

THE LEGALITY OF THE ASSAULT ON TAX AVOIDANCE PRACTICES IN THE PHILIPPINES

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The distinction between tax avoidance and tax evasion is very clear in the academe. Tax books have often defined tax avoidance as an attempt to minimize the payment or altogether eliminate tax liability by lawful means, while tax evasion refers to the elimination or reductions of one's correct and proper tax by fraudulent means. The consequence of each case is also clear. The former is not criminally punishable while the latter is criminally punishable. However, the distinction between the two cases seems to have been blurred by the inconsistent practice of the government in its treatment of the subject matter.

Very often, the Bureau of Internal Revenue (BIR) asks for a valid business purpose whenever a taxpayer enters into a transaction which has the effect of reducing tax liability. For instance, when a father sells a parcel of land to his son, the BIR looks into the financial capability of the son to buy the subject land, in order to ensure that the sale was not for the sole purpose of saving on the payment of estate taxes. The taxpayer has to come up with a valid reason for selling his land to his son. An honest answer from the taxpayer that the transaction was for purposes of tax avoidance will not be acceptable to the BIR. The BIR will impose the higher tax rate in its assessment, as well as the corresponding interests and penalties. This situation leads one to wonder whether tax avoidance is legal or not in the Philippines.

This paper aims to show that the attack on tax avoidance transactions in the Philippines has no legal basis. It urges consistency and certainty on the part of the government in its response towards tax avoidance. To eliminate further injustice and inefficiencies, it is imperative that a law be passed to inform the taxpayers as to what constitutes "permissible" and "impermissible" tax avoidance. In the absence of such law, tax avoidance transactions entered into by the taxpayers must be respected.

Keywords: tax avoidance; tax evasion

I. INTRODUCTION

Tax Avoidance vs. Tax Evasion – Distinctions and Similarities

The distinction between tax avoidance

and tax evasion seems to be very clear. Assume for instance that Corporation "A" is engaged in real estate business. It owns a parcel of land which it would like to transfer

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to buyer "B". An outright sale of the land from corporation "A" to buyer "B" will result to an income tax liability on the part of corporation "A" at the rate of thirty percent (30%) of taxable income.¹

However, if corporation "A" creates a subsidiary by transferring the parcel of land to subsidiary "C" in exchange for the shares of stocks of subsidiary "C", the transfer is not subject to any tax liabilities.² Corporation "A" can subsequently transfer the shares of stocks of subsidiary "C" to buyer "B". Stock transfers are subject to a maximum tax rate of only ten percent (10%) based on net capital gain.³ As can be seen from this illustration, by creating a subsidiary and selling the shares of stocks, corporation "A" was able to achieve its purpose of transferring a parcel of land to buyer "B", but at a reduced tax rate of ten percent (10%) instead of thirty percent (30%). This is an example of tax avoidance, whereby a taxpayer lawfully arranges its affairs to minimize taxes by utilizing the loopholes in the tax law.

Using the same example given in the preceding paragraph, if corporation "A" sells a parcel of land worth ten million pesos (P10,000,000.00) and intentionally understated the selling price to reduce its income tax liability, then it has committed a

clear case of tax fraud. Tax fraud or evasion refers to the elimination or reduction of one's correct and proper tax by fraudulent means.⁴ The fraud contemplated by law is actual and not constructive. It must be intentional, consisting of deception wilfully and deliberately done or resorted to in order to induce another to give some legal right.⁵ Tax evasion typically involves failing to report income, or improperly claiming deductions that are not authorized.

Clearly, "avoidance" is distinguishable from "evasion" which means avoidance by artifice as distinguished from an avoidance permitted by law.⁶ Authors have often defined tax avoidance as the tax saving device within the means sanctioned by law. Tax evasion, upon the other hand, is a scheme used outside of those lawful means and, when availed of, it usually subjects the taxpayer to further or additional civil or criminal liabilities.⁷ In practice, however, the dividing line between the two is unclear. As will be shown in this paper, the three branches of the government respond differently towards tax avoidance/tax planning schemes. This trend is troubling - because it lays the foundation for making criminals out of those who are otherwise innocently and legally engaged in minimizing their tax burden.⁸

II. BACKGROUND OF THE STUDY

Taxes are imposed on the theory that they are necessary for the government to supply the services needed by its citizens. However, no matter how useful taxes are to society, one cannot change the fact that it is unpleasant for the individuals to pay them. As such, it is just human nature for individuals to act on their own interests to avoid paying more taxes than they need to. There are two ways of doing so: one is to evade taxes and the other is to avoid them.

In the Philippines, tax evasion is clearly

made illegal by our laws. The legality of tax avoidance, however, is a gray area. There seems to be no categorical prohibition on tax avoidance under Philippine laws. However, the Bureau of Internal Revenue (BIR) rules and decides as if there is. This creates an unjust environment and leads to inefficiencies.

An unjust environment is created when some taxpayers are caught and levied fines for acts that other taxpayers can get away with. Since there are no clear-cut rules, in

practice, the liability of a taxpayer to pay additional taxes largely depends on the BIR personnel assigned to interpret the nature of a taxpayer's transaction. The bigger companies, which the BIR usually focuses their resources on, are more likely to receive assessments for tax avoidance practices compared to smaller companies doing almost the same act.

The inefficiencies are borne out of the taxpayer's desire to decrease his tax payments. For instance, he will enlist himself, his employees if any, and use his resources towards the goal of avoiding taxes. The BIR, on the other hand, will enlist its personnel to weed out "sham" transactions entered into for the sole purpose of avoiding taxes. Certain business decisions are also

unnecessarily made more complicated and even altered because the decision makers need to provide allowances for risks. They need to make allowances just in case the BIR treats some of their valid business transactions as "sham" transactions.

To avoid further injustice and inefficiencies, a law should be passed defining what constitutes permissible and impermissible tax avoidance. Foreign countries like the United States, Australia, Germany and France have adopted anti-avoidance laws. For a country like the Philippines, whose budget deficit and foreign debts have been on a constant rise, the need for an anti-avoidance law to prevent further tax leakages cannot be overemphasized.

III. OBJECTIVES AND METHODOLOGY OF THE STUDY

The main objective of this paper is to present the current legal status of tax avoidance/tax planning schemes in the Philippines. This will be done by examining the response of the three branches of the government towards tax planning. The discussion will emphasize on the undesirable consequences of the present system wherein what constitutes permissible and impermissible tax avoidance practices cannot be traced to the Tax Code, but is a matter that is left entirely to the discretion of the BIR.

Delimitations of the Study

1. Tax avoidance mechanisms can be international or domestic in nature. The discussion of this paper shall be limited to domestic tax avoidance schemes.
2. It is not the objective of this paper to eliminate tax avoidance/tax planning schemes completely. It is not feasible to do so. However, this paper operates on the assumption that it is important to keep the level of tax avoidance/abusive

tax planning under control.

3. In determining the legality of tax avoidance practices in the Philippines, the author will make its observations: (a) by tracing certain changes that the Philippine Tax Code has undergone; (b) by examining how judicial doctrines have evolved over the years; and (c) by looking into some of the issuances of the BIR. In trying to establish a trend, this paper will cite patterns of behaviour only by way of example. The documented examples are not intended to be exhaustive.
4. In proposing the passage of an anti-avoidance law, certain economic consequences will follow, such as the possibility of attracting lesser foreign investments, or making the cost of doing business higher, or removing certain tax planners out of jobs. These economic implications are policy issues which are beyond the scope of this paper.
5. This paper aims to establish the need for legislative action to legally and

effectively curb tax avoidance. Although other methods of curbing tax avoidance may be adopted by the other branches of

the government, a study of these approaches is beyond the scope of this paper.

IV. ASSESSMENT OF PHILIPPINES TAX AVOIDANCE RULES

The three main branches of the Philippine government are the legislative branch (or the law-making body), the judicial branch (or the law-interpreting body), and the executive branch (or the law-enforcing body). Section 24 Article VI of the 1987 Philippine Constitution provides that the power to enact revenue or tariff bills lies exclusively with Congress, while Article VIII thereof provides that the power to interpret laws and settle controversies lies with the Supreme Court as the highest judicial body in the Philippines. The power to implement tax laws is vested in the BIR, acting under the supervision and control of the Department of Finance, pursuant to Section 2 Title I of Republic Act No. 8424. Having established the role of each branch of the government in the enactment, implementation and interpretation of tax laws, this paper shall now assess the attitude of each branch of the government towards tax avoidance practices in the Philippines.

The Legislative Department (Congress)

1. Section 40 of the 1997 NIRC

A specific anti-avoidance provision adopted by Congress is contained in Section 40 of the 1997 National Internal Revenue Code (NIRC), which states:

“SEC. 40. Determination of amount and recognition of gain or loss.

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(C) Exchange of Property. –

(1) General Rule. – Except as herein provided, upon the sale or exchange of property, the entire amount of the gain or loss, as the case may be, shall be

recognized.

(2) Exception. – No gain or loss shall be recognized if in pursuance of a plan of merger or consolidation –

(a) A corporation, which is a party to a merger or consolidation, exchanges property solely for stock in a corporation, which is a party to the merger or consolidation; or

(b) A shareholder exchanges stock in a corporation, which is a party to the merger or consolidation, solely for the stock of another corporation also a party to the merger or consolidation; or

(c) A security holder of a corporation, which is a party to the merger or consolidation, exchanges his securities in such corporation, solely for stock or securities in another corporation, a party to the merger or consolidation.

No gain or loss shall also be recognized if property is transferred to a corporation by a person in exchange for stock or unit of participation in such corporation of which as a result of such exchange, said person, alone or together with others, not exceeding four (4) persons, gains control of said corporation; *Provided*, That stocks issued for services shall not be considered as issued in return for property.

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(6) Definitions. –

(a) xxx

(b) The term ‘merger’ or ‘consolidation’, when used in this Section, shall be understood to mean: (i) the ordinary merger or consolidation, or (ii) the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock; *Provided*, That for a transaction to be regarded as a merger or consolidation

within the purview of this Section, it must be undertaken for a *bona fide* purpose and not solely for the purpose of escaping the burden of taxation: *Provided, further*, That in determining whether a *bona fide* purpose exists, each and every step of the transaction shall be considered and the whole transaction or series of transactions shall be treated as a single unit: *Provided, finally*, That in determining whether the property transferred constitutes a substantial portion of the property of the transferor, the term 'property' shall be taken to include the cash assets of the transferor."

