bonus pursuant to Section 3 of its by-laws. The lower court upheld the tax examiner. Petitioner argued that its fish nets division enjoyed a tax exemption as a new and necessary industry.

On appeal by *certiorari*, the Supreme Court held that:

> At the administrative level, the petitioner implicitly admitted that profit derive from the sale of its Muntinglupa land, a capital asset, was a taxable gain... [T]he BIR therefor had no occasion to pass upon the issue.[13]

[8] NIRC, Sec. 224.

[9] *Sambrano v. Commissioner of Internal Revenue*, 101 Phil 1 (1957).

[10] *Cordero v. Gonda*, 18 SCRA 331 (1966).

[11] NIRC, Sec. 229

[12] 112 SCRA 136 (1982).

[13] *Id.* at 140.

It was only after the said decision [of the CTA] was rendered and a motion for reconsideration thereof that the issue of tax exemption was raised by the petitioner for the first time. It was not one of the issues raised by the petitioner in his petition and supporting memorandum the Court of Tax Appeals.[14]

Citing the doctrine of exhaustion of administrative remedies, the Court held that:

> [T]o allow a litigant to assume a different posture when he comes before the court and [to] challenge the position he had accepted at the administrative level would be to sanction a procedure whereby the court—which is supposed to review administrative determinations—would not review, but determine and decide for the first time, a question not raised at the administrative level. This cannot be permitted, for the same reason that underlies the requirement of prior exhaustion of a administrative remedies[:] to give administrative authorities the opportunity to decide matters within its competence, in much the same way that, on the judicial level, issues not raised in the lower court cannot be raised for the first time on appeal.[15]

But what exactly constitutes a final assessment? The difficulty in determining such an assessment can be gleaned from the fact that the Code does not, in itself, define final assessment. Not even the noted commentator on taxation, Umali, is able to produce a definition. He merely notes that "where the commissioner states in his decision that it is his final decision and that he can not entertain further request for reconsideration, the said final decision is appealable [to the CTA]."[16]

In practice, the Bureau sends the taxpayer two collection letters from its Assessment Division informing the taxpayer of the amount of the assessed deficiencies against him, and instructing the taxpayer to pay as soonest possible time. After this, the taxpayer's case is referred to the Bureau's Enforcement Division where the taxpayer is warned that, upon his failure to pay, he is subjected to appropriate action such as distraint, levy, or the filing of a civil or criminal case against him.

[14] *Id.* at 141

[15] *Id.* at 140

[16] R.M. UMALI, REVIEWER OF TAXATION 570 (1985), citing *Janda v. Collector*, 1 SCRA 604 (1961) and *St. Stephen's Association v. Collector*, 104 Phil 314 (1958).

The last letter, by virtue of its mandatory nature, is generally taken as the final assessment. But this procedure is not always followed, considering that the Commissioner of Internal Revenue is under no obligation to rely on a request for investigation before bringing an action for the collection of an internal revenue tax, in order to fully protect the rights of the client; hence, it becomes necessary to protest the assessment at the first instance.[17] Under these circumstances, waiting for a reply to the request for reinvestigation or reconsideration could prejudice the taxpayer's right to appeal, since a mere request for reinvestigation or reconsideration does not suspend the running of the prescriptive period for making the assessment or filing a suit for collection.[18]

That, however, is assuming the worst. If the Commissioner does respond to the request for reinvestigation or reconsideration by denying such request, the taxpayer has thirty (30) days within which to petition the Court of Tax Appeals to review the decision of the Commissioner of Internal Revenue acting through a Revenue District Officer in denying the protest.[19] This thirty-day period is jurisdictional, since the failure to comply with the statutory period deprives the Court of Tax Appeals of jurisdiction to hear the case.[20] On the part of the government, the time within which the request was pending shall be subtracted from the period within which the file to a suit for collection.[21]

Alternatively, a warrant of distraint and levy may be issued by the government without taking any action on the pending protest. This happened in one case where the facts were as follows:[22]

14 January 1965 – Private respondent, a domestic corporation engaged in engineering, construction and other allied activities, received a letter assessing it ₱ 83,183.85 as delinquency income taxes.

