

INDIVIDUAL TAX SYSTEM REFORM PROPOSALS

By: Tax Management Association of the Philippines

BACKGROUND

Personal Income Taxation (PIT) plays a significant role in a developing country, like the Philippines. It is a means to raise revenues and, because of its personal nature, it strengthens the connection between taxpayers and the Government.

Currently, PIT revenues mainly arise from taxes imposed on labor income. Based on the BIR's collection performance, the Government still has to maximize its revenue opportunities from the self-employed and professionals (SEPs). Meanwhile, marginal income earners, who usually operate within the informal economy, still largely remain outside the tax system.

Revenue Collections from Individuals*	2013 (in PHP billions)
Withholding tax on wages	200.77
Withholding tax at source	20.79
Individual income tax	14.31
Capital gains tax	10.70
TOTAL	246.58

**From BIR Annual Report CY 2013*

The PIT bias towards labor income is also aggravated by the high marginal tax rates imposed under the current income tax table. The top statutory tax rate of 32% has remains unchanged since 1997, even if the corporate income tax rate was already reduced from 35% to 30% in 2009. Moreover, the P500,000 threshold for applying the top statutory tax rate has been in use since 1986, when a uniform tax table was prescribed for compensation, business and other income. Previously, separate income tax tables were used for the compensation and non-compensation income earners.

Meanwhile, as the Philippines prepares for the ASEAN Economic Community (AEC) 2015, there is a greater need for competitiveness in the PIT system, especially in light of human capital mobility. Currently, the Philippines has the highest effective tax rates within the ASEAN region, with other countries working towards reducing its PIT rates. In the case of Thailand, it already reduced its top PIT rate from 37% to 35% effective taxable year 2013. The lowering of tax rate

was specifically aimed at reducing the individual's tax burden, which would lead to more consumption and boost the domestic economy in the long run.

TAX REFORM PROPOSALS

With all these in mind, the Tax Management Association of the Philippines (TMAP) respectfully recommends the following comprehensive measures towards Individual Tax System reform.

These recommendations are anchored on the following objectives:

- Ensure greater fairness and equity in the tax system; and
- Simplify the system to enhance compliance, expand the base and, consequently, increase Government revenue collections

Target sectors for the reform are as follows:

- Compensation income earners
- Self-employed and Professionals (SEPs)
- Marginal Income Earners (MIEs)

PROPOSAL 1: REVISED INCOME TAX TABLE

The 1997 National Internal Revenue Code (NIRC) prescribes the following tax table:

			Tax Rate		
	Tax Base		Fixed Tax	In excess of	Rate
1		Not over P10,000			5%
2	Over P10,000	Not over P30,000	500.00	In excess of P10k	10%
3	Over P30,000	Not over P70,000	2,500.00	In excess of P30k	15%
4	Over P70,000	Not over P140,000	8,500.00	In excess of P70k	20%
5	Over P140,000	Not over P250,000	22,500.00	In excess of P140k	25%
6	Over P250,000	Not over P500,000	50,000.00	In excess of P250k	30%
7	Over P500,000		125,000.00	In excess of P500k	32%

TMAP proposes the following revised income tax table applicable for all individual taxpayers:

		TAX RATE		
TAX BASE		Fixed Tax	In excess of	Rate
	Not over P300,000	-	-	0%
Over P300,000	Not over P500,000	-	In excess of P300k	10%
Over P500,000	Not over P1,000,000	P20,000	In excess of P500k	20%
Over P1,000,000	Not over P2,500,000	P120,000	In excess of P1M	25%
Over P2,500,000		P495,000	In excess of P2.5M	30%

The proposed revised income tax table has the following features:

- a) **Simplified yet progressive income tax table.** From 7-tiers, the revised tax table has been reduced to 5-tiers with broadened income spread in-between levels. This also retains the “progressivity” of the tax system – i.e., the effective tax rate increases as income rises.

