

# INDIVIDUAL INCOME TAX REFORM UNDER HOUSE BILL NO. 5296 AND UNDER SENATE BILL NO. 2261: A COMPARATIVE EVALUATION

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## TABLE OF CONTENTS

<b>I. INTRODUCTION</b>	
.....	269
<b>II. OVERVIEW OF THE TWO HOUSE BILLS</b> .....	271
A. HOUSE BILL NO. 5296: SNITS REVIVED.....	271
B. SENATE BILL NO. 2261: FLAT TAX ON INCOME.....	275
<b>III. CONCEPTUAL FRAMEWORK: AICPA'S GUIDING PRINCIPLES OF GOOD TAX POLICY</b> .....	276
A. EQUITY AND FAIRNESS.....	277
B. CERTAINTY.....	278
C. CONVENIENCE OF PAYMENT.....	278
D. ECONOMY IN COLLECTION.....	279
E. SIMPLICITY.....	279
F. NEUTRALITY.....	280
G. ECONOMIC GROWTH AND EFFICIENCY.....	280
H. TRANSPARENCY AND VISIBILITY.....	281
I. MINIMUM TAX GAP.....	281
J. APPROPRIATE GOVERNMENT REVENUES.....	283
<b>IV. EVALUATION FRAMEWORK</b> .....	284
<b>V. RESULTS AND DISCUSSIONS</b> .....	286
A. EQUITY AND FAIRNESS VIS-A-VIS THE DISTINCTIONS LAID OUT IN <i>SISON V. ANCHETA</i> .....	286
B. SIMPLICITY IN TERMS OF CERTAINTY, ECONOMY IN COLLECTION, TRANSPARENCY, AND MINIMUM TAX GAP.....	290
1. Certainty.....	290
2. Economy in Collection.....	292
3. Transparency and Visibility.....	293
4. Minimum Tax Gap.....	294

C. NEUTRALITY: COMPROMISED BY SNIT SCHEME, CHAMPIONED BY FLAT TAX SCHEME .....	298
D. BOTH PROPOSALS ENTAIL LOSSES, BUT HOW MUCH AND HOW BAD? .....	299
VI. CONCLUSION.....	300

# INDIVIDUAL INCOME TAX REFORM UNDER HOUSE BILL NO. 5296 AND UNDER SENATE BILL NO. 2261: A COMPARATIVE EVALUATION\*

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## I. INTRODUCTION

Income tax is a form of national internal revenue tax levied on the yearly profits arising from property, professions, trades or offices.<sup>1</sup> Under the National Internal Revenue Code of 1997 as amended (NIRC or the present Code), income tax is imposed on individuals, corporations, and estates and trusts. It is not simply the tax paid by individuals who earn an income, but may likewise be viewed as each person's contribution, as a subject of his or her country, to the so-called "lifeblood"<sup>2</sup> of the government. But however essential the contribution and collection of individual tax is, the reality in our country is that individuals are not so willing to make this contribution and individual income tax is not so easy to collect.

Indicative of this difficulty is the individual income tax gap from 2000 to 2004 that averaged ₱ 32.6 billion annually, as estimated in a study conducted by the National Tax Research Center (NTRC). Put another way, the government has failed to collect, and individuals have failed to contribute, an estimated ₱ 163 billion in individual income taxes for five years. Of the estimated individual income tax gap, compensation-income earners account for ₱ 7.17 billion of the tax losses while ₱ 25.43 billion may be attributed to businessmen, professionals and the self-employed individuals, or seventy-eight percent (78%) of the total potential income tax from individual income tax. On the flip side, the compensation income earners accounted for eighty-seven percent (87%) of the total individual income tax payments for these years, while businessmen and professionals

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<sup>1</sup> Fisher v. Trinidad, 43 Phil. 973 (1922).

<sup>2</sup> Vera v. Fernandez, 89 SCRA 199 (1979).

contributed only a thirteen percent (13%) share. All these figures mean one thing: compensation income earners bear a heavier burden of taxation than do professionals and self-employed individuals.

The inequity is apparent but so is the reason for such inequity. Under the present Philippine individual income taxation structure, professionals and self-employed individuals have more opportunity to avoid and evade income tax than compensation income earners. Because their income is withheld, compensation-income earners do not even get to touch that portion of their income which they contribute as tax. And because professionals and self-employed individuals file their own income tax returns, they have bigger opportunity to under-declare their gross income and over-state their deductible business expenses. Compensation-income earners are only able to claim personal and additional deductions, and premium payment on health and/or hospitalization insurance, while professionals and self-employed individuals are able to claim other deductions, as do corporations. They can claim for deduction every single business expense they incur, even those that have a personal element to them.

While the Bureau of Internal Revenue (BIR) needs only to verify the truthfulness of personal and additional exemptions being claimed by the compensation income earners, in the case of professionals and self-employed individuals, it also needs to ascertain the veracity of the gross revenues declared and of each and every deductible expense claimed. This likely breeds corruption and bribery of tax examiners.

Taking such inequity into account, the Legislature has moved to restructure individual income tax. The thrust of the reform is simplifying individual income taxation for the purpose of improving tax compliance and reducing tax evasion, thereby plugging the income tax system's loopholes and leakages, and increasing government revenues. Simplification is the end, and the House of Representatives and the Senate have each proposed different means of achieving such end. In House Bill No. 5296, the House of Representatives has proposed a revival of the "Simplified Net Income Taxation Scheme" (SNITS) instituted by Republic Act No. 7496 from 1992 until its repeal in January 1998 by the present tax system through Republic Act No. 8424, or the Tax Reform Act of 1997. On the other hand, in Senate Bill No. 2261, the Senate has proposed a form of flat tax with a level of exemption pegged at ₱ 144,000.00. These are two vastly different proposals to amend the NIRC with the singular aim of simplifying individual income taxation for the purpose of re-aligning the inequity in the present individual income tax system.

This paper aims to evaluate the operation and various implications of the House of Representatives' and the Senate's individual income tax reform proposals. It shall present a factual overview of the two bills and how each proposal works. Then, it shall present the framework for evaluating tax proposals developed by the American Institute of Certified Public Accountants, Inc. (AICPA). The mandates of uniformity, equitability and progressivity as set forth in the 1987 Constitution shall also be brought in line in discussing some of the relevant principles enumerated in the AICPA's framework. The two tax proposals shall be analyzed and compared in reference to this framework and, a final assessment of the two shall be made thereafter.

## II. OVERVIEW OF THE TWO BILLS

### A. HOUSE BILL NO. 5296: SNITS REVIVED

The House of Representatives has transmitted to the Senate House Bill No. 5296, An Act Restructuring the Income Taxation for Individuals by Creating a New Section, Section 34-A, Repealing Subsection (L) of Section 34 and Amending Sections 22, 24, 32 and 35, all under the National Internal Revenue Code of 1997, as amended, per Committee Report No. 1581. HB No. 5296 proposes new individual income tax rates applicable to citizens and resident aliens of the Philippines, repealing those provided for in Section 24 of the NIRC.<sup>3</sup> From the seven brackets under the present Code, the new schedule merely has six. It also purports to raise the level of exemption, from ₱ 10,000.00 under the present Code, to ₱ 55,000.00. This is to benefit minimum wage earners who are to be exempted from paying income tax under the new tax schedule. The highest income bracket was maintained at those over ₱ 500,000.00 but the top marginal rate was increased, from thirty-two percent (32%) to thirty-five percent (35%), without any proviso for future reductions, unlike in the NIRC. Basic personal exemptions were increased from ₱ 20,000.00 to ₱ 30,000.00 for unmarried individuals or judicially-declared legally separated married individuals with no qualified dependents; ₱ 25,000.00 to ₱ 37,500.00 for

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<sup>3</sup> The new schedule appears thus:

Not over P55,000.....	0%
Over P55,000 but not over P150,000.....	25% of the excess over P55,000
Over P150,000 but not over P250,000.....	P23,750 + 28% of the excess over P150,000
Over P250,000 but not over P350,000.....	P51,750 + 31% of the excess over P250,000
Over P350,000 but not over P500,000.....	P82,750 + 33% of the excess over P350,000
Over P500,000.....	P132,250 + 35% of the excess over P500,000

heads of families; and ₱ 32,000.00 to ₱ 48,000.00 for married individuals. Additional exemption per dependent was likewise increased from ₱ 8,000.00 to ₱ 12,000.00. Thus, more individuals would be exempted from income tax under this proposition than under the present Code.