18 January 1965 – Request for Reconsideration filed with and received by the BIR.

[17] *Republic v. Marsman*, 44 SCRA 148 (1972)

[18] *Republic v. Acebedo*, 22 SCRA 134 (1968).

[19] REPUBLIC ACT NO. 1125, AN ACT CREATING A COURT OF TAX APPEALS, Sec.11

[20] *Philam Mining Corp. v. Court of Tax Appeals*, 34 SCRA 498 (1970).

[21] *Republic v. Aquias*, 33 SCRA 607 (1970).

[22] *Commissioner of Internal Revenue v. Algue, Inc.*, 158 SCRA 9 at 13 (1988).

12 March 1965 – Warrant of distraint and levy presented to private respondent through its counsel. Service of warrant later suspended.

6 April 1965 – Counsel for private respondent was finally informed that the BIR was not taking any action on the protest. He then accepted the warrant of distraint and levy sought to be served.

23 April 1965 – Petition for review with CTA filed.

The BIR argued that, as a rule, the warrant of distraint and levy is "proof of the finality of the assessment" and "renders hopeless a request for reconsideration," being "tantamount to an outright denial thereof and makes the said request deemed rejected."[23] In view thereof, since the petition for review was filed only on 23 April 1965, or more than thirty (30) days from the time the deficiency assessment was received, the petition should be dismissed for being filed out of time. But, the Supreme Court, speaking through Justice Cruz, rejected this argument. It upheld the finding of the Court of Tax Appeals finding the protest to be meritorious (not *pro forma*) and based on strong legal considerations. In view thereof, the filing of the protest had the effect of suspending the reglementary period. The period started running again only on 7 April 1965, when the private respondent was definitely informed of the implied rejection of the protest and when the warrant was finally served upon it. Hence, when the appeal was filed on 23 April 1965, only twenty (20) days of the reglementary period had been consumed.

It must be noted that the proper way to appeal is by way of petition for review. This is vital because there are cases where the appeal was thrown out of the Court of Tax Appeals for failure to conform with the prescribed form. This is the last forum where prescription as a defense can be raised.

Applying the general principles of Remedial Law, it might be useful to remember that the petitions for review merely check to see whether or not the decisions rendered was conformable to law, while an appeal is more in the nature of a trial *de novo*, since appellate courts are triers both of the facts and of the law, the recent amendments to

[23] Id. at 12, citing *Philippine Planters Investment Co. Inc. v. Acting Comm'r of Internal Revenue*, CTA Case No. 1266, Nov. 11, 1962 and *Vicente Hilado v. Comm. of Internal Revenue*, CTA Case No. 1256, Oct.12, 1962.

the Rules of Court notwithstanding. Hence, the mode of appeal sets certain limitations on the strength of the taxpayer's cause of action.

III. COLLECTION IN THE CIVIL AND CRIMINAL PROCEEDINGS

A. Civil Proceedings

Once a civil case for the collection of taxes has been instituted, then the court where the civil action has been filed acquires the jurisdiction to hear and determine the issues, and to rule upon them. As such, the issue of prescription can properly be raised therein only if it was previously raised either by way of protest or by petition to the CTA.

In *Basa v. Republic*,[24] petitioner was assessed deficiency income taxes for 1957 to 1960 totalling ₱ 16,353.12. However, he failed to contest the assessments either administratively or in the tax court. On the assumption that the assessments had become final and incontestable, the Commissioner sued the taxpayer for collection, and judgement was rendered against the petitioner. Petitioner sought to appeal to the Court of Appeals but failed. He went to the Supreme Court by way of a special civil action for certiorari.

After all his efforts, the Supreme Court denied his petition, stating that he did not have a proper cause of action and that if he wanted to contest the assessments, he should have appealed to the Tax Court. Not having done so, he could not contest the same in the Court of First Instance.[25]

Hence, prescription as a defense can no longer be invoked on a petition for certoirari to the Supreme Court, since the Supreme Court can entertain only question of law.