Section 40 allows for two exceptions to the general rule that all exchanges are subject to tax: (1) those made in pursuance of a plan of merger or consolidation; and (2) those involving the transfer of property to a corporation as a result of which the transferor gains control over the corporation. It is important to note that Section 40, in the definitions provided therein, states that for a merger or consolidation to be tax-free, it must be undertaken for a *bona fide* purpose and not solely for the purpose of escaping the burden of taxation. Such condition is imposed only with respect to the first exception. As far as the second exception is concerned, the law is silent. Given that the requirement of "bona fide purpose and not solely for the purpose of escaping the burden of taxation" is explicitly required for merger or consolidation, under the statutory principle of *expressum facit cessare tacitum*,⁹ can it be inferred that for all other types of transactions, such requirement need not be complied with? It is the humble opinion of the author that on the basis of Section 40(c)(2), it can be inferred that the business purpose requirement exists only with respect to transactions involving tax-free merger or consolidation, such that for all other types of transactions, the business purpose requirement is irrelevant.

Respecting the motive of tax avoidance

should be seen as the norm, rather than the exception. It is a given that the primary goal of a corporation and other business entities is to earn profit. One way to do so is to reduce business expenses. Since taxes form part of legitimate business expenses, reduction of taxes through legitimate means should be treated as a valid business purpose. This should be the general rule. To deviate from the general rule, Congress has to make a clear exception, such as in the case of a tax-free merger or consolidation wherein the requirement is that, the intent of reducing taxes, although a valid business purpose, cannot be the sole purpose.

2. Section 50 of the 1997 Tax Code

Another important provision of the Tax Code which aims to deter tax avoidance schemes can be found in Section 50 of the 1997 NIRC:

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

This section is perhaps the closest provision under local statutes that is comparable to the general anti-avoidance laws adopted by countries abroad. Strictly speaking, however, Section 50 falls short of the requirements of an anti-avoidance law. First, it does not empower the Commissioner to reconstruct a transaction nor to group different taxpayers into a single unit, whose

taxes shall be computed based on the grouping and to be subsequently allocated among the various taxpayers belonging to that group. Second, it does not explicitly prohibit related companies from entering into tax avoidance transactions. Related parties may continue committing tax avoidance practices without the risk of suffering any form of penalties. The only consequence in entering into tax avoidance transactions is that, when discovered by the BIR, the Commissioner has the power to make certain adjustments on the income or deductions reported. Third, if the parties to a transaction are made to appear to be unrelated, then Section 50 is automatically not applicable. Lastly, if the related parties agree not to report any income or charge any expenses to one another, then there is nothing left for the Commissioner to distribute, apportion or allocate. It can be noted that the Commissioner is merely empowered to allocate or distribute the amounts reported. He does not possess the power to impute taxes. In other words, the power granted to the Commissioner under Section 50 of the Tax Code is quite limited.

3. *Other amendments to the Tax Code*

By examining other provisions introduced by Congress in the 1997 NIRC, it becomes apparent that the Legislature has adopted a hole-and-plug process in addressing the issue of tax avoidance. Instead of expressly prohibiting taxpayers from entering into abusive tax planning practices, Congress tried to diminish the tax benefits of these schemes. Examples of these amendments pertain to improperly accumulated earnings, interest arbitrage and tax on branch profits.

Improperly accumulated earnings

In order to deter the practices of certain corporations in avoiding income tax due from its shareholders, Section 29 was

introduced in the 1997 Tax Code, which provides:

“SEC. 29. Imposition of improperly accumulated earnings tax.

a. In general - In addition to other taxes imposed by this Title, there is hereby imposed for each taxable year on the improperly accumulated taxable income of each corporation described in Subsection B hereof, an improperly accumulated earnings tax equal to ten percent (10%) of the improperly accumulated taxable income.

b. Tax on corporations subject to improperly accumulated earnings tax.

(1) In general - The improperly accumulated earnings tax imposed in the preceding Section shall apply to every corporation formed or availed for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.”

The purpose of imposing the ten percent (10%) Improperly Accumulated Earnings Tax was explicitly stated by the BIR in its revenue regulation (RR), as follows:

“x x x. The rationale is that if the earnings and profits were distributed, the shareholders would then be liable to income tax thereon, whereas if the distribution were not made to them, they would incur no tax in respect to the undistributed earnings and profits of the corporation. Thus, a tax is being imposed in the nature of a penalty to the corporation for the improper accumulation of its earnings, and as a form of deterrent to the avoidance of tax upon shareholders who are supposed to pay dividends tax on the earnings distributed to them by the corporation.”¹⁰ (underline supplied)

It can be noted that for purposes of

applying Section 29, the touchstone of the liability is the purpose behind the accumulation of the income. The fact that any corporation is a mere holding company or investment company shall be prima facie evidence of a purpose to avoid the tax upon its shareholders or members.¹¹ Likewise, the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members.¹² On the contrary, if the failure to pay dividends were due to some other causes, such as the use of undistributed earnings and profits for the reasonable needs of the business, such purpose would not generally make the accumulated or undistributed earnings subject to tax.¹³

Note that Section 29 is an example of a specific anti-avoidance provision involving the unreasonable accumulation of earnings. When a corporation accumulates earnings beyond its reasonable needs, the presumption of tax avoidance kicks in, and the ten percent (10%) improperly accumulated earnings tax automatically attaches. This provision is an effective deterrent against tax avoidance because the indications of tax avoidance are explicitly identified and are objectively verifiable. The consequence of violating this provision is also clear---taxpayers must pay an additional ten percent (10%) tax. In effect, this provision has defined in clear terms what constitutes impermissible tax avoidance in transactions involving accumulation of earnings. It has also provided certainty as to how taxes will be computed when violations are discovered.

Interest arbitrage

Interest arbitrage used to be a common form of tax planning scheme employed by taxpayers engaged in business. By obtaining a loan and investing the proceeds of that loan in a tax favored investment with the same

lending bank, the taxpayer was able to incur tax savings of thirty-five percent (35%)¹⁴ out of the interest expense incurred in such loan. The interest income arising out of the tax favored investment, on the other hand, would be subject to only twenty-percent (20%) final withholding tax or could even be tax-exempt. These transactions enabled the taxpayer to pocket the spread, without the need of any money actually changing hands between the parties, apart from transaction fees.

In order to protect the further erosion of tax revenues due to interest arbitrage transactions, Congress amended the former Tax Code by reducing the amount of interest that a taxpayer can claim as deduction in case the taxpayer earned interest income in the same taxable year. The provision on interest deductibility was first amended by R.A. 8424 to read as follows:

“Section 34. Deductions from gross income.

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(B) Interest.-

(1) *In General.* - The amount of interest paid or incurred within a taxable year on indebtedness in connection with the taxpayer's profession, trade or business shall be allowed as deduction from gross income: *Provided, however,* That the taxpayer's otherwise allowable deduction for interest expense shall be reduced by an amount equal to the following percentages of the interest income subjected to final tax:

Forty-one percent (41%) beginning January 1, 1998; Thirty-nine percent (39%) beginning January 1, 1999; and Thirty-eight percent (38%) beginning January 1, 2000.”

This amendment is effective in terms of deterring taxpayers from entering into interest arbitrage transactions since the supposed tax benefit associated with it is now negated, as shown in the following computations:

Effective tax benefit in arbitrage transactions	=	$\frac{\text{Normal tax rate} - \text{Reduced tax rate}}{\text{Normal tax rate}}$
	=	$\frac{32\% - 20\%}{32\%}$
	=	37.5% or 38%

This amendment, similar to Improperly Accumulated Earnings Tax, is an effective deterrent against tax avoidance transactions involving interest arbitrage. The conditions for the application of Section 34 are well defined. The manner of computing taxes is also clear. When a taxpayer has interest expense and interest income in one taxable year, the law conclusively presumes that the taxpayer is engaging in interest arbitrage transactions, and the computations outlined under Section 34 must be followed.

Branch profit

Another tax avoidance scheme utilized by multi-national corporations is the use of their Philippine Branch as tax shelter against tax on dividends or other passive Income. Under the 1997 NIRC, inter-corporate dividends received by domestic and resident corporations, such as the branch, are exempt from dividend tax. On the other hand, dividends received by a non-resident corporation are subject to a thirty percent (30%) tax¹⁵ or to a lower treaty rate of fifteen percent (15%).¹⁶ This being so, passive investments of the foreign home office which are not connected with its operations in the Philippines are usually channelled through the branch in order to avail of the

zero-rate tax on dividend instead of the thirty percent (30%) withholding tax rate directly paid to the home office.¹⁷

Congress tried to plug this loophole by putting a proviso under Section 28(A)(5) of the 1997 NIRC, specifying that for an income to be considered an income of the branch and not the Home Office, it must be effectively connected with the branch's trade or business in the Philippines. Otherwise, it is considered as income received by a non-resident foreign corporation taxable at thirty percent (30%) based on gross income.

Based on the foregoing illustrations, it can be observed that Congress has generally adopted a reactionary approach towards tax avoidance. Instead of explicitly barring tax avoidance schemes, it tried to deter tax avoidance practices through the following methods:

- a. imposing additional taxes, such as in the case of improperly accumulated earnings;¹⁸
- b. imposing a limit on the amount of deductions that can be claimed, such as in the case of interest expense; and
- c. imposing a certain conditions under which a lower tax rate may be availed of, such as in defining what constitutes branch profit.

4. Sanctions imposed

Unlike tax avoidance, the illegality of tax evasion is clearly provided for under the

law. In an effort to deter tax evasion practices, Congress has increased the fine/imprisonment sanctioned under the old NIRC, which is summarized below:

Violation	Fine/Imprisonment under the National Internal Revenue Code of 1977	Fine/Imprisonment under the Comprehensive Tax Reform Program
Attempt to Evade or Defeat Tax	Fine of not more than P10,000 or imprisonment for not more than 2 years or both ¹⁹	Fine of not less than P30,000 but not more than P100,000 and imprisonment of not less than 2 years but not more than 4 years ²⁰
Failure to File Return, Supply Correct and Accurate Information, Pay Tax, Withhold and Remit Tax and Refund Excess Taxes Withheld on Compensation	Fine of not less than P5,000 nor more than P50,000, or imprisonment for not less than 6 months and 1 day but not more than 5 years, or both ²¹	Fine of not less than P10,000 and suffer imprisonment of not less than 1 year but not more than 10 years. ²²
Penal Liability of Corporations	A fine of not less than P10,000 but not more than P100,000 for each act or omission ²³	A fine of not less than P50,000 but not more than P100,000 for each act or omission ²⁴
Penal Liability for Making False Entries, Records or Reports	For each act or omission, a fine of not less than P10,000 but not more than P50,000 or imprisonment of not less than 4 years and 1 day but not more than 6 years or both ²⁵	For each act or omission, a fine of not less than P50,000 but not more than P100,000 and suffer imprisonment of not less than 2 years but not more than 6 years ²⁶

Moreover, Section 267 of the 1997 Tax Code provides that:

“Any declaration, return and other statements required under this Code, shall, in lieu of an oath, contain a written statement that they are made under the penalties of perjury. Any person who willfully files a declaration, return or statement containing information which is not true and correct as to every material matter shall, upon conviction, be subject to the penalties prescribed for perjury under the Revised Penal Code.”