Under the bill's insertions in Section 23 of the NIRC, "self-employed" shall mean those persons engaged in trade or business and who derive their personal income from such trade or business. This includes single proprietorships such as, but not limited to, manufacturers, traders, market vendors, owners of eateries, farmers and service shops. On the other hand, the term "professionals" covers those persons who derive their income from the practice of a profession such as lawyers and other persons who are registered with the Professional Regulation Commission such as doctors, dentists, certified public accountants, architects etc. The term shall also refer to those who pursue and make their living from the arts or sports.

Section 24 of the NIRC is to be further amended by introducing provisions for the institution of a simplified net income taxation scheme (SNIT) for self-employed taxpayers engaged in trade or business and for professionals engaged in the practice or profession. Under this scheme, a simplified net income tax, following the proposed schedule earlier mentioned, shall be levied upon the taxable income derived during each taxable year from all sources within and without the Philippines by an individual resident citizen and from all sources within the Philippines by an individual non-resident citizen or individual resident alien engaged in trade, business, or professional practice.

Consistent with the institution of a simplified net income tax scheme for self-employed and professionals, a new section to be known as Section 34-A is to be added, thus:

*Deductions from the Gross Revenues of Self-employed and/or Professionals.* – In computing the taxable income subject to tax under subsection 24(A)(3) in the case of individuals engaged in trade/business and/or practice of profession, only the following expenses/deductions incurred in doing business shall be allowed to be subtracted from the gross revenues of such individuals:

- (A) Sales discounts;
- (B) Sales returns and allowances;
- (C) Raw materials, supplies and direct labor;
- (D) Salaries of employees directly engaged in activities in the course of or pursuant to the business, trade or practice of their profession;

- (E) Telecommunications, electricity, fuel and water: provided, that the total amount of these expenses should not exceed ten percent (10%) of gross income of such individual;
- (F) Business rentals;
- (G) Depreciation in accordance with subsection 34(F) hereof;
- (H) Contributions made to the government or any of its agencies or any political subdivision thereof exclusively for public purposes, or to accredited domestic corporations or associations organized and operated exclusively for religious, charitable, scientific, youth and sports development, cultural or educational purposes, or for the rehabilitation of veterans, or to social welfare institutions, or to nongovernment organizations, in accordance with subsection 34(H) hereof;
- (I) Interest paid or accrued within a taxable year on loans contracted from accredited financial institutions which must be proven to have been incurred in connection with the conduct of a taxpayer's profession, trade or business in accordance with subsection 34(B) hereof;
- (J) Freight, handling and trucking;
- (K) Insurance expense;
- (L) Professional fees;
- (M) SSS, GSIS, PHILHEALTH, and HDMF (PAG-IBIG) contributions; and
- (N) Taxes and licenses in accordance with subsection 34(C) hereof.

For individuals engaged in trade/business and/or practice of their profession whose expenses/deductions enumerated in the preceding paragraph are difficult to determine, said individual shall be allowed an optional standard deduction equivalent to forty percent (40%) of his gross revenues in lieu of the said expenses/deductions provided herein. Unless the taxpayer signifies in his return his intention to elect the optional standard deduction, he shall be considered as having availed himself of the expenses/deductions prescribed under this section. Such election when made in the return shall be irrevocable for the taxable year for which the return is made: provided, that an individual who is entitled to and claimed for the optional standard deduction shall not be required to submit with his tax return such financial statements otherwise required under this code: provided, further, that except when the commissioner otherwise permits, the said individual shall keep such records pertaining to his gross revenues during the taxable year, as may be required by the rules and regulations promulgated by the Secretary of Finance, upon the recommendation of the commissioner.

Seeing as the last paragraph of this new section includes a proviso for an Optional Standard Deduction (OSD) of forty percent (40%), it follows that Section 34 (L) of the present Code which pegs the OSD at ten percent (10%), shall have, and was proposed, to be repealed. Under the SNIT scheme, a professional and/or self-employed individual remains subject to the same tax rate schedule as other individual citizen and resident alien taxpayers. Unlike in the present Code however, where professionals and/or self-employed individuals are treated in the same manner as corporations insofar as allowable deductions to gross income are concerned, the SNIT scheme under HB 5296 provides for a lesser number of allowable deductions for professionals and/or self-employed individuals compared to those allowable to corporations. Considering that much of the tax leakage in the current system is attributable to overstatement of deductible business expenses by self-employed individuals and professionals, the proposal seeks to limit allowable deductions for these individuals to those expenses which are essential to the conduct of the business, namely, *cost of goods sold* or *cost of sales* and *operating expenses*. Thereby, the income tax base is expanded, translating ultimately to increased tax revenues. The share of self-employed individuals and professionals in the cost of financing the government is increased and re-aligned with the burden carried by compensation-income earners.

In determining the amount deductible from gross income, HB 5296 still makes available to professionals and/or self-employed individuals whose allowable itemized deductions are difficult to determine the OSD granted under the present Code, which may be claimed in lieu of the itemized deductions. But the ceiling on the amount of the standard deduction which may be claimed was increased, from ten percent (10%) of gross income under the NIRC to forty percent (40%). The move to increase the ceiling was intended to encourage more taxpayers to avail of this option, which provides a simplified formula in computing the individual income tax and does away with having to submit with the tax return such financial statements otherwise required under the present Code.

As earlier discussed, the SNIT scheme is basically a revival of SNITS<sup>4</sup> under RA 7496. Both limited the allowable deductions of individuals engaged in business or practice of profession to certain direct costs. It also provided for a forty percent (40%) OSD. The difference

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<sup>4</sup> In this paper, "SNITS" refers to the earlier scheme instituted in RA 7496 in 1992, formally known as the "Simplified Net Income Taxation Scheme for the Self-Employed and Professionals Engaged in the Practice of their Profession", and which should be distinguished from "SNIT scheme" referring to the scheme proposed by H.B. No. 5296.



however, is that SNITS provided for different rate schedules applicable to for self-employed individuals and/or professionals, and to all other individual tax subjects. Both have the same thrust however – to simplify income taxation for self-employed and professionals by re-aligning the allowable deductions from their gross income and limiting said deductions to the cost of goods sold or cost of sales and operating expenses thus precluding frequently abused deductions.

HB 5296 proposes other amendments. It seeks an increase of the ceiling on the total exclusion due to 13th Month Pay and other benefits in Section 32(B)(7)(e) of the NIRC from ₱ 30,000.00 to ₱ 45,000.00. It would also exclude *de minimis* benefits from gross income.

#### **B. SENATE BILL NO. 2261: FLAT TAX ON INCOME**

On June 5, 2006, the Committee on Ways and Means of the Senate submitted Committee Report No. 78 recommending approval of Senate Bill No. 2261 in substitution of HB 5296. In lieu of the seven income tax brackets provided under Section 24 of the NIRC, SB 2261 recommends a flat tax scheme with only two (2) brackets and an exemption level of ₱ 144,000.00. Under this flat tax scheme, those with a taxable income of not more than ₱ 144,000.00 are exempt from paying income tax; while those with a taxable income of over ₱ 144,000.00 shall be taxed at thirty-five percent (35%) of the excess. Furthermore, this thirty-five percent (35%) rate would be reduced by five percent (5%) effective January 1, 2009.

In computing net income, no personal and additional exemptions such as those available under the present Code would be allowed. This is because the threshold of ₱ 144,000.00 already serves as a standard exemption much higher than the exemption which may be availed of in the NIRC. For instance, a married individual with four dependents, who is only allowed ₱ 64,000.00 in personal and additional exemptions under the NIRC, could claim ₱ 80,000.00 more under the flat-rate proposal. Section 35 of the NIRC on the allowance of personal exemption for individual taxpayers is accordingly deleted under SB 2261, and taxable income shall only refer to gross income less allowable deductions. In the computation of taxable income, however, mandatory government contributions such as GSIS, SSS, PhilHealth, and PAG-IBIG remain excluded items and the standard deductions covers only basic salary.

With the flat tax scheme, even more individuals would be exempted from income tax than under the present Code. Moreover, most individuals who have a taxable income over ₱ 144,000.00 would have income tax liabilities lower than that for which they are presently liable. As for those who have higher income tax liability, it is estimated that they merely compose 14.66% of the 2.86 million salaried taxpayers and these individuals are the ones belonging to the higher middle up to the high income brackets.<sup>5</sup>

Like in the SNIT scheme, the flat tax scheme also makes the forty percent (40%) OSD available to professionals and/or self-employed individuals. The flat tax scheme further extends such option to both domestic and resident foreign corporations. In addition, professionals and/or self-employed individuals may avail of the same itemized deductions allowable to corporations. Thus, the flat tax scheme seeks to achieve simplification of the individual income tax structure essentially through the singular tax rate and exemption level, inasmuch as these will make efficient and uncomplicated, *First*, the computation of the income tax of the individual who will have a better understanding of his tax liabilities; and *Second*, the collection and administration by the government which may now focus its limited resources on validating lesser income tax variables.