In the case of *Republic v. Ricarte*,[26] the collection of deficiency income taxes was resisted on the ground that the suit for collection had been instituted beyond the five-year prescriptive period for collection. The crux of the case revolved around the existence of an assessment

[24] 138 SCRA 34 (1985)

[25] *Id.* at 37-38

[26] 140 SCRA 1 (1985) [emphasis added].

allegedly made and sent to the taxpayer. Ruling on assessment, the Supreme Court, then under Chief Justice Makasiar, held in this wise:

> [I]t was the finding both of the former City Court of Cebu and the defunct Court of First Instance of Cebu that no evidence had been presented by the appellant that the appellee actually received a copy of that assessment notice regarding the alleged deficiency tax. *Such finding, being one of fact, can no longer be reviewed by this Court.*

In case there are actions simultaneously pending in the regular courts and in the Court of Tax Appeals, the filing of a petition for review with the Court of Tax Appeals divests the ordinary court of jurisdiction to hear and determine the the case. In such a case, the issue of prescription should be raised in CTA.

B. Criminal Proceedings

By way of contrast, in criminal actions filed against the taxpayer for failure to pay deficiency income taxes, the action is brought to the Supreme Court by way of appeal, and not by way of petition for review on certiorari. This being the case, grounds not previously raised can properly raised for the first time and passed upon by the Supreme Court.[27] Prescription is one such ground.

It must be noted that these general rules on prescription are subject to waiver. For instance, in cases where assignment has become final, the taxpayer, as a rule, can no longer raise defenses as to the validity of the assessment, or claim the benefit of prescription. However, where the taxpayer raised the defense of prescription seasonably, and the government litigated on the issue instead of questioning the taxpayer's right to raise prescription as a valid defense, the government is deemed to have waived its right to object to the setting up of prescription as a defense against it.[28]

Procedurally, the rules on invoking prescription are somewhat modified when it is government invoking the benefit of prescription instead of the taxpayer. In the case of *Pacific Banking Corp. v. Commissioner of Internal Revenue*,[29] petitioner bank sought the refund

[27] The case of *People v. Balagtas*, (Unreported), July 29, 1959, illustrates the application of the rule.

[28] *Republic v. Ker*, 18 SCRA 207 (1966).

of its income tax overpayment for 1962 by way of petition for review filed with the CTA in 1963. The Commissioner failed to raise prescription as a defense in the CTA, but the CTA dismissed the petitioner's claim. When the case reached the Supreme Court, it upheld the CTA, stating as follows:

> While Section 2, Rule 9 of the Rules of Court provides that "defenses and objections not pleaded either in a motion to dismiss or in the answer are deemed waive x x x," the failure of respondent Commissioner to plead prescription in the answer should not preclude the Court from considering the defense of prescription, since from the very facts stipulated it can be clearly gleaned, without need of additional evidence, that the petitioner's action for refund has indeed prescribed. This Court has repeatedly ruled *that the failure to plead prescription cannot be considered a waiver thereof, where the plaintiff's own allegations in the complaint and/or the evidence presented clearly showed that the action had prescribed. And in such a case the Court may act motu propio to extend to the defendant the benefit of the defense of prescription even if he did not plead the defense.*

CONCLUSION

As we have seen, for prescription to prosper as a valid defense it must be invoked at the soonest possible time either administravely, in a request for reinvestigation or reconsideration, or judicially, in a petition for review with the Court of Tax Appeals. The failure to invoke the defense seasonably bars its use, as illustrated in the case of *Basa v. Republic*, save in instances when criminal cases for collection are filed, or when the defense is raised in a civil case and the government litigates on the merits of the case. However, if the government invokes the defense of prescription to resist liability, then such a ground can be raised even in the Supreme Court for the first time, when the plaintiff's own allegations provide the evidentiary basis for invoking the defense.

[29] Unreported Resolution, October 28, 1985 [emphasis added].