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Amid yuletide celebrations, Philippine entities are busy closing their books of accounts for 2014. We take this opportunity to point out some key issues that are worthy to remember.

Client advisory letter

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Income tax computation and tax return preparation

No or under withholding of tax disallows the related expense

Failure to remit the required withholding tax on time will result to deficiency: (1) income tax and (2) withholding tax assessments.

Expenses must be accrued/deducted and subjected to withholding tax (if applicable) once the obligation is fixed and the amount is knowable.

When claiming deductions for income tax purposes, taxpayers are obliged to withhold tax on those income payments that are subject to withholding tax.[1] The withholding tax should be withheld and remitted to the BIR within the due dates provided under the Tax Code and withholding tax regulations.[2]

In terms of the timing, withholding agents are obligated to withhold tax when the income is paid, becomes payable or when the expense/asset is accrued/recorded in the books, whichever comes first. In case the income is not yet paid or payable but has already been accrued or recorded as an expense or asset in the books of the taxpayer, the obligation to withhold tax arises in the last month of the quarter when the deduction is claimed for income tax purposes.[3]

In the past, the BIR had allowed deductions even if the withholding taxes were paid only at the time of audit or investigation.[4] But now, despite payment of deficiency withholding tax during audit or investigation, the related expense shall still be disallowed as deduction.[5] As a result of this punitive measure, the withholding agent will be penalized twice for failure to comply with the withholding tax requirement. This is too steep a penalty especially if you consider the fact that the income recipient is expected to have reported the income and paid the corresponding income tax. However, the imposition appears to have basis in the Tax Code. Thus, it is the lookout of taxpayers to properly comply with the requirement.

On a related note on taking deductions, taxpayers must properly distinguish valid expense "accruals" from mere "provisions" or estimates. Accounting rules play an important role on this matter. In fact, the Supreme Court provided clear guiding principles on when an expense should be accrued and deducted for tax purposes. According to the High Court, a taxpayer must recognize an expense when the obligation to pay is already fixed; the amount can be determined with reasonable accuracy; and it is already knowable, meaning the propriety of an accrual must be judged not only by the facts that a taxpayer knew, but also those facts that the taxpayer could reasonably be expected to have known.[6]

Looking at it the other way, if the right to pay is uncertain in terms of timing and amount, the related expense should be considered a mere provision or estimate in the meantime. As such, it cannot be claimed as a valid deduction for tax purposes and thus no withholding obligation should apply.

Expenses and input tax without compliant official receipts or invoices not valid

Alternative evidence to support expense deduction and input tax credit is useless if not duly registered with BIR

As a rule, when claiming a deduction, taxpayers are required to substantiate such expense with sufficient

1 Section 34(K), Tax Code.
2 Sections 58 and 81, Tax Code; Revenue Regulations ("RR") No. 2-98, as amended.
3 RR 12-2001.
4 RR 14-2002.
5 RR 12-2013.
6 Commissioner of Internal Revenue vs. Isabela Cultural Corporation, GR No. 172231 dated 12 February 2007.

evidence, such as official receipts or other adequate records, showing the amount of expense and its direct connection to one's trade or business.[7]

In this regard, an old Supreme Court case[8] provides that not only must the taxpayer meet the business test, he must substantially prove the deductions claimed by evidence or records; otherwise, such deductions will be disallowed. The taxpayer must prove by substantial evidence that the expense being claimed has a proximate relation to his business.

Significantly, in 2013, the BIR mandated taxpayers to secure a new Authority to Print (ATP) covering all their principal and supplementary receipts or invoices.[9] Non-compliance with the ATP rule will be treated as if no receipts/invoices were issued. Consequently, no deduction or input tax credits shall be allowed if supported by non-compliant receipts/ invoices as they are not valid proof of substantiation. The Bureau's objective is to increase compliance not just on the purchasers, but more so, on the supplier side.

The BIR's new rule restricts the amount that may be validly claimed as a deduction as it disregards other adequate records or evidence as proof of deduction, which many view as contrary to what the Tax Code and jurisprudence allows. In reviewing deductions to be taken, taxpayers should assess the level of substantiation available, and decide accordingly.

7 Section 34(A)(b), Tax Code.
8 Atlas Consolidated Mining & Development Corporation vs. CIR, GR No. L-26911 dated 27 January 1981.
9 Revenue Memorandum Circular No. 52-2013.