### III. CONCEPTUAL FRAMEWORK: AICPA'S GUIDING PRINCIPLES OF GOOD TAX POLICY

In 2001, the Tax Division of the AICPA issued *Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, the first in a series of tax policy concept statements intended to aid in the development of American federal tax legislation. This concept statement sets forth a framework developed to evaluate tax reform proposals so as to best ensure an efficient and effective system of taxation based on good tax policy. In answering the question “How should proposals to change the existing tax rules be analyzed?” ten guiding principles of good tax policy were enumerated as indicators of a good tax policy. This discussion of the ten-principle framework is reiterated and augmented in AICPA's *Understanding Tax Reform: A Guide to 21st Century Alternatives* which was released in September 2005.

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<sup>5</sup> Sponsorship speech on Senate Bill 2261 by Senator Ralph Recto, Senate, Manila, September 6, 2006.

### A. EQUITY AND FAIRNESS

Similarly situated taxpayers should be taxed similarly. Equity usually embodies the principle of taxing similar taxpayers similarly, and is thus frequently viewed as a principle of fairness. Whether or not a tax system is fair is usually determined by looking at both horizontal and vertical equity. Horizontal equity is the idea that people with a similar or equal ability to pay taxes should pay the same or similar amounts while vertical equity is the idea that people with a greater ability to pay taxes should pay more.

At this juncture, it is important to discuss the limits to the government's inherent and plenary power to tax set forth in the fundamental law. The first subsection of Section 28, Article VI of the 1987 Constitution mandates that the rule of taxation shall be uniform and equitable and calls upon Congress to evolve a progressive system of taxation. 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."<sup>6</sup> Classification is not prohibited, but a reasonable distinction in making the classification is essential to justify a disparate tax treatment of certain articles or persons. The classification must rest upon "substantial distinctions that make real differences."<sup>7</sup> It is evident that uniformity in taxation and equal protection are "kindred" concepts and this has been recognized by the Supreme Court in *Tan v. del Rosario*.<sup>8</sup>

A progressive system of taxation is one where the tax rate increases as the tax base increases. Father Joaquin Bernas, SJ rationalizes that the directive in the 1987 Constitution which calls upon Congress to evolve a progressive system of taxation simply reflects the desire of the Constitutional Convention for Congress to utilize, in accordance with the command of social justice, the power to tax as a tool for distributing wealth more equitably.<sup>9</sup> And in *Tolentino v. Secretary of Finance*<sup>10</sup>, the Supreme Court explained that "regressivity is not a negative standard for courts to enforce," and that "[w]hat Congress is required by the Constitution to do is to 'evolve a progressive system of taxation.'"

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6 *Eastern Theatrical Co. v. Alfonso*, 83 Phil. 852 (1949).

7 *Sison v. Ancheta*, 130 SCRA 654 (1984).

8 *Tan v. del Rosario*, 237 SCRA 324 (1994).

9 BERNAS, *THE 1987 CONSTITUTION OF THE REPUBLIC OF THE PHILIPPINES: A COMMENTARY* 779 (2003).

10 *Tolentino v. Secretary of Finance*, 235 SCRA 630 (1994).

From the foregoing, it is evident that vertical equity is embodied in the concept of a progressive system of income taxation while horizontal equity, which essentially espouses tax neutrality, is embodied in the concept of an equitable and uniform tax rate. Thus, in mandating that the rule of taxation be uniform, equitable, and progressive, the Philippine Constitution reaffirms equity and fairness as principles to be sought in legislating tax reforms. That our own Constitution adopts the principles of equity and fairness as guiding principles in evolving a system of taxation makes it all the more imperative that the tax reforms proposed by the Congress incorporate these particular principles.

### **B. CERTAINTY**

The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined. Certainty in any system of taxation is desirable as it enhances compliance with tax laws and increases the respect for that particular system. When taxpayers do not feel competent in terms of knowing what their tax obligations are, irrespective of whether their calculations are correct, and whether their returns are properly filed, compliance rates fall and collection costs rise. Thus, tax laws must enable taxpayers to determine the tax base and the rates they are subject to. It should be easy to identify and appraise which transactions are subject to tax, as contra-distinguished from a system where the tax base depends on subjective assessments or transactions that are hard to categorize. Also, the niceties of compliance such as how and when taxes are to be paid should be spelled out in the applicable laws, tax forms and instructions. In general, certainty comes from statutes that are clear and unambiguous, and from timely and understandable administrative guidance readily available to taxpayers. This principle of certainty is closely linked to simplicity, *i.e.*, the more complex the tax rules and system, the greater likelihood that the certainty principle will be compromised.

### **C. CONVENIENCE OF PAYMENT**

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer. This principle is significant in enhancing compliance with the tax system. The more difficult a tax is to pay, the more likely that it will not be paid. Consequently, the tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer. Typical payment mechanisms include withholding and periodic payments of estimated tax liability. In determining the appropriate payment mechanism,

one should consider the amount of the liability, at what point would the tax be best collected, the frequency in collection and the ease of collection.

#### **D. ECONOMY IN COLLECTION**

The costs to collect a tax should be kept to a minimum for both the government and taxpayers. Cost-efficiency in collection is an important attribute of a good tax policy. Here, there are two collection costs to be considered: the enforcement costs to be incurred by the government, which may be influenced by the number of revenue officers necessary to administer the tax, and the compliance costs incurred by the tax payer. The costs of collecting a tax should be kept to a minimum for both the government and taxpayers. Like certainty, economy in collection is closely related to simplicity, *i.e.*, the more complex a tax, the greater the costs for the government to administer it and the greater the compliance costs for taxpayers to determine their tax liability and report it.

#### **E. SIMPLICITY**

The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

Simplicity in the taxation system offers great advantages for both the taxpayer and the government. The more complicated the rules are, the more likely errors and loopholes would be created. A complex system makes it more difficult for the government to enforce tax laws and collect tax liabilities and may even be taken advantage of by unscrupulous taxpayers who wish to evade payment of taxes. In contrast, a simple taxation system allows tax officials to better administer tax laws. Efficient enforcement and collection translates to reduced leakage due to tax evasion and more savings and revenues for the government. A simple tax system allows taxpayers to better comprehend tax laws and the tax implications of transactions in which they engage or plan to engage in, and to comply with tax liability rules accurately and cost-effectively. Simplicity in the tax structure has a psychological effect on the taxpayer who may otherwise feel disrespect for a complex tax system. The increased understanding and respect for the tax system is an incentive to tax compliance and a disincentive to evade tax. Simplicity is likewise the basis for realizing many of the other tax policy goals, such as transparency, minimizing noncompliance, cost-effective collection, and payment convenience.

### **F. NEUTRALITY**

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

The policy behind this principle is that tax considerations should have minimal effect on a taxpayer's business and personal decisions. Proposals that favor one industry or type of taxpayer over another are discouraged or should at least require a legitimate reason. A system which neither encourages nor discourages taxpayers from taking certain courses of action primarily due to the effect of the tax law on the activity or action, should be endeavored. It is, however, recognized that a completely neutral tax system is unlikely because although the primary purpose of a tax is to raise revenue for governmental activities, tax law is often purposefully used to influence taxpayer behavior. But it is urged that tax considerations should have, at the minimum, the smallest possible effect on a taxpayer's economic decisions.

### **G. ECONOMIC GROWTH AND EFFICIENCY**

Tax reform should aspire towards a system that neither discourages nor hinders an economy's productive capacity. The system should encourage national economic goals, such as economic growth, capital formation, and international competitiveness. The principle of economic growth and efficiency is achieved by a tax system that is aligned with the economic principles and goals of the jurisdiction imposing the tax and is impeded by tax rules that favor a particular industry or investment thereby causing capital and labor to flow to such areas for reasons not supported by economic factors which can potentially harm other industries and investments, as well as the economy as a whole.

Economic growth and efficiency seem to be at odds with the principle of neutrality, which appears to discourage tax laws that distort taxpayer behavior. But these two principles actually proceed from the singular argument that tax rules that distort taxpayer behavior may hinder economic efficiency. Therefore, a system that distorts behavior in a manner as to encourage economic efficiency is not objectionable as violative of the neutrality principle.

