***BDB Law's "Tax Law for Business"** appears in the opinion section of **Business Mirror** every Thursday.*

Undeclared expense as undeclared income

PAYMENT of taxes in the Philippines is done through self-assessment, that is, a taxpayer is required to determine his own tax liabilities and pay the same to the tax authority. Payment of tax, however, is not conclusive of its correctness. To determine if the taxes paid are correct, the Bureau of Internal Revenue is authorized to conduct examination of taxpayers' records.

In carrying out their mission to determine the correctness of the tax payments made, many revenue examiners make a practice of comparing the information or amounts indicated in different records or reports of the taxpayer. This approach is not incorrect. The problem is in the conclusion made out of the differences or discrepancies noted.

For instance, the amount of an item of expense as reported in the income-tax return (ITR) is compared with the same item of expense as reported in the books or in the financial statements. Regardless of which is higher, there is always a resulting income-tax assessment. If the amount in the ITR is higher, the difference is disallowed and a deficiency income tax is assessed. Similarly, if the amount of expense in the ITR is lower, the same results in a deficiency income-tax assessment.

The latter one is usually justified on the ground that there is a resulting unreported income. This does not only defy the rule in the Tax Code but it also defies logic. The odd part of it is that this conclusion is embraced by the reviewers as shown in a number of preliminary and final assessment notices containing this type of assessment. This issue had, in fact, been decided by the Tax Court in a number of cases, holding that this approach is not correct.

In one case (CTA Case 7853), the Tax Court emphasized that there are three elements on the imposition of income tax, which are: (1) there must be gain or profit, (2) that the gain or profit is realized or received, actually or constructively, and (3) it is not exempted by law or treaty from income tax. Income tax is assessed on income received from any property, activity or service. Thus, in the imposition or assessment of income tax, it must be clear that there was an income, not when there is an under-declaration of purchases.

In another case, the Tax Court held that it would be illogical to conclude that with the underdeclaration of business expense, that there would be a corresponding underdeclaration of income. The taxpayer would even be "prejudiced with any reduction to its deductible expense because this would necessarily mean an increase in tax base, and as the tax base increases, the amount of tax payable to the government would likewise increase."

In the same case noted above, the Court said that for income tax purposes, a taxpayer is free to deduct from its gross income a lesser amount, or not claim any deduction at all. What is prohibited by the income-tax law is to claim a deduction beyond the amount authorized therein.

Apparently, the revenue examiners usually refer to the same old case in justifying the assessment out of a lower amount of expense. A reference to that case, however, shows that it involves the application of the net worth method of assessment. The basic concept of this net worth method of determining income is that any increase in taxpayer's net worth, after making some adjustments, constitutes taxable income. The general theory underlying this method is that the taxpayer's money and other assets in excess of liabilities after accurate and proper adjustment of non-deductible and non-taxable items not accounted for in his tax return is deemed to be his unreported income. Otherwise stated, the theory is that the unexplained increase in net worth of a taxpayer is presumed to be derived from taxable sources. The application of this principle is anchored on a different theory and finds no application in the discrepancies of a taxpayer's expenses based on different reports for the same period.

Indeed, an expense is not an income. In fact, it is a deduction from income, and correspondingly a reduction in net worth, not an increase. Non-reporting of expense is not equivalent to non-reporting of income. Thus, a taxpayer should not be penalized for claiming an expense lower than what he is entitled to.

* * * *

The author is a junior associate of Du-Baladad and Associates Law Offices (BDB Law), a member-firm of World Tax Services (WTS) Alliance.

 If you have any comments or questions concerning the article, you may e-mail the author at eveart.pomarin@bdblaw.com.ph or call 403-2001 local 311.