Glossary

BIR - Bureau of Internal Revenue
eFPS - Electronic Filing and Payment System
PCD - Philippine Central Depository

Noncompliant alphalist of payees disallows expense deductions

Under the Tax Code, failure to file correct or accurate alphalist of payees gives rise to monetary penalty only but according to the BIR it shall result to disallowance of the related expenses

Early 2014[10], the BIR requires all withholding agents, regardless of the number of employees and payees, whether the employees or payees are exempt or not, to submit an alphabetical list of employees and list of payees on income payments subject to creditable and final withholding taxes in the following manner:

- Attachment in the eFPS
- Electronic Submission using the BIR's website address at esubmission@bir.gov.ph
- Electronic Mail (email) to dedicated BIR addresses

According to the BIR submissions of alphalist where income payments and taxes withheld are lumped into one single amount (e.g. various employees, various payees, PCD nominees, others) shall not be allowed. Non-conformity with the prescribed format constitutes non-receipt of the submission and the income payment shall not qualify as a deductible expense.

Note that the Tax Code[11] imposes only administrative penalties (PHP1,000 for every failure; PHP25,000 maximum for a calendar year) for failure to file certain information returns. Thus, the penalty of disallowing the related expenses is too harsh and many taxpayers have bravely opposed this regulation.

10 Revenue Regulations No. 1-2014
11 Section 250

In fact several organizations went to the Supreme Court[12] and have been successful in securing temporarily restraining order ("TRO") effective immediately and until further orders, stopping the BIR, the DoF and SEC from further enforcing said regulations.

Intention to avail OSD must appear in first taxable quarter

Once the itemized deductions are used in the first quarter, OSD is no longer allowed at year-end
According to BIR, having mixed income makes you ineligible to use OSD

Without any qualification, Philippine companies and branches of foreign companies may opt to claim a 40% Optional Standard Deductions (OSD) in lieu of itemized deductions. They need only signify such election in the tax return which shall be irrevocable for the taxable year.[13]

Under the BIR's rules[14], the taxpayer must signify his irrevocable intention to use either OSD or itemized deductions in the first quarter return. Moreover, when the BIR issued the use of New Tax Forms earlier this year[15], it also denied certain entities the right to avail of the OSD and mandated them to claim itemized deductions. These entities are those exempt under Section 30 and 27(C) of the Tax Code; those subject to special rates; and those with mixed income. Many believe that the above is not in accord with the intention of the Tax Code.

Direct cost of PEZA-registered entities not exclusive

Despite BIR regulations and rulings to the contrary, for purposes of computing the 5% gross income tax of entities registered with the Philippine Economic Zone Authority (PEZA), the Court of Tax Appeals (CTA) has confirmed that the list of direct costs under RR No. 11-2005 is not all-inclusive. The factors in determining whether the item of cost or expense should be part of direct costs are the direct relation of such item to the PEZA-registered activities. [16]

Option to carry-over excess creditable withholding tax is lasting

Decision to refund excess creditable withholding tax (CWT) can be changed
Carry-over option is permanent

The Tax Code[17] provides that any excess of the sum of the quarterly tax payments over the total tax due on the entire taxable income of that year shall either be:

- carried over as excess credit; or
- refunded.

Taxpayer who indicated the option to cash refund or tax credit certificate or who did not indicate any of the option may still use the excess CWT as credit against its income tax due for the following years.

Once the option to carry-over has been elected, such option shall be irrevocable. According to the Supreme Court, the irrevocability rule is not limited to the immediately following taxable year but extends to the next succeeding taxable years. Such unused tax credits will remain in the taxpayer's books in the succeeding taxable years until fully utilized.[18] In short, the carry-over option is permanent.

Next-day payment before noontime cut-off is late

Previously, taxpayers are allowed to file tax returns and pay tax the following day before noontime cut-off without penalties.[19] However, starting 2012, the BIR no longer considers this as a valid reason to abate penalties.[20] Thus, taxpayers should ensure that returns are filed and corresponding taxes are paid within the deadlines to avoid incurring penalties.

12 PSE, BAP, PASBDI, FMAP, TOAPMHI vs. Secretary of Finance, CIR and Chairperson of SEC, G.R. No. 213860 dated 9 September 2014
13 Section 34(L), Tax Code.
14 Revenue Memorandum Circular No. 16-2010.
15 Revenue Regulations No. 2-2014.
16 East Asia Utilities Corporation vs. CIR, Court of Tax Appeals Case No. 8179 dated 21 May 2014.
17 Section 76, Tax Code.
18 Asiaworld Properties Philippine Corporation vs. CIR, GR. No. 171766 dated 29 July 2010.
19 Revenue Regulations No. 13-2001.
20 Revenue Regulations No. 4-2012.