## H. TRANSPARENCY AND VISIBILITY

Taxpayers should know that such a tax exists and how and when it is imposed upon them and others. Visibility enables individuals and businesses to know the true cost of transactions and to better understand the impact of the tax system. It also enables them to see what their total tax liability is and to which level of government it is being paid. When a tax is not visible, it can be easily retained or raised with little, if any, awareness among taxpayers about how the tax affects them. As earlier said, transparency is related to simplicity, *i.e.*, complex provisions make it more difficult for taxpayers to assess whether and when they will be taxed.

## I. MINIMUM TAX GAP

A tax should be structured to minimize non-compliance. A gap between the amount of tax owed and the amount voluntarily paid or collected may exist due to intentional errors or unintentional errors or for a number of other possible reasons. Some tax laws encourage noncompliance because the provisions are too complex to understand or to comply with. The tax gap can be minimized by increasing the ease of compliance, decreasing the incentives to avoid compliance, and using appropriate procedural rules and enforcement measures that encourage compliance. In general, compliance measures must balance the compliance level desired, the enforcement costs and the level of intrusiveness of the tax system.

In this light, a discussion on the alleged causes of the Philippines' ₱163 billion individual income tax gap from 2000 to 2004 – corruption and tax evasion – may be pertinent. In a paper prepared by lawyer Rowena R. Salido for the National Tax Research Council,<sup>11</sup> corruption was defined as the “use, misuse, or abuse of public power, office or authority for private benefit through bribery, extortion, influence peddling, nepotism, fraud, speed money, or embezzlement” covering likewise, “the betrayal of public trust for public gain.”<sup>12</sup> Three causes of corruption were identified: low salary, opportunity for corruption, and the perception that corruption is a low risk, high reward activity. It was argued that to effectively combat corruption, the motive or incentive and the opportunity of public officials to abuse their position for personal gain must be diminished. Motive for corruption may be diminished by the institution of both positive and

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11 *Anti-Corruption Measures in Tax Administration*. 15.5 NTRC TAX RES. J. Sept.-Oct. 2002.

12 *Ibid.*

negative incentives, such as competitive compensation for the public officials and sanctions for the public official being bribed and the taxpayer bribing him. As regards the opportunities for corruption, the most important method to limit opportunity is tax simplification. Certain tax simplification reforms, such as reducing the rate, broadening the tax base, eliminating special exemptions, and limiting contact between the tax payer and tax officials, tend to make tax obligations transparent and reduce the compliance cost of taxpayers. In turn, these translate to lesser opportunity for corruption on the part of the public official and lesser motive for the taxpayer to corrupt the public official. It was also stated that "presumptive taxation of small businesses, who may keep insufficient books and records, can also reduce the discretionary power of tax inspectors and make tax calculations simpler and clearer."

On the other hand, tax evasion is a tax saving scheme used by the taxpayer outside of the means sanctioned by law which, when availed of usually exposes such taxpayer to further civil or criminal liabilities.<sup>13</sup> It is the direct opposite of tax compliance. While a simplified income tax system seeks to reduce tax evasion, naturally, it seeks to increase tax compliance. Simplifying the income tax structure realizes these objectives by (1) reducing the motives or incentives to evade tax, and (2) limiting the opportunities for evading tax. Michael Graetz and other tax policy experts have suggested simplifying the tax system as an effective way of increasing taxpayer compliance, upon the theory that, since many studies have shown that a positive perception of the tax system is a significant factor determinative of tax compliance, simplifying the tax system may translate to better understanding and improved perception of the system and thereby increase overall tax compliance. Seen at another angle, this improved understanding and perception of the system is a disincentive to evade tax.<sup>14</sup>

A further disincentive to tax evasion is the lower burden of tax to be borne by the taxpayer and the lesser compliance costs which the simpler tax structure will entail. Because one's income tax liabilities and the costs of complying with such liabilities are lower, avoiding such tax responsibilities by resorting to unlawful means has become a high risk, low reward activity that is simply not worthwhile. In short, because the tax and compliance costs are already quite low, it is no longer worth the risk of getting caught for many tax evaders. It is expected, therefore, that the improved perception

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13 *Commissioner of Internal Revenue v. Toda, Jr.*, 438 SCRA 290 (2004), citing JOSE C. VITUG AND ERNESTO D. ACOSTA, *TAX LAW AND JURISPRUDENCE* 44 (2nd ed., 2000), and DE LEON, *FUNDAMENTALS OF TAXATION* 53 (1988).

14 See M. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX* (1997).



and understanding of an uncomplicated tax structure, coupled with the lower tax burden and compliance costs under the simplified income tax system, will dissuade the taxpayer from resorting to tax evasion and increase tax compliance.<sup>15</sup>

A simplified income tax structure would not only reduce the motives or incentives to evade tax, it would likewise limit the opportunities for evasion in a manner similar to how it limits the opportunities for corruption. The simpler structure makes for easier, more straightforward and more transparent tax enforcement and collection. The ease and transparency allows tax enforcers to implement the tax laws more efficiently and effectively. Logically, the more complicated the tax system is, the more nooks and crannies there are which the taxpayers may take advantage of to evade tax. The simplified income tax structure removes such loopholes in the system which makes for limited opportunities for tax evasion, more efficiency in tax collection and, consequently, more revenues for the government.

That a tax system's simplicity is positively related to tax compliance and negatively related to tax evasion is borne by the experience in Russia where the surge in compliance rate is largely attributed to the simplicity of their tax system which adopted a form of flat tax.<sup>16</sup>

This discussion of corruption and tax evasion is no different from the AICPA's discussion of the principle of minimum tax gap, particularly when the AICPA's discussion speaks of minimizing the tax gap by increasing the ease of compliance and decreasing the incentives to avoid compliance.

## **J. APPROPRIATE GOVERNMENT REVENUES**

The tax system should enable the government to determine how much tax revenue will likely be collected and when. Tax systems should allow the government to determine with reasonable predictability and reliability, just how much revenue from tax is likely to be collected and when. While taxpayers should be given reasonable relief from taxation, the operation of the government must not be crippled by immense loss in revenues from taxes. The government must still be able to collect a reasonable level of

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<sup>15</sup> See *Concept Paper on the Application of Flat Tax on Income*, 18.3 NTRC TAX RES. J May-June 2006.

<sup>16</sup> See A. RABUSHKA, *THE FLAT TAX AT WORK IN RUSSIA: YEAR THREE* (2004).

revenue. If the proposal entails revenue losses, there must be some way that such losses may be remedied or recouped.

#### IV. EVALUATION FRAMEWORK

These ten principles are considered indicators of a good tax policy. AICPA's tax policy concept statement explains that these guiding principles are equal in importance and are not numbered in any particular order as indicative of each principles importance. The statement recognizes that a key challenge is the reality that not all ten of the principles can always be achieved to the same degree for all proposed tax changes and thus, legislators must carefully balance the ten principles to achieve an optimal law.

In relation to the purpose of this study, it must be acknowledged that not all ten guiding principles are equally pertinent in evaluating the SNIT scheme and the flat tax scheme and so those principles that have no relevance shall not be discussed. Specifically, because these two proposals do not suggest any reform in terms of payment mechanism, evaluation of the proposals on the basis of the complexity of the proposed payment scheme is precluded, and so, the principle of convenience of payment shall not be discussed. And because the impact of the reforms on the economy, i.e., whether they impede or reduce the productive capacity of the economy, is difficult to assess without empirical data or technical simulations, the principle of economic growth and efficiency shall not be discussed as well.

Simplicity as an indicator of a good tax policy is argued to be closely related to four more indicators: certainty, economy in collection, transparency, and minimum tax gap. The more complex the tax rules and system, the greater likelihood that the certainty principle will be compromised and the more difficult it is for taxpayers to assess whether and when they will be taxed. Also, the more complex the tax system is, the more inconvenient it is for the taxpayer to pay, the greater the enforcement and compliance costs for the government and the taxpayers, and the bigger the incentives to avoid compliance. Since these principles are correlated, these five guiding principles shall be discussed in concurrently.