Despite the increase in the sanctions imposed for violations of the provisions of the 1997 NIRC, and notwithstanding the possibility of being prosecuted for perjury

under the Revised Penal Code, the effectivity of these penalties in deterring tax avoidance is highly doubtful. This is because the sanctions imposed are *criminal* in nature. This means that for a case to prosper, the BIR must be able to establish fraud by clear and convincing evidence. Mere preponderance of evidence is not even adequate to prove fraud.²⁷ Since intent is internal, it is very difficult to ascertain and prove. Moreover, since tax avoidance is a gray area, the conclusion that there is absence of fraud will always follow. Therefore, in the present situation, tax avoidance will always thrive.²⁸

5. Powers of the Commissioner

Congress has also accorded greater

powers to the Commissioner of Internal Revenue with the objective of enabling the Commissioner to conduct investigations and collect proper taxes. Apart from the power to make assessments, the Commissioner is also granted the following authorities: (1) to conduct inventory-taking, surveillance and to prescribe presumptive gross sales and receipts;²⁹ (2) to terminate taxable period;³⁰ (3) to prescribe real property values;³¹ (4) to inquire into bank deposit accounts;³² (5) to accredit and register tax agents;³³ (6) to prescribe additional procedural or documentary requirements;³⁴ and (7) to issue access letter³⁵.

These powers are granted to the Commissioner for purposes of establishing the existence of prima facie indications of fraud.³⁶ As discussed in the preceding section, a problem exists with respect to the quantum of proof required to be established in tax prosecution cases, which is, the existence of fraud beyond reasonable doubt. Since tax avoidance transaction, by definition does not carry with it the element of fraud, without an anti-avoidance law, these broad powers appear to be useless in the campaign against tax avoidance.

6. Tax Avoidance and the Legislative Department

Based on the foregoing, the following observations can be made with regard to the attitude of the Legislature towards tax avoidance:

- a. Section 40 of the 1997 NIRC is the sole anti-avoidance provision adopted under Philippine tax laws which contains the requirement of "bona fide purpose and not solely for purposes of escaping the burden of taxation." This requirement is expressly imposed on tax-free mergers or consolidations. Outside of merger or consolidation, it can be inferred that a tax planning scheme
- b. should not be invalidated for the sole reason that the requirement of "bona fide purpose and not solely for the purpose of escaping the burden of taxation" was not complied with.
- b. What Congress has explicitly declared illegal is tax evasion. As for tax avoidance, Congress has introduced certain specific anti-avoidance provisions in the 1997 Tax Code. Apart from those specifically identified, it would seem that Congress intended to respect other types of tax avoidance practices.
- c. The attitude of Congress towards tax avoidance can be characterized as reactionary. Although Congress has not explicitly declared an anti-avoidance policy, from the various amendments introduced into the Tax Code, it can be observed that Congress is trying to deter tax avoidance by plugging the loopholes in the Tax Code.
- d. Some of the measures adopted by Congress are effective in deterring tax avoidance schemes (i.e. Sections 29 and 34 of the 1997 NIRC), while others are not (i.e. Section 50 of the 1997 NIRC). In general, an anti-avoidance provision serves as an effective deterrent if it clearly provides for factual conditions which will trigger the applicability of the provision, and if it specifically provides for the proper manner of computing the amount of imputed taxes.

The Judiciary (Supreme Court)

1. Piercing the veil of corporate fiction

*Yutivo v. CTA*³⁷

The Philippine Supreme Court first ruled on a local tax-planning scheme in the 1960s

in the case of *Yutivo vs. CTA*. In this case, Yutivo sold imported cars and trucks to Southern Motors, which in turn, sold them to the public in the Visayas and Mindanao. Yutivo, as an importer, paid sales tax prescribed on the basis of its selling price to Southern Motors, and since such sales tax is collected only once on original sales, Southern Motors paid no sales tax on its sales to the public.

In 1950, the Collector of Internal Revenue assessed Yutivo for deficiency sales tax and surcharge for the period covering July 1, 1947 to December 31, 1949, claiming that the taxable sales were the retail sales made by Southern Motors to the public and not the wholesale sales made by Yutivo to the latter, inasmuch as Southern Motors and Yutivo were one and the same corporation, the former being the subsidiary of the latter.

At the outset, the Supreme Court upheld the right of a taxpayer to avoid taxes by means which the law permits:

“x x x. In this connection, it should be stated that a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes or altogether avoid them by means which the law permits. [U.S. vs. *Isham*, 17 Wall. 496, 506; *Gregory vs. Helvering*, 293 U.S. 465, 469; *Commr. Vs. Tower*, 327 U.S. 280; *Lawton vs. Commr.*, 194 F (2d) 380] Any legal means used by the taxpayer to reduce taxes are all right [Benny vs. *Commr.*, 25 T. Cl. 78]. A man may, therefore, perform an act that he honestly believes to be sufficient to exempt him from taxes. He does not incur fraud thereby even if the act is thereafter found to be insufficient. x x x”³⁸

The Court even held that the Court of Tax Appeals erred in the imposition of the fifty percent (50%) fraud surcharge, and that a mere understatement of tax in itself does not prove fraud.³⁹ In ruling against the taxpayer, the Supreme Court did not cite as basis any of the provisions under Philippine

tax laws. Instead, it applied the principle of piercing the veil of corporation fiction:

“It is an elementary and fundamental principle of corporation law that a corporation is an entity separate and distinct from its stockholders and from other corporations to which it may be connected. However, ‘when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime,’ the law will regard the corporation as an association of persons, or in the case of two corporations merge them into one. x x x”⁴⁰

The Supreme Court agreed with the findings of the lower court that Southern Motors was actually owned and controlled by Yutivo as to make it a mere subsidiary or branch of the latter. This is evidenced by the fact that Yutivo, through common officers and directors, exercised full control over Southern Motor's resources, cash transactions and operations. As such, the Supreme Court ruled that the taxpayer must pay the deficiency tax, plus 25% surcharge-

“Southern Motors being but a mere instrumentality or adjunct of Yutivo, the Court of Tax Appeals correctly disregarded the technical defense of separate corporate entity in order to arrive at the true tax liability of Yutivo.”⁴¹

It can be noted from the case of Yutivo that, because of the lack of anti-avoidance schemes in Philippine tax laws, the Supreme Court had to apply corporate law principles as legal basis in requiring Yutivo to pay the proper amount of taxes. Conversely, if Yutivo elected a separate set of directors and officers for Southern Motors, and maintained a semblance of independence of operations from that of Southern Motors, perhaps the Supreme Court would have ruled otherwise.

*Liddell and Co. v. CIR*⁴²

In the subsequent case of *Liddell and Co. v. CIR*, whose facts are substantially similar to that of *Yutivo*, the Supreme Court also pierced the veil of corporation fiction in computing the proper amount of tax due. *Liddell and Co.* was engaged in the business of importing and selling cars and trucks at retail. A majority of its stocks was owned by Frank Liddell. Subsequently, *Liddell Motors, Inc.* was organized, with the wife of Frank Liddell, Irene Liddell, owning a majority of its stocks. *Liddell and Co.* then sold its vehicles to *Liddell Motors*, which in turn, sold them to the public with a steep mark-up. Since then, *Liddell and Co.* paid sales taxes on the basis of its sales to *Liddell Motors, Inc.*, considering said sales as original sales.

The Collector of Internal Revenue determined that the latter corporation was a mere alter ego of *Liddell and Co.*, alleging that Frank Liddell also owned *Liddell Motors*, since there is no showing that his wife had income to cover the subscription price. Hence, for tax purposes, the sales made by *Liddell Motors* to the public should be used as the proper tax base for computing the sales tax.

The Court ruled against the taxpayer, rationalizing as such:

“As opined in the case of *Gregory v. Helvering*, “the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.” But, as held in another case, “where a corporation is a dummy, is unreal or a sham and serves no business purpose and is intended only as a blind, the corporate form may be ignored for the law cannot countenance a form that is bald and a mischievous fiction.”⁴³

2. *Test of reasonableness*

Although a taxpayer has the right to

reduce taxes by claiming all available deductions permitted by law, such right is not absolute. The amount of deductible expenses must be reasonable. In the two cases discussed below, the Supreme Court held that the amount of deductible expenses should meet the test of reasonableness.

*Kuenzle and Streiff, Inc. v. CIR*⁴⁴

In *Kuenzle and Streiff, Inc. v. CIR*, petitioner claimed as deductible expense the bonuses which it paid to its officers. The Commissioner disallowed the deduction on the ground that they were not ordinary, or necessary, or reasonable expenses within the purview of Section 30(a)(1) of the NIRC. The Court found that the bonuses were not reasonable because petitioner had suffered net losses during those years.

*C.M. Hoskins and Co. v. CIR*⁴⁵

In *C.M. Hoskins and Co. v. CIR*, the Supreme Court reiterated the doctrine in *Kuenzle*, when it disallowed as a deductible item supervision fees paid to a controlling stockholder, and ruled instead that the fees should be treated as a distribution of earnings and profits of the taxpayer. Petitioner failed to meet the test of reasonableness, particularly described as follows:

“There is no fixed test for determining the reasonableness of a given bonus as compensation. This depends upon many factors, one of them being ‘the amount and quality of the services performed with relation to the business.’ Other tests suggested are: payment must be ‘made in good faith’; the character of the taxpayer’s business, the volume and amount of its net earnings, its locality, the type and extent of the services rendered, the salary policy ‘of the corporation’; ‘the size of the particular business’; ‘the employees’ qualifications and contributions to the business venture’; and ‘general

economic conditions' (4 Mertens, Law of Federal Income Taxation, Secs. 25.44, 25.49, 25.50, 25.51, pp. 407-412). However, in determining whether the particular 'salary or compensation payment is reasonable, the situation must be considered as whole. Ordinarily, no single factor is decisive it is important to keep in mind that it seldom happens that the application of one test can give satisfactory answer, and that ordinarily it is the interplay of several factors, properly weighted for the particular case, which must furnish the final answer."⁴⁶

3. Cases decided in favor of taxpayers

Commissioner of Internal Revenue v. Court of Appeals, et al.⁴⁷

Apart from meeting the required quantum of proof, the difficulty of prosecuting tax avoidance schemes is further compounded by the doctrine laid down by the Court in the case of CIR v. Court of Appeals, et al. In this case, petitioner CIR filed a complaint with the Department of Justice against private respondents Fortune Tobacco Corporation, its corporate officers, nine other corporations and their respective corporate officers, for alleged fraudulent tax evasion for the year 1992. Private respondents were alleged to have adopted and employed fraudulent schemes. By making fictitious and simulated sales of its cigarette products to non-existent individuals and entities, private respondents were alleged to have under declared its wholesale prices for tax purposes.