Employee stock options are taxed depending on position

Stock options are subject to fringe benefit tax if the employee is supervisor or manager while it will be subject to withholding tax on compensation if given to rank and file employees

BIR treats stock options as shares of stock and imposes DST, CGT and/or donor's tax on every transfer thereof

Recently, the BIR issued a more comprehensive circular[21] on stock options, discussing the specific tax treatment of the income/gain arising from the various stages of the stock option cycle, i.e., grant, exercise and sale.

The RMC declares that stock options are "shares of stock" and shall be taxable as such. When a stock option is granted by the employer without any consideration, the employer cannot claim any expense deductions. In case the option is granted for a price, the entire consideration shall be subject to capital gains tax of 10% (5% for the first PHP100,000 net gain) on the net capital gain. In either case, the issuance of the option is subject to documentary stamp tax (DST).

Any transfer of stock options shall be treated as sale or exchange of unlisted shares subject also to capital gains tax and DST. If the transfer is without consideration, however, it will instead be subject to 30% donor's tax based on the fair market value (FMV) of the option.

Upon exercise, the excess of the FMV over the exercise price shall be taxed depending on the position of the grantee. For rank and file grantees, the excess shall be subject income tax and withholding tax on compensation; for supervisors and managers, the excess shall be subject to fringe benefit tax.

In case the grantee is a supplier, the stock options shall be treated as payment for the supply of goods/services, hence subject to the relevant withholding tax and other applicable taxes.

The BIR also imposed reportorial requirements during each stage of the stock option transaction.

21 Revenue Memorandum Circular No. 79-2014.

Tax compliance matters

BIR orders taxpayers to preserve their records for ten years

The law says taxpayers must keep their books for three years unless there is a finding of fraud

The BIR says ten years without distinction

The Tax Code requires taxpayers to preserve their books of accounts, including subsidiary books and other accounting records, for a period from the last entry in each book until the last day within which the Commissioner is authorized to make an assessment.[1] The Commissioner is authorized to examine the books and make an assessment within three (3) years from the due date of filing the tax return or actual date of filing the return, whichever is later.[2] In case of fraud, the Commissioner can make an assessment within ten (10) years from discovery of such fraudulent acts.[3]

Starting 2013, however, taxpayers are required by the BIR to retain hardcopies of their books and accounting records for ten years instead of three years.[4] In 2014, the BIR further modified the rule, requiring taxpayers to keep hardcopies of their books for the first five (5) years, while electronic copies may be retained for the next five (5) years using an Electronic Storage System (ESS) that meets the BIR's control requirements to ensure the integrity, accuracy and reliability.[5]

While it may be more practical to store documents electronically, as opposed to maintaining voluminous hard copies, which can fade away or be accidentally destroyed, certainly, having a compliant ESS entails additional costs (which can be relatively substantial) of doing business

1 Section 235, Tax Code.
2 Section 203, Tax Code.
3 Section 222, Tax Code.
4 Revenue Regulations No. 17-2013.
5 Revenue Regulation No. 5-2014.

for taxpayers. The issue remains whether a ten-year retention period is in keeping with what the Tax Code requires.

Documenting transfer pricing arrangement must not be an afterthought

Transactions with related parties must be at arm's length and must be supported with simultaneous documentations

The BIR's transfer pricing rules became effective in February 2013.[6] One of the crucial requirements in the guidelines is for taxpayers to have transfer pricing documentation to demonstrate compliance with the arm's length principle as regards related party transactions. The documentation must be "contemporaneous" i.e., must be in existence at the time the taxpayer develops or implements any intercompany arrangement, or reviews these arrangements when preparing tax returns. While the BIR does not require transfer pricing documents to be submitted when the tax returns are filed, such documents should be retained by the taxpayers and submitted to BIR upon request.

We hope that the above pointers will help ease your year-end review process as another year comes to a close and help you manage your tax position for 2014.

6 Revenue Regulations No. 2-2013.

Yuletide greetings

We wish you and your families a amazing new year!

meaningful Christmas and an

Talk to us

For further discussion on the contents of this issue of the *Client Advisory Letter*, please contact any of our partners.

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