It must likewise be emphasized that the evaluation of the two proposals is merely conceptual and no claim based on empirical data is made. A "Tax Reform Analysis Questionnaire" based on the guiding principles of good tax policy set forth in AICPA's *Tax Policy Statement 1* was appended to AICPA's *Understanding Tax Reform: A Guide to 21st Century*

*Alternatives*, but this paper did not attempt to use the said questionnaire since most of the specific questions therein required the conduct of technical simulations which are not available to this author. Rather, the subject tax policies, that is, the SNIT scheme and the flat tax scheme, shall be evaluated along the following line of queries:

(a) *Equity and fairness*: Are similar taxpayers taxed similarly? Are people with a similar or equal ability to pay taxes made to pay the same or similar amounts? Are people with a greater ability to pay taxes made to pay more? If there is classification for purposes of taxation, does it rest upon “substantial distinctions that make real differences”?

(b) *Simplicity*: Is the tax law simple enough as to promote certainty, convenience of payment, economy in collection, transparency and visibility, and as to minimize the tax gap?

(1) *Certainty*: Does the reform propose a tax structure that is simple enough as to lay out in clear and unambiguous terms how the amount to be paid is to be determined?

(2) *Economy in collection*: Does the reform propose a tax structure that is simple enough as to keep enforcement costs and compliance costs to a minimum?

(3) *Transparency and visibility*: Does the reform propose a tax structure that is simple enough as to raise the awareness among taxpayers about how the tax affects them?

(4) *Minimum tax gap*: Does the reform propose a simple tax system structured to increase the ease of compliance, decrease incentives to avoid compliance, and/or encourage compliance?

(c) *Neutrality*: Does the reform favor one industry or type of taxpayer over another? And if in the affirmative, is there a legitimate reason or purpose for the non-neutral provisions?

(d) *Appropriate government revenues*: Despite the proposed reforms, will the government still be able to collect a reasonable level of revenue? If there are revenue losses, how will they be remedied?

## V. RESULTS AND DISCUSSION

### A. EQUITY AND FAIRNESS VIS-À-VIS THE DISTINCTIONS LAID OUT IN *SISON V. ANCHETA*

Under the SNIT scheme, compensation income earners and business income earners are subject to the same rates of tax but are still treated differently in terms of allowable itemized deductions, although unlike in the present tax system, self-employed individuals and professionals are subject under the SNIT scheme to a lesser number of deductions than those allowed to corporations. On the other hand, under the flat tax scheme of S.B. No. 2261, compensation income earners and business income earners are also subject to the same flat tax rates and likewise treated differently in terms of allowable itemized deductions. However, unlike in the SNIT scheme, the flat tax scheme retains the similar treatment of individual and corporate business income earners under the NIRC. Otherwise stated, under the flat tax scheme, business income, whether earned by self-employed individuals and professionals or corporations, is still subject to the same allowable itemized and optional standard deductions.

To determine whether the reform proposed under the House Bill and that proposed under the Senate Bill is equitable and fair, it must first be determined whether self-employed individuals and professionals are situated similarly to compensation income earners and to corporations, whether they have similar or equal ability to pay, and if not, who among them have the greater ability to pay.

Self-employed individuals and professionals are situated similarly to compensation income earners to the extent that both groups of taxpayers pertain to a singular natural person. They are similarly situated in terms of their capacity to earn. They differ, however, in the kind of income that they earn. Compensation income earners earn fixed income, whereas self-employed individuals and professionals earn business income.

It is in this regard that self-employed individuals and professionals are similar to corporations. But while both are business income earners, corporations and self-employed individuals and professionals are not similarly situated. Corporations are artificial beings composed of several natural persons who have pooled their resources to allow the juridical person greater capacity to earn. Self-employed individuals and professionals, being singular natural persons, rake in less income than do corporations. From the foregoing, it is apparent that individuals should be treated

differently from corporations but business income should likewise be treated differently from fixed or compensation income.

The evenhandedness of the dissimilar treatment of compensation income and business income in terms of deductions allowable has been upheld by the Supreme Court in the case of *Sison v. Ancheta*.<sup>17</sup> The Court, in this case, recognized that compensation income taxpayers are set apart as a class and are not entitled to make deductions for income tax purposes, as there is practically no overhead expense, while in the case of professionals or businessmen, there is no uniformity in the costs or expenses necessary to produce their income. Thus, there is a reasonable distinction between compensation income and business income to justify different treatment of one from the other. Allowing business expenses as deductions to the gross income would, at least theoretically, put businessmen and professionals in the same position as compensation income earners. Otherwise put, such allowance is a measure towards horizontal equity.

Taking into consideration the natural distinction between individuals, as natural persons, and corporations, as artificial beings, as well as the distinction between business income and compensation income as laid down in *Sison v. Ancheta*, it appears that the flat tax scheme proposed by SB 2261 is more consistent with the principle of equity. The two reforms correctly subject compensation income earners and business income earners to the same rates of tax. They are, after all, both individual taxpayers with just about the same capacity to pay tax. It is likewise equitable and fair that these individual taxpayers are treated differently in terms of allowable itemized deductions, consistent with the ruling in *Sison v. Ancheta*. The SNIT scheme, however, treats the business income differently when earned by individuals and when earned by corporations, and allows self-employed individuals and professionals a lesser number of deductions than those allowed to corporations. On the other hand, under the flat tax scheme, while self-employed individuals and professionals are subject to a set of rates different than that to which corporations are subject to, business income is treated similarly in both. Such income is subject to the same allowable itemized and optional standard deduction, whether it is earned by individuals or by corporations. The treatment of business income under the flat tax scheme appears to be more consistent with the ruling in *Sison v. Ancheta*. It seems more equitable to treat business income consistently, and to have different tax rates applicable to self-employed and corporations to account

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<sup>17</sup> *Sison, Jr. v. Ancheta, et al.*, 130 SCRA 654 (1984).

for the fundamental distinction between individual and corporate income tax.

But what of the reality that although self-employed individuals and professionals have about similar or equal ability to pay taxes as compensation-income earners, these business income earners actually bear a lighter burden of tax because they have more opportunity or means not to strictly comply with their tax liabilities? Although the intent of such disparate treatment is to put compensation income earners and business income earners on equal footing, in actuality, it has compromised horizontal equity. As clairvoyantly said by Justice Vicente Abad Santos in his separate opinion in *Sison v. Ancheta*, "those who file returns on the basis of net income will pay less taxes because they can claim all sorts of deductions justified or not."

While limiting deductible expenses of self-employed individuals to those which can be easily verified by the BIR is a good way of addressing the abuses made by self-employed individuals in stating their deductions, it does not appear fair to disallow legitimate business expenses because they are difficult to verify and thus commonly abused. It also offends equity inasmuch as there is no reason why business income should be taxed in another way when it is earned by self-employed individuals and when it is earned by corporations. It just does not sit well with the policy laid out in *Sison v. Ancheta*. As Senator Ralph Recto convincingly argues:

[Aligning the income taxation of the self-employed with that of corporations] is sound policy because if we come to think of it, why should the same type of income, which is business income, be taxed differently if earned by a corporation and earned by an individual?

...

Allowing the deductibility of all legitimate expenses is a fair treatment of a business concern consistent with the principle of income taxation.<sup>18</sup>

Thus, S.B. No. 2261 takes a different course in handling the abuses in deductions by individual business income earners. While it is recognized that certain business expenses are being abused, addressing this problem through a structural reform that intends to disallow their deductibility may not necessarily be the appropriate response. If business deductions are being padded to bring down tax liability, this problem should be solved through intensive and sustained tax audits by the BIR. However, changing the base

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18 Sponsorship speech on Senate Bill 2261 by Senator Ralph Recto, Senate, Manila, September 6, 2006.

of the OSD simplifies tax administration because the BIR will only have to focus on checking the veracity of gross revenues declared. Under the current formula, the BIR would need to check each item falling under “costs of goods sold” or “costs of sales” which are required to be itemized, which would be laborious exercise.

So the thrust of the flat tax scheme in solving the horizontal inequity extant in the present system is not to change the itemized deductions allowable to business income earners, like in H.B. No. 5296, but to simplify the individual income tax structure through a singular tax rate and exemption level. Perhaps another approach is to re-evaluate the deductions currently allowed under the present system and or to apply ceilings to those business expenses that are commonly abused.