The Department of Justice (DOJ) Task Force issued a subpoena directing private respondents to submit their counter-affidavits. Instead of filing their counter-affidavits, private respondents filed a Verified Motion to Dismiss which the DOJ denied. As a consequence, private respondents filed a petition for certiorari and prohibition with prayer for preliminary

injunction with the Regional Trial Court of Quezon City. The trial court issued an order granting the prayer for the issuance of a preliminary injunction, mainly on the ground that the Commissioner, in a letter dated August 13, 1993, gave Fortune Tobacco Corporation a period of thirty (30) days from receipt thereof within which to pay the alleged tax deficiency assessments, and that the Commissioner filed the criminal complaint for tax evasion before the period lapsed. The regional trial court ruled that the criminal complaint was filed prematurely and in violation of the constitutional right of the respondents to equal protection of the laws. The trial court issued two more orders, likewise enjoining the preliminary investigation of the two other complaints filed with the Quezon City Prosecutor's Office and the DOJ for fraudulent tax evasion for the taxable years 1990 and 1991. This was affirmed by the Court of Appeals and by the Supreme Court, rationalizing as such:

"We share with the view of both the trial court and Court of Appeals that before the tax liabilities of Fortune are first finally determined, it cannot be correctly asserted that private respondents have willfully attempted to evade or defeat the taxes sought to be collected from Fortune. In plain words, before one is prosecuted for willful attempt to evade or defeat any tax under Section 253 and 255 of the Tax Code, the fact that a tax is due must first be proved."⁴⁸

It is unfortunate that the Supreme Court did not rule on the legality of the tax planning scheme utilized by Fortune Tobacco, but simply limited its discussion on the procedural issue as to whether the regional trial court acted with grave abuse of discretion in issuing the writ of preliminary injunction. What needs to be emphasized, however, is that the Supreme Court made a categorical statement that "before one can be

prosecuted for willful attempt to evade or defeat any tax, the fact that a tax is due must first be proved." This statement seems to be in contrast with a previous doctrine laid down by the court in the case of Ungab V. Cusi,⁴⁹ wherein the Court stated:

"The contention is made, and is here rejected, that an assessment of the deficiency tax due is necessary before the taxpayer can be prosecuted criminally for the charges preferred. The crime is complete when the violator has, as in this case, knowingly and willfully filed fraudulent returns with intent to evade and defeat a part or all of the tax."⁵⁰

"An assessment of a deficiency is not necessary to a criminal prosecution for willful attempt to defeat and evade the income tax. A crime is complete when the violator has knowingly and willfully filed a fraudulent return with intent to evade and defeat the tax. The perpetration of the crime is grounded upon knowledge on the part of the taxpayer that he has made an inaccurate return, and the government's failure to discover the error and promptly to assess has no connections with the commission of the crime"⁵¹

The conflicting doctrines laid down by the Court in the case of CIR v. CA and in the case of Ungab v. Cusi can be very confusing to the taxpayers and the tax authorities alike. Based on the more recent doctrine, what is apparent is that the BIR will have an even more difficult time in its drive against tax avoidance. Since creative tax planning schemes are growing more and more complicated, it is almost impossible to directly trace a series of transactions as covered by a single provision of the Tax Code on the basis of which the amount of tax due shall be computed and must be duly proven in court.

Commissioner v. Marubeni Corp.⁵²

In the more recent case of CIR v. Marubeni Corporation, the Supreme Court upheld the tax-planning scheme employed by a foreign corporation. In this case, taxpayer Marubeni is a corporation duly organized in Japan. It is registered to engage in business in the Philippines and maintains a branch office in Manila. The CIR assessed Marubeni for deficiency contractor's tax covering the fiscal year ending March 1985. The deficiency, according to the BIR, arose out of Marubeni's failure to report as Philippine income two construction contracts which were completed in 1984. These two contracts were made on a "turn-key" basis and the gross income from the two projects amounted to nine hundred sixty-seven million two hundred sixty-nine thousand eight hundred eleven pesos and fourteen centavos (P967,269,811.14). Marubeni, however, argued that each of the two contracts was divided into two parts, i.e., the Onshore Portion and the Offshore Portion. The contract price was also divided into the Japanese Yen portion and the Philippine peso portion. All materials and equipment under the "Offshore portion" were manufactured and completed in Japan, not in the Philippines, and therefore, not subject to Philippine taxes. The BIR argued that since the two agreements are turn-key,⁵³ they call for the supply of both materials and services to the client. They are contracts for a piece of work and are indivisible. Accordingly, the entire receipts from the contract, including the Offshore Portion, constitute income from Philippine sources. Thus, total gross receipts should be subjected to contractor's tax.

The Supreme Court ruled in favor of the taxpayer and against the government, rationalizing as follows-

"Clearly, the service of 'design and engineering, supply and delivery,

construction, erection and installation, supervision, direction and control of testing and commissioning, coordination ...' of the two projects involved two taxing jurisdictions. These acts occurred in two countries - Japan and the Philippines. While the construction and 'installation work were completed within the Philippines, the evidence is clear that some pieces of equipment and supplies were completely designed and engineered in Japan. x x x All services for the design, fabrication, engineering and manufacture of the materials and equipment under Japanese Yen Portion were made and completed in Japan. These services were rendered outside the taxing jurisdiction of the Philippines and are therefore not subject to contractor's tax."⁵⁴

The Supreme Court, in ruling for the taxpayer, applied Section 42 of the 1997 NIRC, which identifies the different types of income from sources within and from sources without the Philippines. The purpose of the 'source of income' rules under the Tax Code is to allocate the income where the income is earned. In case of services, it shall be considered as gross income from sources within the Philippines if performed in the Philippines.⁵⁵

Although not explicitly stated in the decision of the case, it is important to point out that the Supreme Court actually adopted the doctrine of substance over form in upholding the tax planning scheme employed by Marubeni. The BIR argued that a turn-key contract is an indivisible contract for a piece of work, which under the law, should be subject to Philippine tax in its entirety. The Supreme Court ignored the form of the contract, and went into the substance of the agreement. This is because in practice, turn-key contracts are entered into not for purposes of avoiding taxes, but for purposes of simplifying the coordination work necessary in a given project by reducing the number of contact persons to only one.

This decision has a significant impact in the field of tax planning. Based on interviews conducted with various tax practitioners, it was revealed that prior to the Marubeni decision, taxpayers would divide an agreement into two contracts: an offshore contract and an onshore contract. This is done in order to preserve the application of the source of income rule. Because of the Marubeni decision, the Supreme Court has actually rendered this tax avoidance scheme unnecessary. Taxpayers can now divide a single contract into an offshore and onshore portion, and expect that only the onshore portion will be covered by Philippine taxation.

Despite the fact that the division of the contract into an Offshore and Onshore Portion clearly resulted to tax savings on the part of Marubeni, the Supreme Court upheld the tax-planning scheme that was employed. In other jurisdiction, altering the incidence of taxation or anything that reduces taxes are forms of tax avoidance, which are prohibited. The logical conclusion that one can derive from the Marubeni case is that certain tax avoidance schemes are valid in the Philippines.

Given that the Supreme Court has given its stamp of approval on the tax-planning scheme employed by Marubeni, it can be reasonably expected that soon, similar schemes involving the alteration of the incidence of taxation will grow in number. Consequently, the amount of taxes that the BIR would be able to collect will also drop. But can we fault the Supreme Court for that? The answer is no. Given the inadequacy of Philippine tax laws in dealing with tax avoidance transactions, the Court is simply performing its mandated duty of applying and interpreting the laws.

4. *Tax Avoidance and the Judiciary*

Based on the foregoing cases, the attitude of the Judiciary towards tax avoidance transactions can be summarized as follows:

- a. Absent specific anti-avoidance provision, Courts are constrained to rely on corporate law principles (such as piercing the veil of corporation fiction) in order to deter abusive tax planning schemes.
- b. The test of reasonableness was adopted by the Court in order to put a deterrent on the practice of some taxpayers in claiming excessive deductible expenses. The "reasonableness" requirement for deductible expenses can be traced to the Tax Code.
- c. The doctrine laid down by the Court in CIR v. CA, which was decided in 1999, seems to run counter to the doctrine laid down in Ungab v. Cusi. The new doctrine has the effect of further compounding the difficulty of the BIR in winning tax avoidance cases in court.
- d. As far as the courts are concerned, not all types of tax avoidance transactions are illegal in character. This can be clearly gathered from the decision of the Supreme Court in the case of Marubeni.

The Executive Department (BIR)

The BIR, being the agency tasked with the implementation of Philippine tax laws, has consistently adopted an adverse attitude towards tax planning schemes. Although the Philippine Tax Code does not explicitly ban tax avoidance, the BIR has released various issuances whose objective is to stop tax avoidance practices as well as to plug the loopholes existing in the present Tax Code. This can be illustrated in the discussion below.

1. Revenue Audit Memorandum Order (RAMO) No. 1-86

RAMO 1-86 provides that sales purportedly consummated abroad by the

home office shall be treated as sales constructively consummated in the Philippines and made by the branch office, hence, income therefrom shall be considered income from sources within the Philippines. To determine the constructive sales of the branch in the Philippines, the BIR personnel are instructed to check from the records of the Bureau of Customs all shipments coming from the branch's home office during the taxable year.

Note that RAMO 1-86 covers all multinational companies doing business in the Philippines under a branch-head office relationship. It has in effect amended the "source of income" rule provided under Section 42 of the 1997 NIRC since it laid down a *conclusive* presumption that all shipments coming from the branch's home office are sales entered into by the branch and therefore, are to be taxed as such.

2. RAMO 1-98⁵⁶

The BIR has also issued RAMO 1-98 which provides for the audit guidelines and procedures in the examination of interrelated group of companies. Said memorandum order specifically pertains to tax avoidance schemes committed by related companies:

"1. Background

"x x x

"1.2 The magnitude of revenue lost has become so alarming that there is a need to immediately address this problem. It is a fact, that because these companies are more interested in their net income as a whole (rather than as individual corporation) there is a desire to minimize tax payment by taking advantage of the loopholes in our tax system and by making use of schemes that allow them to move around the law in order to reduce their tax obligations.

"1.3 It is therefore necessary to conduct a joint and coordinated examination of interrelated group of companies in order to identify the tax avoidance schemes, and be able to

prescribe the necessary measures in order to avoid the erosion of revenues.”

The guideline also identified seven audit issues which revenue officers must focus on, namely: (1) use of tax shelters (such as foundation or a tax-exempt company) in order to avail of tax exemptions or of lower tax rates; (2) shifting income and/or expenses in favor of a related company with special tax privileges (e.g., BOI Incentives, Tax Holidays, etc.); (3) transfer pricing in inter-company supply of goods (tangible and intangible) and services; (4) inter-company loans and advances, and financing arrangements where the interest charged for the use of money is not at arm's length; (5) arbitrary cost-sharing arrangements for common expenses; (6) tax avoidance through resale and agency arrangements; and (7) thin capitalization and earning stripping.