While the flat tax scheme better embodies horizontal equity than the SNIT scheme, there are concerns that it violates vertical equity or progressivity of tax. However, while a pure flat tax inarguably offends the idea that people with a greater ability to pay taxes should pay more, a flat tax rate could be made progressive by instituting a threshold income exempt from taxes and providing for a standard deduction.<sup>19</sup> Such is the flat tax scheme proposed by S.B. No. 2261. This scheme does not institute a flat tax per se but proposes two income brackets: (1) taxable income of ₱ 144,000.00 and below which are exempt from income tax, and (2) taxable income over ₱ 144,000.00. Thus, in this flat tax scheme, the threshold income exempt from taxes as well as the standard deduction is pegged at ₱ 144,000.00. As explained by Senator Recto:

Although a flat tax rate is applied uniformly on net incomes across all income levels, the personal exemption, which is uniformly granted, is effectively a larger amount of relief to the smaller-income taxpayer than to a higher-income taxpayer.

As a result, a large amount of net income becomes taxable for the richer taxpayer than a poorer taxpayer. The exemption level mainly lends to the regressivity to the proposed income tax structure.<sup>20</sup>

Thus, under the flat tax scheme, considerations of fairness and equity, whether horizontal or vertical, are well incorporated. On the other hand, under the SNIT scheme, although vertical equity is not violated, horizontal equity is compromised. The disparate treatment of business

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<sup>19</sup> *Concept Paper on the Application of Flat Tax on Income*, 18.3 NTRC TAX RES. J May-June 2006.

<sup>20</sup> Sponsorship speech on Senate Bill 2261 by Senator Ralph Recto, Senate, Manila, September 6, 2006.

income in terms of the deductions allowable to individual business income earners and corporations may be considered as a classification which does not rest upon substantial distinctions that make real differences which violates the distinctions and principles of uniformity and equitability in taxation laid out in *Sison v. Ancheta*.

### **B. SIMPLICITY IN TERMS OF CERTAINTY, ECONOMY IN COLLECTION, TRANSPARENCY, AND MINIMUM TAX GAP**

As already mentioned, because the complex tax system is believed to be one of the main reasons why tax compliance is low and tax avoidance is high, the main thrust of the two reforms proposed by the Legislature is the simplification of individual income taxation. Because, under the AICPA's framework, simplicity is considered as a basis for realizing four other tax policy goals, namely, certainty, economy in collection, transparency, and minimum tax gap, these indicators shall serve as parameters in determining whether simplicity as an end is met by the two tax proposals.

#### **1. Certainty**

There is no fault in the language employed by H.B. No. 5296 in instituting the SNIT scheme. The wording of the proposal is clearly lays down when and how tax is to be paid and how the amount to be paid is determined. The flaw, rather, lies in the structure proposed by the scheme.

The central feature and pride of the SNIT scheme is the list of itemized deductions especially applicable to self-employed individuals and professionals which is limited to those expenses which are essential to the conduct of the business and are easily verifiable by the BIR. Limiting the itemized deductions to essential business costs and expenses that are easily verifiable is commendable as furthering the principle of certainty inasmuch as it makes it easier and simpler to identify and appraise which transactions are subject to tax, in contrast to a system where the tax base depends on subjective assessments or transactions that are hard to categorize. The disparate treatment, however, of compensation income earners, individual business income earners, and corporate income earners in terms of their allowable deductions not only offends horizontal equity, but also necessitates that each of these taxpayer groups have their own formula for arriving at their taxable base. Hence, a person has to find out what kind of taxpayer he is so as to find out what his allowable deductions are. The government likewise has to verify three sets of allowable deductions.



On the other hand, under the flat tax scheme, since the itemized deductions allowable to self employed individuals and professionals are the same as those allowed to corporations, there are only two formulas for arriving at the taxable base, one for compensation income earners and one for business income earners. The taxable base applicable to individual income tax payers itself is made simpler and broader under the flat tax scheme inasmuch as the basic personal and additional exemptions under the present law have been replaced by the ₱ 144,000.00 standard exemption. Thus, there is no need to ascertain whether the taxpayer is a head of the family, or single, or whether he may claim additional exemptions since the ₱ 144,000.00 standard exemption is neutral across all individual taxpayer.

The simpler schedule of tax under the flat tax scheme also makes computing the tax liability more certain. While the SNIT scheme prescribes one less bracket than the present system, the six brackets it proposes is a far cry from the two brackets prescribed by the flat tax scheme. To compute income tax liability, both the SNIT scheme and the present scheme require the taxpayer to identify which income tax bracket he falls under. Having identified the pertinent income tax bracket, a threshold income particular to said income bracket shall be subtracted from the individual's taxable income. The appropriate percentage rate shall be applied to the difference and finally, a fixed amount shall be added to the product. Under the flat tax scheme, income tax liability is computed by subtracting ₱ 144,000.00 standard exemption from the taxable income and applying the thirty-five percent (35%) flat tax rate to whatever difference should result.

It is evident from the foregoing discussion that the flat tax scheme is much simpler in structure than the SNIT scheme. The singular tax rate and the standard exemption that is neutral across all individual taxpayers make the applicable tax base and tax rate is easier to ascertain. The procedure for determining the amount to be paid is likewise uncomplicated given the lesser number of variables to factor in the equation. Given such ease and simplicity in the tax system, it is highly likely the individual would feel much more confident in computing his income tax liability under the flat tax scheme than in the SNIT scheme. For these reasons, S.B. No. 2261's simpler flat tax scheme lays out in clearer and more certain terms when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined than H.B. No. 5296's SNIT scheme does.

## 2. Economy in collection

As earlier mentioned, the two tax proposals do not suggest any reform in terms of payment mechanism, thus precluding an evaluation on the basis of the cost-efficiency of the payment scheme. That notwithstanding, H.B. No. 5296 and S.B. No. 2261 may still be evaluated in reference to economy in collection inasmuch as the more complex the tax system is, the greater the costs for the government to administer it and the greater the compliance costs for taxpayers to determine their tax liability and report it.

Any measure which seeks to reduce the amount of resources that the BIR has to expend in verifying the veracity of the gross income declared and the deductions claimed shall likewise reduce administrative or enforcement costs. Thus, if evaluated purely on the basis of economy of collection, the central feature of the SNIT scheme of limiting the itemized deductions to essential business costs and expenses that are easily verifiable, is highly commendable as it seeks to reduce the resources needed to ascertain the veracity of claimed deductions. Hence, it is expected to translate to lower enforcement costs on the part of the government.

The flat tax scheme is likewise commendable for imposing a standard deduction of ₱ 144,000.00, in lieu of the personal and additional exemptions. As further justification for the deletion of the personal and additional exemptions, it is argued that the BIR often finds it difficult to ascertain whether a taxpayer is actually single, head of the family, or married. Also, the number of dependents claimed is not easily verifiable. That these deductions are prone to abuse is addressed by the flat tax scheme's standard deduction. Because the standard deduction is applicable equally whether the taxpayer is single, judicially decreed as legally separated with no qualified dependents, the head of the family, or married, and regardless of whether the taxpayer has any qualified dependents, under such a scheme, ascertaining these hard to prove social variables becomes unnecessary. This will ultimately lend to a more efficient and straightforward tax collection and administration by the government. Thereby, abuses related to claiming personal and additional exemptions are addressed. And, since the government need not allocate its resources for verifying these social variables, the reduced verification expenses are expected to translate to government savings which the State may use for other needs, such as substantiating other income tax variables.

The two reforms also propose a similar measure which not only reduces the government's enforcement costs but likewise keeps the

taxpayer's compliance costs to a minimum: the forty percent (40%) OSD. Even under the present Code, the OSD is meant to provide a cost-efficient option to taxpayers in the computation of their taxable income. This option provides an easier formula in the computing the individual income tax, as well as a simplified substantiation procedure for both the government and the taxpayer. Under this option, the government need only confirm the taxpayer's declaration of his gross revenues and accuracy of the computation of the standard deduction, since there are no more itemized deductions claimed for the government to verify. Again, such is expected to translate to government savings in terms of resources allocated in determining the accuracy of tax declarations. Meanwhile, the taxpayer need not submit with his tax return such financial statements otherwise required under the present Code, which is likewise expected to translate to taxpayer savings in terms of resources allocated for complying with substantiation requirements.

This option, whether under the present Code or under the two tax reform proposals, is laudable inasmuch as it will undoubtedly translate to reduced compliance costs for the taxpayer and enforcement costs for the government. But what makes the OSD under the two proposals even more commendable than the OSD under the present Code is its increase from ten percent (10%) to forty percent (40%). During the 1992-1998 SNITS regime, a forty percent (40%) OSD was likewise made available to self-employed and professions, but this was reduced to ten percent (10%) by RA 8424. Naturally, the lower OSD ceiling was less appealing than the higher ceiling under the SNITS. Thus, it is expected that increasing the OSD level back to its forty percent (40%) ceiling will bear the fruits borne by the SNITS regime during which many availed of the standard deduction because of the expediency of not having to hang on to receipts and invoices to support their deductions. The inarguably more attractive level of forty percent (40%) is expected to increase the number of taxpayers availing of this privilege which is a good measure to simplify income taxation and reduce the government's enforcement costs and the taxpayer's compliance costs.

### **3. Transparency and visibility**

Transparency and visibility put a premium on the increased awareness among taxpayers about how the tax affects them. In assessing transparency and visibility of the two reforms in question, it must be recalled that transparency is related to simplicity, *i.e.*, complex provisions make it more difficult for taxpayers to assess whether and when they will be taxed.

The provisions of the present Code have often been complained of as too complicated. Yet the provisions of H.B. No. 5296 do not significantly differ in structure from the provisions of the present Code. While the scheme under the House Bill is known as "Simplified Net Income Taxation", the reform proposed under such scheme merely simplified the list of itemized deductions specifically available to self-employed and professionals to make it shorter and limited only to the most essential business expenses and to those expenses that are allegedly easier to verify by the BIR. In essence, what is simplified under the SNIT scheme is the verification of the deductions claimed by self-employed and professionals. Because the reform under the SNIT scheme is not really that much simpler to understand and appreciate than the present scheme, it is not likely to raise much awareness of tax liabilities and consequences among taxpayers.

On the other hand, the flat tax scheme proposed by S.B. No. 2261 introduces a tax structure that is vastly different and inarguably simpler than the structure of the present tax system. Because income tax liability under this scheme is a function of significantly lesser variables and because tax computation is more clear-cut, taxpayers have an easier time assessing whether and when they will be taxed. And since arriving at one's tax liability is more straightforward, the impact of the tax and the true cost of transactions are better appreciated by the taxpayer. In short, under the simple structure of the flat tax scheme, taxpayers better understands how the tax affects them.

#### **4. Minimum tax gap**

Bear in mind that a tax system's simplicity is positively related to tax compliance and negatively related to tax evasion. And because, in general, the tax structure proposed under S.B. No. 2261 is simpler than that proposed under H.B. No. 5296, the former proposal has more potential to encourage compliance and curb corruption and tax evasion. But it must be recognized that the respective measures suggested by each of the two proposals have their own merits which must be acknowledged.

Under H.B. No. 5296, there may be identified three propositions for achieving a minimum tax gap, the limited itemized deductions from the gross revenues of self-employed and/or professionals, the lower tax rates and higher personal and additional exemptions, and the OSD that has been increased to forty percent (40%).

Limiting the itemized deductions allowed to individual business income earners to the most essential and direct business expenses and to those expenses that are easily verifiable by the government reduces the opportunities for corruption, as it broadens the tax base, makes tax obligations more transparent, and reduces the discretionary powers of tax officials who now have lesser number of items of deductions to verify. Because there are lesser items of allowable deductions which is limited to those that are easily verifiable, the opportunities for tax evasion are likewise limited, since computing and ascertaining the deductions claimed is more straightforward and there are lesser nooks and crannies which the taxpayers may take advantage of to evade tax. Hence, limiting the itemized deductions allowed to the self-employed and professionals, to essential and easily verifiable expenses is expected to directly address the huge income tax gap which this type of taxpayers account for. By this SNIT scheme, the individual business-income earners' share in the cost of financing the government is increased and re-aligned with the burden carried by compensation-income earners.

Lowering the tax rates and increasing the allowable personal and additional exemptions is expected to reduce the motive for tax evasion. Because the tax liabilities under the SNIT scheme is already quite low, more taxpayers would rather just comply with their tax obligations than resort to unlawful means to avoid tax. The incentives for evading tax simply appear insignificant compared to the risk of getting caught.

Lastly, the 40-percent OSD falls squarely in one of the tax simplification reforms identified in the NTRC's study on corruption, i.e., the "presumptive taxation of small businesses, who may keep insufficient books and records." As projected by the study, this measure "can also reduce the discretionary power of tax inspectors and make tax calculations simpler and clearer." But not only will this measure limit the opportunities for corruption, it will likewise reduce both the motive and the opportunities for tax evasion. The SNIT scheme's OSD is expected to reduce the motive for tax evasion owing to the higher and more attractive ceiling, and the lesser compliance costs which it entails. The simple formula for arriving at the taxable income is likewise expected to be positively perceived by the taxpayer who may have a better understanding of his tax liabilities and may perceive the rates as fair. In turn, the taxpayer's improved understanding and perception is expected to increase overall tax compliance, consistent with

the Graetz theory<sup>21</sup>. The reduction of the opportunities for tax evasion is attributable to the more transparent calculation of the taxable income under the OSD. Because the formula for arriving at the taxable income under the OSD renders does not involve claiming itemized deductions, the taxpayer lacks the opportunity to overstate the deductions claimed. And the administrative costs expected to be saved from this measure may now be used by the government for verifying the taxpayer's declaration of his gross revenues.

The reform under S.B. No. 2261 has four features for achieving a minimum tax gap: (1) the flat tax scheme, (2) the standard deduction, (3) the lower tax rates and the higher exemption level, and (4) a forty percent (40%) OSD.

That the structure of the flat tax scheme is simpler than that of the present tax scheme and the SNIT scheme has already been illustrated. Because arriving at one's tax liabilities under the flat tax scheme is much simpler and involves lesser variables, tax obligations appear more transparent and straightforward and tax officials have lesser opportunity for corruption. Taxpayers likewise have lesser opportunities to evade tax, since the less complicated the tax system is, the lesser the instruments which may be taken advantage of by the taxpayer to avoid his responsibilities. And since computing for taxable income under the flat tax scheme is straightforward, tax officials may easily check whether there are mistakes in the computation. Thus, tax gap may also be minimized by reducing the likelihood of unintentional errors like miscomputations as such errors may be easily checked by the tax officials under this scheme. Lastly, the necessary computations are easily understood by the taxpayer who gains a better awareness of his tax liabilities and a positive perception of the tax system, thereby reducing his motive to evade tax while increasing overall tax compliance.

The standard deduction under the flat tax scheme incorporates one of the tax simplification reforms identified in the NTRC's study on corruption, i.e., eliminating special exemptions. Because the ₱ 144,000.00 standard deduction, as contra-distinguished from the personal and additional exemptions which may be availed of under the present tax scheme, does not discriminate whether the taxpayer is single, judicially decreed as legally separated with no qualified dependents, the head of the family, or married, and whether the taxpayer has any qualified dependents, ascertaining these

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21 See note 14, *supra*.

social variables becomes unnecessary and the discretionary powers of tax officials are reduced in effect reducing the opportunity for corruption. What is more is that this standard deduction reduces both the opportunities and the motive for tax evasion. There is no point for the taxpayer to falsely declare that he is married or that he has four dependents because the standard deduction applies neutrally across all types of taxpayers. Besides, there is a lesser incentive to evade tax under the flat tax scheme since the ₱ 144,000.00 standard deduction is indubitably already a huge exemption, compared to what may be availed of under the present Code.<sup>22</sup>

Understandably, the flat tax scheme and the ₱ 144,000.00 standard deduction are likely to minimize the tax gap by limiting the opportunities for corruption and reducing both the motive and the opportunities for tax evasion.

The flat tax scheme and the standard deduction is accompanied by effectively lower tax rates and the higher exemption level. Furthermore, the flat tax scheme makes provision for a forty percent (40%) OSD similar to that offered under the SNIT scheme, except that under the flat tax scheme, this option is likewise extended to corporations. How the forty percent (40%) OSD, and the lower tax rates and the higher exemption level is suppose to minimize the tax gap is the same under the SNIT scheme and under the flat tax scheme, thus the previous discussion of these two measures under the SNIT scheme applies equally to this discussion under the flat tax scheme.

In addressing the unduly heavier burden of tax borne by compensation income earners as compared to that borne by self-employed individuals and professionals, proponents of the flat tax purposely did not adopt any kind of measure similar to H.B. No. 5296's SNIT scheme. It was argued that while it is not disputed that some business expenses are being exploited, restructuring the tax system so as to disallow deductibility of commonly abused expenses may not necessarily be the appropriate response, inasmuch as all legitimate expenses should be allowed as a deduction as this is consistent with the fair treatment of an item of business. Thus, the flat tax scheme proposes to address this particular problem by intensive and sustained tax audits by the BIR. And because the simplified structure under this scheme is expected to translate to enhanced efficiency,

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22 Recall the earlier illustration of the extent of this exemption in the case of a married individual with four dependents.

reduced enforcement costs, and increased government savings, it is anticipated that the BIR would have more resources which it could use for conducting such intensive and sustained audits.