It can be noted that the BIR did not limit its guideline in dealing with tax evasion cases alone. It has expressly declared its policy to crack down on tax avoidance transactions.

3. *RR No. 4-2003*⁵⁷

In 2003, the BIR issued RR No. 4-2003 to plug vehicle tax loopholes. The regulation amended RR No. 14-97. The Commissioner earlier said that the amendment was done because of the loopholes seen in the previous revenue regulation⁵⁸. The new regulation provided for guidelines by which the number of seats of an automobile is to be measured. The movement to plug the loophole was in reaction to the excise tax exemption claimed by Honda Philippines when it manufactured a ten-seater vehicle, which under existing regulations, is tax exempt.

4. *RR No. 7-2003*⁵⁹

Another example is RR No. 7-2003, which the BIR has issued to deter the practice of taxpayers in converting ordinary

income to capital gains or vice-versa, in an effort to lower tax due. The pertinent portions of said regulation which plugged the loophole existing in the Tax Code is provided below:

"Sec. 3. x x x

"a. Taxpayers engaged in the real estate business. x x x

"x x x

"A property purchased for future use in the business, even though this purpose is later thwarted by circumstances beyond the taxpayer's control does not lose its character as an ordinary asset. Nor does a mere discontinuance of the active use of the property change its character previously established as a business property.

"x x x

"e. Treatment of abandoned and idle real properties. x x x

"Provided however, that properties classified as ordinary assets for being used in business by a taxpayer engaged in business other than real estate business as defined in Section 2 (g) hereof are automatically converted into capital assets upon showing of proof that the same have not been used in business for more than two (2) years prior to the consummation of the taxable transactions involving said properties.”

The revenue regulation, in effect, laid down an absolute rule for taxpayers engaged in real estate business: once an ordinary asset, always an ordinary asset. This rule is inconsistent with the doctrine laid down by the Supreme Court in *Calasanz v. CIR*,⁶⁰ which provides that the classification of an asset, whether as ordinary or capital, shall be determined at the time the transaction is entered into:

“The statutory definition of capital assets is negative in nature. If the asset is not among the exception, it is a capital asset; conversely, assets falling within the exceptions are ordinary

assets. And necessarily, any gain resulting from the sale or exchange of an asset is a capital gain or an ordinary gain depending on the kind of asset involved in the transaction.

“However, there is no rigid rule or fixed formula by which it can be determined with finality whether property sold by a taxpayer was held primarily for sale to customers in the ordinary course of his trade or business or whether it was sold as a capital asset. Although several factors or indices have been recognized as helpful guides in making a determination, none of these is decisive; neither is the presence nor the absence of these factors conclusive. Each case must in the last analysis rest upon its own peculiar facts and circumstances.

“Also a property initially classified as a capital asset may thereafter be treated as an ordinary asset if a combination of the factors indubitably tend to show that the activity was in furtherance of or in the course of the taxpayer's trade or business. Thus, a sale of inherited real property usually gives Capital gain or loss even though the property has to be subdivided or improved or both to make it salable. However, if the inherited property is substantially improved or very actively sold or both it may be treated as held primarily for sale to customers in the ordinary course of the heir's business.”⁶¹

Hence, a confusing situation is created whereby Supreme Court decisions, which form part of the legal system of the Philippines,⁶² are in conflict with a BIR revenue regulation. Moreover, the regulation imposed a two-year holding period which is

not found under the Tax Code. As one tax practitioner observes:

“The new regulation leaves no room for abuse and little room for anything else. The scrimmage line between tax advisers and the BIR has been obliterated by the regulation. As taxpayers, we have no choice but to abide by the regulations. The law is the law, even in the form of an administrative regulation. The question is: is the regulation reasonable and does it have legal basis?”⁶³

5. *Tax Avoidance and the BIR*

Based on the foregoing, it can be gathered that the BIR has been constantly trying to stop tax avoidance schemes through the issuance of revenue regulations, revenue audit memorandum orders, and other administrative pronouncements. The validity of these issuances would have been unquestionable if they were issued to effectively enforce the provisions of the Tax Code,⁶⁴ or if they merely amended a previous regulation validly issued by it, as in the case of RR No. 4-2003. The problem arises when the BIR takes an extreme position in dealing with tax avoidance that is difficult to trace to any specific provision of the Tax Code or runs counter to the doctrines laid down by the Court. While some of these administrative issuances are arguably invalid, suffice is to say that the BIR is left with no choice but to take an anti-avoidance stand in order to provide for the necessary funding for the government.

V. NECESSITY OF AN ANTI-AVOIDANCE LAW

Comparative Analysis of the Response of the Three Departments

Based on the foregoing, it can be

observed that the three branches of government differ in their response towards tax avoidance, as follows:

Legislature

Congress has generally adopted a hole-and-plug approach in dealing with tax avoidance. This can be seen from the various amendments introduced into the Tax Code. Its attitude is to discourage tax avoidance schemes by plugging the loopholes or minimizing the tax benefits of such schemes. Except for some anti-avoidance provisions in the Tax Code, Congress has not explicitly banned all other types of anti-avoidance transactions. What Congress has thus far explicitly prohibited is tax evasion.

Judiciary

Absent an anti-avoidance law, courts have used statutory construction principles and corporate law principles in dealing with tax cases. Provided that the transaction is not fraudulent, courts will uphold the validity of a transaction, even if the intent is to minimize or avoid taxes. No less than the Court has stated that the use of corporate entity to gain advantage (such as minimization of taxation) is not by itself a fraudulent scheme. The corporate entity is there for both businessmen and lawyers to tinker with, to gain every advantage available under the law, and that alone is not a reprehensible act.⁶⁵ The attitude of the judiciary is consistent with its previously held doctrine that a taxpayer has a right to reduce his taxes.

Executive

BIR, on the other hand, adopts an overly eager drive to collect taxes. It has adopted an adverse attitude towards tax avoidance through the continuous issuance of regulations which tend to limit the options legally available to the taxpayers. It also tried to plug some of the loopholes existing in the Tax Code which Congress has failed to address.

From the foregoing, there seems to be a

consensus among the three branches of the government that certain types of tax avoidance schemes must be prohibited. It can be recalled that evasion refers to the attempt, whether successful or not, to reduce or altogether eliminate tax liability by means which the statutes declare to be unlawful, while avoidance refers to reaching the same ends by lawful means.⁶⁶ A comparison of the response of the three branches of the government vis-à-vis the preceding definition would show that the definition is clearly inaccurate. It failed to reflect the reality that in the Philippines, tax avoidance is not absolutely legal. Under the Philippine legal system, there are actually two types of tax avoidance: permissible and impermissible.

The distinction between permissible and impermissible tax avoidance would depend on the branch of government one is dealing with. To Congress, tax avoidance is permissible as long as it is not prohibited by the Tax Code. To the Court, tax avoidance transaction is permissible provided it is not fraudulent or abusive or contrary to law. To the BIR, these two concepts are used interchangeably.⁶⁷

The different treatment accorded to tax avoidance practices by the three branches of the government will necessarily hamper the efforts of the BIR in successfully prosecuting tax avoidance cases. To win a tax avoidance case, the BIR must pass the stringent test that 'the transaction is illegal. The required level of proof, which is similar to that of criminal cases, is counter-productive. This can be illustrated by looking at the annual report of the BIR. It has been reported that in 2001, the regional Legal Divisions of the BIR handled five (5) assessment cases involving P2.35 billion and nine (9) refund cases with a total revenue potential of P830.6 million. All fourteen (14) cases, totalling P3.181 billion, are pending with the Supreme Court.⁶⁸ In the same year, the Supreme Court rendered two decisions in favour of the government: one assessment case

involving P2.785 million and one refund case involving P2.693 million, for a total of P5.478 million.⁶⁹ It can be deduced from the data given that the BIR is experiencing a relatively low success rate in collecting taxes through the Court. This is further confirmed by the data provided in the BIR Annual Report for 2007 which indicates that out of the eighty-nine (89) cases filed by the BIR with the DOJ and various courts since 2005, sixty-six (66) cases were pending with the DOJ as of December 2007; eight (8) cases pending with the Court of Tax Appeals; two (2) cases pending with the Court of Appeals; three (3) cases pending with the Supreme Court; four (4) cases were referred back to the BIR for reinvestigation, while six (6) cases were dismissed⁷⁰.

Undesirable Consequences of the Status Quo

Apart from the difficulty of prosecuting tax avoidance cases, the status quo could lead to extremely undesirable consequences, such as:

1. *Loss of revenues.*

The evident impact of the absence of an anti-avoidance law is the loss of much needed revenues on the part of the government, which translates to a reduction in the funding available for public services.

2. *Creation of an unfair environment.*

The different ways by which anti-avoidance policy is being implemented by the government creates an unfair environment wherein the ultimate losers are the honest taxpayers. They end up paying for the avoidance practices of others by shouldering a greater share of the tax burden.

3. *Creation of a vicious cycle.*

In addition, businesses that avoid taxes give themselves an unfair advantage over competitors who do not. Businesses that are able to avoid taxes are capable of reducing the prices of their goods or services. Often, their competitors will feel obliged to follow suit in order to remain competitive in the market. Thus, a vicious cycle is created. Stated another way, tax avoidance breeds tax avoidance. In the long run, the confidence of the taxpayers in the integrity and fairness of the tax systems, and in the government in general, will decline.

4. *Problems associated with piecemeal issuances of administrative regulations.*

The current approach of combating tax avoidance, which is mostly left to the piecemeal administrative pronouncements of the BIR, also raises a lot of concerns. First, there are instances when the administrative pronouncements are not reasonable in a sense that the conditions imposed therein have no statutory basis. Because taxpayers perceive the regulations and other issuances as unreasonable, or lacking in legal basis, many believe that they are not bound by these pronouncements. Second, given the complexity of the Philippine Tax Code, the reliance on existing and future administrative pronouncements to deter tax avoidance will further complicate the current tax system, which is already hard to comprehend from a layman's point of view.

5. *Wastage of economic resources.*

Furthermore, the status quo would result to continuous wastage of huge amount of economic resources. In order to deter tax avoidance, huge resources are allocated each year for the BIR officials to

conduct investigations and to file cases in courts. Taxpayers, on the other hand, waste huge amount of time and resources defending themselves. The resources being devoted to fighting tax avoidance are funded by the taxpayers themselves. As a result, another vicious cycle that penalizes the non-avoiders as well as the avoiders, is started.

When tax avoidance cases are litigated in court, their outcome is almost predictable. The taxpayers have the resources to hire good lawyers, while the government's resources are limited. In the end, the position of the government is worse than ever. It has used its limited resources to finance investigations and prosecutions which hardly prosper in court.

From a legal perspective, because the Tax Code does not provide for an absolute ban on tax avoidance practices, the validity of tax avoidance transactions has remained to be a gray area. Expectedly, the BIR and the taxpayers are taking extreme positions on the matter. Both sides have legal basis to support their contentions, hence the imperative need for a legislative enactment to finally clarify matters.

Legal Contentions of the taxpayers

1. *Proper construction of tax laws.*

On the part of the taxpayers, penalizing tax avoidance when there is no law prohibiting it violates an elementary principle in statutory construction which provides that tax laws are construed strictly against the State and liberally in favor of the taxpayers. The doctrines laid down by the court on how tax laws are to be interpreted is summarized below:⁷¹

"Where the question is whether a statute subjects a matter, property, or person to tax, the statute is to be construed strictly against the subjection to tax liability, and it will not be

construed as imposing a tax unless it does so clearly, expressly and unambiguously.⁷² A tax cannot be imposed without clear and express words for that purpose. The general rule of requiring adherence to the letter in construing statutes applies with peculiar strictness to tax laws and the provisions of a taxing act are not to be extended by implication. In case of doubt, tax statutes are to be construed most strongly against the government and in favor of the subjects or citizens because burdens are not to be imposed nor presumed to be imposed beyond what statutes expressly and clearly import.⁷³

"Tax or customs laws may not be extended by implication beyond the clear import of their language, nor their operation enlarged so as to embrace matters not specifically provided.⁷⁴ If a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to be to the judicial mind. On the other hand, if the government seeking to collect tax or customs duties cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be."⁷⁵

2. *Limitations on administrative legislation.*

As discussed in this paper, the BIR has constantly adopted an anti-avoidance policy. In doing so, the BIR has at times imposed conditions and qualifications in its regulations which cannot be found in the Tax Code. Admittedly, a revenue regulation, the issuance of which is authorized by statute, has the force and effect of law.⁷⁶ However, to be valid, the rules and regulations must be: (a) consistent and in harmony with law; (b) reasonable; (c) useful and necessary; and (d) published in the official gazette.⁷⁷ The BIR may not, by its rules and regulations, amend, alter, modify, supplant, enlarge or limit the

terms of the statute.⁷⁸ This governing principle was long ago expressed by the United States Supreme Court in these words: "[I]f experience shows that Congress acted under a mistake, that does not authorize the Treasury Department- to make new laws which they imagine Congress would have made had it been properly informed."⁷⁹

3. *Violation of Section 24 Article VI of the 1987 Constitution.*

Moreover, to allow the BIR to assess and collect taxes on tax avoidance schemes is tantamount to delegating to the BIR the power to determine the subjects of taxation. This is in direct violation of the provision of the Constitution which requires that "[a]ll appropriation, revenue or tariff bills, bills authorizing increase of the public debt, bills of local application, and private bills shall originate exclusively in the House of Representatives, but the Senate may propose or concur with amendments."

4. *Violation of the Principle of Uniformity.*

The term *uniformity* (equality or "equal protection of the laws") requires that all subjects or objects of taxation, similarly situated, are to be treated alike or put on equal footing both in privileges and liabilities.⁸⁰ In one case,⁸¹ it has been held that equality and uniformity in taxation means that all taxable articles or kinds of property of the same class shall be taxed at the same rate. A tax is considered to be uniform when it operates with the same force and effect in every place where the subject may be found.⁸² At present, the prohibition on tax avoidance is randomly implemented. It becomes prohibited only when a taxpayer happens to be audited by a revenue officer knowledgeable in such practices. This means that if two or more taxpayers have committed the same act, but only one of them is audited by the revenue officer who is able to identify the transaction as a tax

avoidance scheme, then only one will be liable to pay a higher tax. Those who were not subjected to an examination are able to get away with it. In other words, the present system allows the random implementation of the so-called "anti-avoidance policy", thus violating the principle of uniformity in taxation enshrined under Section 28(1) Article VI of the 1987 Constitution.⁸³

5. *Nullum Crimen Nulla Poena Sine Lege.*

Furthermore, under the present system, the BIR prosecutes tax avoidance cases as if they are tax evasion cases, which are criminally punishable. It is a basic principle in criminal law that *nullum crimen nulla poena sine lege*, which means that there is no crime when there is no law that defines and punishes it. The acts of the BIR in treating the two concepts as one and the same violate a fundamental principle of criminal law.

Legal Contentions of the BIR

1. *Construction based on legislative intent.*

The government's main argument hinges on legislative intent. If the statute needs construction, the most dominant in the process is the purpose of the act.⁸⁴ The purpose of enacting tax laws is to ensure that Government is able to provide for the needs of those under its jurisdiction and care.⁸⁵ It is frequently held that taxes are the lifeblood of the Government and their prompt and certain availability are an imperious need.⁸⁶ The theory or underlying basis of taxation is governmental necessity, for indeed, without taxes, government can neither exist nor endure.⁸⁷

In order to raise the required revenues, all taxable transactions identified by Congress should bear its share of the costs and expenses of the government. If tax avoidance were to be treated as legitimate

transactions, it would tantamount to going against the very purpose why tax laws were enacted in the first place. It has been held that courts should not follow the letter of a statute when to do so would depart from the true intent of the legislature or would otherwise yield conclusions inconsistent with the purpose of the act. Legislation is an active instrument of government which, for purposes of interpretation, means that laws have ends to achieve, and they should be so construed as not to defeat but to carry out such ends and purposes.⁸⁸ Moreover, as between two statutory interpretations, that which better serves the purpose of the law should prevail.⁸⁹

2. *Construction to avoid absurdity.*

Moreover, it is absurd to imagine that tax avoidance would be considered as a purpose, whether principal or incidental, behind tax exemptions, credits and incentives granted by Congress. It has been held that statutes may be extended to cover cases not within the literal meaning of the terms if their exact and literal import would lead to absurd or mischievous results.⁹⁰ *Interpretatio talis in ambiguis semper fienda est ut evitetur inconveniens et absurdum.* Where there is ambiguity, such interpretation as will avoid inconvenience and absurdity is to be adopted.⁹¹ In other words, even if the facts are as the taxpayer had presented, if the technical tax results produced by a literal application of the law to those facts are unreasonable and unwarranted, they should not be respected.

3. *Substance over form.*

Finally, the BIR may utilize the substance over form doctrine⁹² in disregarding a tax avoidance transaction. It may argue that the objective facts of the transaction are not the same as how the taxpayer had presented them. This means that the formal way in which the taxpayer

had presented the facts belied their real substance and, as a result, the taxpayer applied the wrong set of mechanical rules in reaching its purported tax consequences.

Possible Ground for Reconciliation

As can be seen from the discussion above, the conflicting positions taken by the BIR and the taxpayers actually involve only one basic issue: For purposes of determining whether tax avoidance transactions should be respected, is the Philippine Tax Code solely determinative of the matter?

To answer this question, the proper role of the Tax Code in the Philippine legal system must first be examined. Since tax law is a field of commercial law, it will be useful to examine the role of commercial law, particularly the Corporation Code, in the Philippine legal system. An established commentator, Associate Dean Cesar Villanueva, in his book on Philippine Corporate Law, made an extensive and illuminating discussion on the matter.⁹³

“It must be, emphasized, therefore, that Philippine Corporate Law is a transplant from United States common law; and though we have a Corporation Code that provides for statutory principles, Philippine Corporate Law is essentially the product of commercial developments. Much of this development can be expected to take place by way of jurisprudential rules that try to apply and adapt corporate principles to changing concepts and mechanisms within the world of commerce. The statutory principles embodied in the Corporation Code should therefore be considered as *dated* rules or legal expressions of approved corporate practices, since they hark back to a time when such principles were the prevailing view, or at least the general controlling influence. Unless the statutory provisions so clearly state, such provisions should by no means be taken to restrict and define future

developments.

“In other words, the high regard with which we hold the Civil Code cannot also be accorded in the Corporation Code. True, both sets of codes represent the people's will, expressed through their Legislature, of the fields that they cover. Nevertheless, the difference in their coverage also dictates the difference in treatment of the two codes. The Civil Code is meant to regulate private relations of members of the civil society, determining their respective rights and obligations.⁹⁴ The reverence and respect we place upon the Civil Code is justified by the idea that it embodies 'timeless truths' since it goes into the very essence of man and his relationships. Through different periods in time, the essence of man does not change, and the basic relationships that result likewise do not change.

“On the other hand, the Corporation Code is meant to be a collection of rules governing only a particular medium of doing business in the Philippines, the corporation, and which actually expresses in statutory form the accepted practice as borne out by jurisprudential rules. Our Corporation Code therefore constitutes an attempt by Legislature to reflect, *at the time of its passage, some* of the prevailing accepted practices and customs of businessmen regarding the corporate vehicle.

“But commercial practices evolve, and so too must the commercial media employed, as well as the legal principles and concepts applicable thereto. Business dynamics are characterized by swift adaptation in the face of technological, scientific, and social developments. To consider therefore the Corporation Code as embodying eternal truths is folly; reverence to the provisions of the Corporation Code should be upheld only insofar as it continues to be relevant to the needs of business and commercial transactions.

“Of course this is not to condone anarchic transgression of such provisions of the Corporation Code as

one considers no longer acceptable or practical. Rather, it is the *treatment* of, and reverential *attitude* towards the Code, that must be defined. Philippine Corporate Law must evolve a philosophy that allows both flexibility and stability.”

With the foregoing concepts in mind, it can be said that the proper treatment of the Tax Code is to see it as dated rules of the tax treatment of identifiable transactions at the time of its passage. Since commercial practices evolve, so too must the concept of taxation that is applicable thereto. As more and more complicated transactions arise, the Philippine tax laws must also evolve in order to deal with existing and emerging risks, with the view of providing stability in government funding.

This is not to say that the Tax Code, being a list of dated taxation rules must be allowed to evolve at the discretion of the BIR. On one hand, there is ample legal ground to support the position of the taxpayers that, absent an explicit law prohibiting tax avoidance, tax-planning schemes should be respected. However, by doing so, the government can be deprived of its much-needed revenues and tax leakages will worsen. In order to strike a balance between the two conflicting needs, a legislative solution to tax avoidance transactions must be fashioned. The worst scenario that can happen is to let the current system prevail, that being, the current after-the-fact, ad hoc approach left entirely to the discretion of the BIR. The remedy is clearly legislative, as aptly observed by Justice Douglas in his opinion in the decision of the Court in *Knetsch v. United States*:

“To disallow the 'interest' deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here.

The remedy is legislative. Evils or abuses can be particularized by Congress. We only deal with 'interest' as commonly understood and as used across the board in myriad transactions.