**C. NEUTRALITY: COMPROMISED BY SNIT SCHEME, CHAMPIONED BY  
FLAT TAX SCHEME**

The principle of neutrality is compromised under the reform proposed by H.B. No. 5296 which provides for a set of itemized deductions for self-employed individuals and professions different from that allowed to corporations, unlike in the present Code and in the flat tax scheme where all business income earners, whether individual or corporate, are treated similarly in terms of their allowable itemized deductions. The SNIT scheme has the effect of disadvantaging self-employed individuals and professionals over corporations since the itemized deductions specifically available to them are lesser than those available to corporations.

Such disparate treatment seeks to minimize the non-compliance specifically of self-employed individuals and professionals who usually find it burdensome to keep formal accounting and business records and thus find ways to "over declare" their allowable deductions. It must be recalled, however, that such a scheme offends the principles of equity and fairness which require that both individual and corporate business income be similarly treated and that business income earners, whether an individual or a corporation, be allowed to claim as deductions all legitimate expense which they may incur in the course of their trade, business, or profession. Thus, in view of how such a distinction offends equity and fairness in taxation, there does not appear a sufficiently legitimate reason why corporate business income earners should be favored over individual business income earners.

Quite the reverse, S.B. No. 2261 appears to champion neutrality with its proposals of a flat tax rate, a standard deduction, and making the 40-percent OSD available to corporations. Based on the simulations conducted by the Department of Finance in connection with this tax reform proposal, it is anticipated that due to the reduced tax rates and increased exemptions under the flat tax scheme, 2.44 million salaried individual income taxpayers out of the 2.86 million today, will either be exempted from paying income tax or will have reduced income tax liabilities. They are individuals belonging to the three lowest income brackets, earning average annual gross incomes of ₱ 60,000.00, ₱ 80,000.00 and ₱ 125,000.00, respectively. Included in those to be benefited are all the minimum wage earners in the private sector, or those earning, in the case of Metro Manila, ₱ 325.00 a day. Only 14.66% of



the 2.86 million salaried taxpayers or 418,739 will have higher income tax liabilities. They are the ones belonging to the higher middle up to the high income brackets. The flat tax scheme favors lower income groups over higher income groups does not offend neutrality since it is reasonable to grant bigger relief to those who have little in life, consistent with the policy of vertical equity.

Moreover, under this reform, all individual taxpayers with a taxable income of not over ₱ 144,000.00 are exempted from tax liability, whether they are compensation income earners, self-employed, or professionals, and regardless of whether they are single, married, with dependents, or the head of the family. Extending the applicability of the forty-percent OSD to corporations was with a view to aligning the income taxation of individual business income earners with that of corporate business income earners, consistent with the argument that there is no legitimate reason why business income should be taxed differently if earned by a corporation and earned by an individual.

Therefore it may be reckoned that the proposals under the flat tax scheme which appear to favor one type of taxpayer over another are amply justified by legitimate reasons, while those reforms under the flat tax scheme which seek to align the treatment of one taxpayer with another merely seeks to eliminate those distinctions made in the present law which do not rest on substantial differences and those distinctions which may simply be done away with in the interest of simplicity and efficiency.

#### **D. BOTH PROPOSALS ENTAIL REVENUE LOSSES, BUT HOW MUCH AND HOW BAD?**

Because both reforms propose a reduction in the applicable tax rates and an increase in allowable exemptions, it is not denied that the SNIT scheme and the flat tax scheme entail revenue losses. In the case of the SNIT scheme, it is projected that the government would forego about ₱ 4.02 billion worth of revenues after losing ₱ 8.64 billion from the lower income tax and raising ₱ 6.84 billion from the SNITS.

In the case of the flat tax scheme, according to the computation by the Department of Finance, the government would lose ₱ 15.97 billion from the proposed simplified tax rate for salaried employees and ₱ 1.1 billion for

self-employed individuals.<sup>23</sup> But according to Senator Recto in his sponsorship speech for S.B. No. 2261, the government is anticipated to lose about ₱ 13 billion in revenues.

However, the consequent reduction in government revenue is expected to be compensated by other benefits offered by the tax reform proposals. In general, the foregone revenue can be recovered through the benefits of efficiency to be gained in a simplified tax structure. Thus, with respect to both schemes, revenue loss is expected to be offset to the extent that there are reduced enforcement costs and increased government savings. Losses are also anticipated to be recouped to the extent that compliance is increased and the leakages from tax evasion and corruption are plugged.

The efficiency gain due to a simple tax system is likely to be greater in the case of the flat tax scheme than in the case of the SNIT scheme precisely because there are more benefits of simplicity to be gained from the flat tax reform. Furthermore, the flat tax scheme has greater capacity for encouraging compliance and curbing corruption and tax evasion. Accordingly, it has more potential to minimize the tax gap. It is likewise expected that the long term benefits from improved efficiency in administration and collection under the flat tax scheme shall be more acutely felt than in the case of the SNIT scheme.

Specifically with respect to H.B. No. 5296, the lower income tax is expected to be incrementally offset by the revenues raised by the SNIT scheme.

## VI. CONCLUSION

Based on the evaluation of the SNIT scheme and the flat tax scheme, vis-à-vis the guiding principles of good tax policy as developed by the AICPA, it is evident that while the flat tax scheme necessitates greater sacrifice on the part of the government in terms of potential revenue, it, nevertheless, better maximizes the benefits of a simplified tax system than does the SNIT scheme. The flat tax scheme is more equitable and fair than the SNIT scheme, since the latter does not fairly treat individual taxation of business income. And while the principle of neutrality is compromised under the SNIT scheme, the flat tax scheme, in contrast, promotes neutrality.

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23 F. Salvosa II, *Texas asks solons to preserve 2006 revenue program*, Business World, June 9, 2006.

Overall, the tax structure of the flat tax scheme is simpler than that of the SNIT scheme. It also lays out in more certain terms when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined than the SNIT scheme does. But as regards economy in collection, both proposals may be given merit for their respective measures for achieving cost-efficiency in collection and for proposing to increase the OSD to forty percent (40%).

On the matter of keeping the tax gap to a minimum, with particular regard to the favored position of self-employed individuals and professionals, who account for the lion's share in the individual income tax gap, the two reforms propose different measures. To prevent the rampant practice of self-employed individuals and professionals of "over declaring" their business expenses, H.B. No. 5296 seeks to institute the SNIT scheme for self-employed individuals and professionals, under which the deductions which may be claimed by this type of taxpayer are limited to those direct, essential and easily verifiable expenses. Proponents of the flat tax scheme, on the other hand, argue that while it is recognized that certain business expenses are being abused, addressing this problem through a structural reform that intends to disallow their deductibility may not necessarily be the appropriate response. Thus, they propose that the problem be solved through intensive and sustained tax audits by the BIR. The BIR is expected to have more resources to accomplish this task because of the expected savings from the more efficient flat tax structure.

While the SNIT scheme is more expected to directly re-align the position of individual compensation income and business income earners, over-all, the flat tax scheme has the greater potential to encourage compliance and curb corruption and tax evasion in general. Thus, while the SNIT scheme specifically addresses the need to increase the share of the self-employed and professionals in the tax burden, the simplicity of the flat tax scheme is expected to increase compliance and reduce noncompliance, in general.

Lastly, in terms of transparency and visibility, the proposed tax structure under H.B. No. 5296 is not significantly simpler as the present system as to greatly improve on its transparency and visibility. In contrast, the flat tax structure, which involves a simpler, more straightforward computation with lesser variables to consider, is expected to be better appreciated by the taxpayer and thus greatly improves on the present system's transparency and visibility.

As emphasized in AICPA's tax policy concept statement, not all ten principles can always be achieved to the same degree for all proposed tax changes and so, lawmakers should balance these principles to achieve an optimal law. While H.B. No. 5296 addresses in a more direct fashion the goal of making self-employed individuals and professionals share a fairer income tax burden, and its implementation entails lesser revenue loss, it does so at the expense of equity, fairness, and neutrality and while failing to greatly improve on the simplicity, certainty, transparency and visibility of the tax system. On the other hand, S.B. No. 2261 achieves many of these principles and takes full advantage of the benefits of simplicity in the tax structure. Therefore, a balance is struck between the losses which government must suffer and the boons of a truly simplified tax system.

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