Since these transactions were real and legitimate in the insurance world and were consummated within the limits allowed by insurance policies, I would recognize them taxwise⁹⁵

VI. RECOMMENDATIONS

Applicability of Foreign Anti-Avoidance Rules in the Philippines

An analysis of the various anti-avoidance models adopted by Australia, Germany and France would show that a general anti-avoidance rule (GAAR) is not yet suitable to the Philippine legal system. GAAR is more appropriate in legal systems whose judicial doctrines have been consistently applied and are well developed. In the Philippines, GAAR is inappropriate for the following reasons:

1. Unlike the Commonwealth countries, the Philippine judicial system does not have a well-defined set of judicial doctrines against tax avoidance. Adoption of GAAR may lead to judicial legislation as well as inconsistencies in the application of the rule by the courts. It may lead to further uncertainties in the tax system.
2. As shown in this paper, the Philippine courts have generally adopted a literal application of the law as opposed to the purposive approach in dealing with tax cases. Adopting a GAAR would be ineffective if the courts would continue in their narrow interpretations of the law.
3. Judicial proceedings are resource-intensive and require a lot of time. When a case is finally decided by the Court, it is possible that the law that was interpreted and applied has already been amended. Moreover, new ways of tax avoidance might have already been fashioned.
4. Judicial decisions are more likely to be ignored by the taxpayers, since taxpayers will always distinguish their case from

those adversely decided upon by the Court. Moreover, this may lead taxpayers to select and rely on judicial doctrines that are most favorable to their stand.

On the other hand, the adoption of specific anti-avoidance provisions similar to that of the United States may not be entirely appropriate for the Philippine setting, for the following reasons:

1. Uncertainties with regard to the legality of a given transaction will still prevail.

Although the United States has prohibited tax avoidance practices for certain types of transactions, it can be noted that some of the prohibitions will not apply if the taxpayers could prove, by clear preponderance of evidence, that the transactions were not entered into for avoidance purposes. If the same rule is to be applied in the Philippines, uncertainties with regard to the legality of certain tax avoidance schemes will still prevail. This is because the BIR will be given the full discretion to determine whether a transaction contains enough bona fide business purpose or not. The taxpayers, on the other hand, may easily concoct a business purpose behind every transaction. This will only mean that the battle between the BIR and the taxpayers will continue.

2. Uncertainties with regard to the correct amount of tax due will continue.

Moreover, under the US Internal Revenue Code, if a transaction falls under a specific anti-avoidance provision, the

Secretary is granted the power to make proper adjustments to eliminate the effects of tax avoidance.⁹⁶ If the same rule is to be applied in the Philippines, there is a risk that uncertainties in the payment of the proper amount of taxes will still prevail. This is because the taxpayers and the CIR may not agree as to the proper tax treatment applicable to a given transaction. In case of disagreement, judicial proceedings, which are time-consuming, may ensue. So long as the taxpayer could distinguish its transaction from a given prohibited anti-avoidance provision, then the efforts of the BIR in fighting against tax avoidance will once again fail. A vicious cycle will once again be created.

Essential Requisites of an Anti-Avoidance Provision in the Philippines

From the foregoing, the author hereby recommends that for an anti-avoidance provision or law to be effective in the Philippines, the following requisites must be present:

1. In the short-run, specific anti-avoidance provisions should be adopted, instead of a general anti-avoidance provision. This view is also shared by former Commissioner Banez,⁹⁷ who opined that the Philippine tax laws are still in the infancy stage of development, and to adopt a GAAR would not solve the problem of uncertainty existing in the current system. In the long run, however, when judicial doctrines are well-established, a shift to GAAR may be advisable.
2. The anti-avoidance law should be precise in identifying the factual conditions that will trigger the applicability of the anti-avoidance law. For instance, a law can be passed which will specify that when a corporation is newly formed under

Section 40(c)(2) of the Tax Code, and its shares of stocks are transferred within six (6) months following the formation of the corporation, a presumption shall arise that the formation of the corporation and subsequent transfer of its shares are intended to avoid taxes. In the example given in the beginning of this paper involving the sale of land by Corporation "A" to buyer "B" through subsidiary "C", the conversion of ordinary income to capital gains from sale of shares of stocks can be automatically classified as a form of prohibited tax avoidance if the required minimum holding period is not satisfied with.

3. The anti-avoidance law should identify clearly the manner of computing the amount of taxes due in case a transaction falls under *it*. In order for an anti-avoidance law to be consistently and uniformly applied, no discretion should be given to the tax authorities and the taxpayers alike in determining the proper amount of tax due. For instance, in the example given above, the anti-avoidance law shall provide that in cases wherein the minimum holding period is not complied with, the proper amount of tax due on the transfer of shares shall be computed at the rate of thirty (30%), as in the case of ordinary income, and not on the basis of ten percent (10%), as in the case of capital gains on sale of shares of stocks.

Other examples of specific anti-avoidance laws

1. Group taxation involving a domestic and a foreign corporation

Multinational corporations have commonly avoided taxes by distorting the allocation of income and expenses among its various subsidiaries. One way of addressing this problem is to adopt group taxation. For

group taxation to apply, the entities must be stapled entities, which mean that by reason of form of ownership, restrictions on transfer, or other terms and conditions, the transfer of one interest necessarily include the transfer of the other interests. For group taxation to be effectively enforced, stapled entities are to be considered as one consolidated group of domestic corporations. The amount of tax due shall be collected from the domestic corporation.

2. Loan agreements between related companies

Another example of a specific anti-avoidance provision can be made with respect to loan agreements between related companies. For instance, the law may provide that when an affiliate extends an interest-free loan to another, the lender shall automatically incur an income tax obligation with regard to the imputed interest income, to be computed at the legal rate of interest based on the total amount of the loan extended. The imputed interest shall apply regardless of the motive of the parties in entering into interest-free loans, and notwithstanding the fact that the interest due was not placed in writing.

Implementation Problems and Recommendations

Addressing the problem of tax avoidance through specific anti-avoidance provisions has various difficulties. First and foremost is the impossibility of identifying and addressing all existing and future types of tax planning schemes. However, in the Philippines, the immediate focus should be limited to the treatment of tax avoidance schemes which have been in existence for decades. This can be easily addressed by reviewing the common types of tax avoidance schemes that had proliferated abroad and how the foreign countries have solved the problem.

By way of reference, the U.S. Congress enacted four principal procedural measures to address the individual tax shelters of the 1970s and 1980s, namely: (1) tax shelter registration requirements; (2) the substantial understatement penalty; (3) a penalty for promotion of abusive tax shelters; and (4) a penalty for aiding and abetting the understatement of tax.⁹⁸ The IRS also established a program in the 1980s whose primary goal is to identify, examine, and investigate abusive tax shelters that utilized improper or extreme interpretations of the law or the facts to secure for the investors substantial tax benefits clearly disproportionate to the economic reality of the transaction.⁹⁹ Administrative efforts include (1) establishing a coordinated body to review promotions identified by IRS personnel and select those for which litigation, penalties, injunctions or notices were appropriate; (2) establishing in each service center an abusive tax shelter "detection team" to analyze returns and other information to identify questionable shelters and make recommendations regarding further audit or prosecution; and (3) handling litigation through special teams in the U.S. Tax Court or U.S. district courts.¹⁰⁰ These procedural and substantive laws enacted by the U.S. in handling tax shelters can serve as useful reference to Philippine Congress.¹⁰¹

Another difficulty in tackling tax avoidance transactions is that they take on many forms and utilize various structures. Because of this, a comprehensive definition of tax avoidance is difficult to formulate. However, the task of targeting specific tax avoidance schemes can be made easier by focusing on transactions which possess the following common elements: (1) insertion of unnecessary steps; (2) presence of offsetting steps; and (3) steps are usually non-commercial in nature.

Finally, the determination of which transactions are to be covered by specific anti-avoidance law is largely a matter of discretion on the part of Congress. However,

to increase the effectiveness of and compliance with an anti-avoidance law, the following framework is suggested:

1. Anti-avoidance rules are intended to prevent abusive tax avoidance transactions or arrangements. As such, it should be couched in terms that will not interfere with legitimate commercial transactions.
2. A more effective penalty system should be introduced in case of violators. Tax avoidance transactions proliferate in situations where the tax-benefit to be derived far outweighs the cost. To come up with an effective deterrent, apart from setting a fixed amount of penalty (which should not be criminal in nature), violators should be disallowed from enjoying the tax benefits intended.
3. There is a need to conduct an intensive and extensive dialogue with various interested groups, such as taxpayers, tax lawyers, corporate executives, and accountants, in order to develop a common understanding as to what constitute permissible and impermissible tax avoidance. This can be done in the following manner: (a) review of existing rulings, regulations etc. in order to determine whether there is a need to revise any statements; (b) immediately withdraw any statements found to be ineffective or deficient; (c) draft interpretation guidelines; and (d) incorporate contextual facts in examples so that the rule will not be inadvertently applied to wider areas than what is intended.
4. A new system of binding rulings from the BIR should be established to help taxpayers determine how the tax system applies in particular circumstances.
5. The BIR should be restructured to form a new group with the technical expertise in handling tax avoidance transactions. This group will be tasked with the duty of conducting continuous training and seminars to all revenue officers to ensure that all cases involving tax avoidance will be handled uniformly.
6. Taxpayers should be allowed to receive a ruling from the BIR in advance, to determine whether a transaction falls under a prohibitive rule. To encourage efficiency and to improve taxpayers' reliance on the integrity of the system, a rule must be made to the effect that failure on the part of the BIR to issue a ruling within a given number of days shall constitute a bar on the part of the government to question the transaction, and shall subject the erring official to administrative and civil liabilities. The ability to request for an advance ruling will serve two important purposes: (a) taxpayers will be able to derive some degree of certainty before enter into any type of transaction; and (b) the BIR will be informed of new forms of tax avoidance schemes even before they are implemented. This will lead to a timely response on the part of the government.
7. Any findings of the BIR about an impending tax avoidance scheme should be brought to the attention of Congress. Congress will then determine if an anti-avoidance law should be enacted for that particular scheme.

VII. CONCLUSION

After evaluating the response of the three branches of the government towards tax avoidance transactions, the inevitable conclusion is that each branch treats of the subject matter differently and inconsistently.

While Congress has not categorically prohibited all types of tax avoidance transactions, it has introduced new taxes into the Tax Code which will make tax avoidance practices more costly to enter into. The BIR,

with the view of meeting target revenue collections, is forced to adopt an aggressive policy towards anti-avoidance. The legality of such policy, however, can only be tested in Court. It can be reasonably expected that the response of the Supreme Court can only be in either of the following extremes: respect the Tax Code pursuant to the enrolled bill doctrine, as in the case of *CIR v. Marubeni*, or invalidate the transaction using corporate law principles when it is a sham or is fraudulent, as in the case of *Yutivo v. CTA*.

The differences in the attitude towards tax avoidance transactions have led to the creation of an unjust and unfair environment, whereby the so-called anti-avoidance policy is being inconsistently and randomly applied to certain taxpayers. In categorizing all tax avoidance transactions as sham transactions or fraudulent transactions, the BIR penalizes taxpayers who are not even aware that they have committed illegal acts. There is absolutely no publication coming from Congress or from the BIR that explains the concept of "sham" transactions for tax computation purposes.

Because there is no express law prohibiting tax avoidance, the acts of the tax authorities in implementing the so-called

anti-avoidance policy may not conform strictly to the constitutional requirement that taxation must be uniform. In order to remedy the injustice and inefficiencies of the current tax system, there is a need for Congress to enact a law.

After studying the various types of anti-avoidance laws adopted by countries abroad, the author believes that a modified version of specific anti-avoidance law is an effective way to solve the problems presented by tax avoidance in the local setting. The law should clearly set forth the types of anti-avoidance transactions that Congress would like to discourage. It must contain certain conditions, the existence of which will trigger the presumption that the transaction falls under the prohibition. More importantly, the law should specifically indicate how tax is to be computed if the transaction falls under the prohibition, without the need of striking down the entire transaction.

The constitutional requirement of due process requires that the law should be applied prospectively so as not to prejudice taxpayers. All matters covered by the law should be deemed prohibited, and conversely, matters not covered therein should be respected.

NOTES

¹ R.A. 8424, Sec. 27(A), as amended by R.A. 9337.

² *Id.*, Sec. 40(C)(2).

³ *Id.*, Sec. 27(D)(2).

⁴ R.M.O. 15-95, Annex A (June 9, 1995).

⁵ *Aznar v. CTA and Collector*, 58 SCRA 519 (1974).

⁶ 4A Words and Phrases, 722 citing *Anglin v. Nasif*, 46 So.2d 309,311,217 La. 392.

⁷ Jose C. Vitug & Ernesto Acosta, *Tax Law and Jurisprudence*, 44 (2nd ed. 2000).

⁸ Richard Salsman, *Treasury Secretary Paul O'Neil Confuses Tax Avoidance versus Tax Evasion*, *Capitalism Magazine*, at <http://capmag.com/article.asp> citing OECD, "Tax Avoidance and Evasion", at <http://www1.oecd.org/daf/fa/evasion/evasion.htm>.

⁹ Where a statute, by its terms, is expressly limited to certain matters, it may not, by interpretation or construction, be extended to other matters. *See Hongkong & Shanghai Bank v. Peters*, 16 Phil. 824 (1910); *Collanta v. Carnation Phil., Inc.*, 145 SCRA 268 (1986).

¹⁰ Revenue Regulations No. 2-2001, Section 2.

¹¹ *Supra* note 1, Section 29(C)(1).

¹² *Id.* Section 29(c)(2).

¹³ As implemented by Revenue Regulations No. 2-2001 dated February 12, 2001.

¹⁴ Prior to the 1997 Tax Code, corporate taxpayers are taxed at the rate of 35%.

¹⁵ *See supra* note 1, Section 28(B)(1).

¹⁶ *Id.* Section 28(B)(5)(b).

¹⁷ *Benedicta Baladad, Taxation and Audit of Multinationals*, X.I NTRC Tax Research Journal, I, 12 (Jan.-Feb. 1998).

¹⁸ The same is true with Fringe Benefits Tax imposed under Section 33 of the 1997 NIRC. This tax was introduced in order to prevent compensation income tax leakages.

¹⁹ NIRC of 1977, Section 287.

²⁰ *See supra* note 1, Section 254.

²¹ *See supra* note 19, Section 288.

²² *See supra* note 1, Section 255.

²³ *See supra* note 19, Section 289.

²⁴ *See supra* note 1; Section 256.

²⁵ *See supra* note 19, Section 290.

²⁶ *See supra* note 1, Section 257.

²⁷ *Maestrado v. Court of Appeals*, 327 SCRA 678 (2000).

²⁸ Interview with Atty. Alex Cabrera, Partner, Joaquin Cunanan and Company PriceWaterhouseCoopers (July 1, 2003).

²⁹ *See supra* note 1, Section 6(C)

³⁰ *See id.* Section 6(D)

³¹ *See id.* Section 6(E)

³² *See id.* Section 6(F)

³³ *See id.* Section 6(G)

³⁴ *See id.* Section 6(H)

³⁵ *See id.* Section 5(B)

³⁶ *See supra* note 4.

³⁷ 1 SCRA 160 (1961).

³⁸ *Id.* at 168.

³⁹ *Id.* at 169.

⁴⁰ *Id.* at 165.

⁴¹ *Id.* at 174.

⁴² 2 SCRA 632 (1961)

⁴³ *Id.* at 641.

⁴⁴ 28 SCRA 366 (1969).

⁴⁵ 30 SCRA 434 (1969).

⁴⁶ *Id.* at 440.

⁴⁷ 257 SCRA 200 (1996)

⁴⁸ *Id.* at 226.

⁴⁹ 97 SCRA 877 (1980)

⁵⁰ *Id.* at 884 citing *Guzik v. U.S.* 54 F2d 618.

⁵¹ *Id.* citing Merten's Law of Federal Income Taxation, Vol. 10, Sec. 55A.05, p. 21.

⁵² 372 SCRA 576 (2001).

⁵³ A "turn-key job" is defined as a job or contract in which the contractor agrees to complete the work of building and installation to the point of readiness for operation or occupancy--Webster's Third New International Dictionary of the English Language, Unabridged [1993].

⁵⁴ 372 SCRA at 601.

⁵⁵ *See supra* note 1, Section 42(A)(3).

⁵⁶ July 7, 1998.

⁵⁷ January 29, 2003

⁵⁸ Doris Dumlao, *Government Plugs Vehicle Tax Loopholes*, Philippine Daily Inquirer, January 30, 2003 at B 1.

⁵⁹ February 11, 2003.

⁶⁰ 144 SCRA 664 (1986).

⁶¹ *Id.* at 669-670.

⁶² Article 8 of the Civil Code provides that [j]udicial decisions applying or interpreting the laws or the Constitution shall form part of the legal system of the Philippines.

⁶³ Amanda R. Carpo, *Capital Assets*, Business World, March 27, 2003, at 3.

⁶⁴ Section 244 of the 1997 Tax Code provides that "[t]he Secretary of Finance, upon recommendation of the Commissioner, shall promulgate all needful rules and regulations for the effective enforcement of the provisions of this Code."

⁶⁵ Cesar Villanueva, Philippine Corporate law, 100 (2001).

⁶⁶ Domingo Paz & Eliseo Pitargue, *Tax Avoidance and Evasion*, Philippine Business Affairs, 77, 77-78, (Jan.-Feb. 1987).

⁶⁷ *Id.* at 78.

⁶⁸ BIR 2001 Annual Report, p. 29.

⁶⁹ *Id.* at 28.

⁷⁰ BIR 2007 Annual report, page 29.

⁷¹ Ruben Agpalo, *Statutory Construction*, 302-3 (4th ed. 1998).

⁷² *Marinduque Iron Mines Agents, Inc. v. Municipal Council of Hinabangan, Samar*, 11 SCRA 416 (1964).

⁷³ *Commissioner of Internal Revenue v. Court of Appeals*, 82 SCAD 45, 271 SCRA 605 (1997).

⁷⁴ *Collector of Internal Revenue v. La Tondena, Inc.*, 115 Phil. 841 (1962).

⁷⁵ *Groehlick & Kuttner v. Collector of Customs*, 18 Phil. 461 (1911)

⁷⁶ *Arches v. Bellosillo*, 20 SCRA 32 (1967)

⁷⁷ *Lim v. Central Bank* 104 Phil. 573 (1958).

⁷⁸ 73 CJS 413-414, 416-417; *CIR v. CA 240 SCRA 368* (1995).

⁷⁹ *Hector S. De Leon & Hector M. De Leon Jr.*, *Administrative Law: Text and Cases*, 97 (2001) citing *Meritt v. Welsh*, 104 U.S. 694 (1882).

⁸⁰ *Juan Luna Subdivision v. Sarmiento*, 91 Phil. 371 (1952).

⁸¹ *City of Baguio v. De Leon*, 25 SCRA 938 (1968).

⁸² *Philippine Trust Company v. Yatco*, 69 Phil. 420, 423 (1940).

⁸³ Section 28(1) Article VI 1987 Constitution states: The rule of taxation shall be uniform and equitable. Congress shall evolve a progressive system of taxation.

⁸⁴ *De Jesus v. City of Manila*, 29 Phil. 73 (1914); *CIR v. Filipinas Compania de Seguros*, 107 Phil. 1055 (1960); *Garcia v. Ambler*, 4 Phil. 81 (1904); *McMicking v. Lichauco*, 27 Phil. 386 (1914).

⁸⁵ *See supra* note 1, Section 2.

- ⁸⁶ Commissioner v. Pineda, 21 SCRA 105 (1967).
- ⁸⁷ See *supra* note 7 at 1.
- ⁸⁸ Mariano, Jr. v. Comelec, 242 SCRA 211 (1995).
- ⁸⁹ Salenillas v. CA, 169 SCRA 829 (1989).
- ⁹⁰ Rufino Lopez & Sons, Inc. v. CTA, 100 Phil. 855 (1957).
- ⁹¹ CIR v. TMX Sales Inc., 205 SCRA 184 (1992).
- ⁹² Under the substance over form doctrine laid down by the U.S. Supreme Court in the case of Gregory v. Helvering (55 S. Ct., 268) in the year 1935, the Internal Revenue Service and the courts may recharacterize a transaction in accordance with its substance, if “the substance of the transaction is demonstrably contrary to the form.”
- ⁹³ Cesar Villanueva, Philippine Corporate Law, 888-889 (2001)
- ⁹⁴ Tolentino, Civil Code of the Philippines, Vol. I, 11 (1990).
- ⁹⁵ 5 Le d 2d at 134.
- ⁹⁶ To illustrate, please refer to Section 845 of the United States Internal Revenue Code.
- ⁹⁷ Interview with Commissioner Rene Banez, Bureau of Internal Revenue (July 25, 2003).
- ⁹⁸ See Sections 6111, 6112, 6707, 6708, 6662, 6700, 6701 and 7408 of the US IRC.
- ⁹⁹ Department of the Treasury, The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals, 72 (July 1999).
- ¹⁰⁰ *Id.* at 74.
- ¹⁰¹ Some of the pertinent sections of the USIRC that may be applied to the Philippines setting are: Section 269 on the acquisition of a corporation to avoid or evade taxes; Section 446 on the authority of the Secretary to prescribe a method of accounting to a particular item; Section 1258 on the prohibition to convert ordinary income to capital gain, under specified conditions; Section 1502 which pertains to the filing of a consolidated return; and Section 7701 (1) on the power of the Secretary to re characterize any multi-party commercial transactions.

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