		TAX RATE			New Max Tax	New ETR
TAX BASE		Fixed Tax	In excess of	Rate		
	Not over P300,000	-	-	0%	-	0.00%
Over P300,000	Not over P500,000	-	In excess of P300k	10%	20,000.00	4.00%
Over P500,000	Not over P1,000,000	P20,000	In excess of P500k	20%	120,000.00	12.00%
Over P1,000,000	Not over P2,500,000	P120,000	In excess of P1M	25%	495,000.00	19.80%
Over P2,500,000		P495,000	In excess of P2.5M	30%		
		If at P3M			645,000.00	21.50%
		If at P5M			1,245,000.00	24.90%
		If at P10M			2,745,000.00	27.45%
		If at P50M			14,745,000.00	29.49%
		If at P100M			29,745,000.00	29.75%

- b) **Adjusted tax base to address the “bracket creep” phenomenon – i.e., inflation pushing income into higher tax brackets.** This is done by considering changes in consumer price index (CPI) since 1986. Thus, the P500,000 threshold for applying the top statutory tax rate is now pegged at P2,500,000.
- c) **Reduced top statutory rate from 32% to 30%, which is at the same level as corporate taxpayers.** This help ensures “neutrality” in the tax system – i.e., decisions are made on their economic merits and not for tax reasons. In this case, the choice of whether one operates a business as a corporation or as a single-proprietorship is decided by factors other than lower income tax enjoyed by corporations.

- d) **Unified P300,000 tax-exempt threshold to simplify the various tax deductions/exemptions.** This provides tax relief for all individuals regardless of their status. The P300,000 per year level assumes a monthly cost of living of P25,000 per individual. This amount more than adequately covers the tax-exemption currently being enjoyed by minimum wage earners and the proposed tax exemption for MIEs. Meanwhile, for compensation income earners, this amount is equivalent to around P23,000 in monthly basic salary (plus 13th month pay) and covers the following tax-exemptions, which they currently enjoy:

Tax Exemptions		(in PHP)
Personal Exemption		50,000.00
Additional Exemption (max)		100,000.00
Tax-exempt bonuses (max)		82,000.00
Tax-exempt de minimis cash allowances (balance)		68,000.00
Total		300,000.00

In light of ASEAN integration, this amount is comparable with the following ASEAN countries, which also provide for tax-exempt threshold in computing taxable income:

- Thailand – THB150,000 (P207k)
- Malaysia – MYR20,000 (P274k)
- Singapore – SGD20,000 (P703k)

- e) **Lower income tax rates to make Philippine workers competitive in view of workforce mobility upon ASEAN integration.** Currently, the Philippines effectively has the highest tax rates in the ASEAN region. The reduction in marginal tax rates will help avoid tax-induced labor migration by the Philippine workers.

To minimize revenue losses arising this proposal, a staggered reduction in the top statutory rate of 32% over a period of three (3) years may be considered. This is to enable the Government to immediately address the issue of high tax rates for the low-income and middle-income earners in the short-term while, ensuring that high-income earners get to fully benefit from it in the medium-term, when the Government would have already achieved a balanced budget.

PROPOSAL 2: AMENDMENTS FOR COMPENSATION INCOME EARNERS

In light of the above proposed revised income tax table, TMAP proposes the following amendments in relation to the taxation of salaried workers:

- **Re-define Tax-Exempt “De Minimis” Benefits**

- Current definition: *“facilities or privileges furnished or offered by an employer to his employees, provided such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, goodwill, contentment, or efficiency of his employees.”* [Section 2.79(D)(3)(d) RR 2-98]
 - Adopt US Internal Revenue Service (IRS) definition: *“one for which, considering its value and the frequency with which it is provided, is so small as to make accounting for it unreasonable or impractical. An essential element of a de minimis benefit is that it is occasional or unusual in frequency. It also must not be a form of disguised compensation.”*
 - Examples of “De Minimis” benefits under the IRS rules:
 - *Controlled, occasional employee use of photocopier*
 - *Occasional snacks, coffee, doughnuts, etc.*
 - *Occasional tickets for entertainment events*
 - *Holiday gifts*
 - *Occasional meal money or transportation expense for working overtime*
 - *Group-term life insurance for employee spouse or dependent with face value not more than \$2,000*
 - *Flowers, fruit, books, etc., provided under special circumstances*
 - *Personal use of a cell phone provided by an employer primarily for business purposes*
 - With the proposed unified P300k tax-exempt threshold, all cash allowances currently considered as tax-exempt “De Minimis” benefits will be considered taxable.
 - This proposal will simplify the tax-treatment of “De Minimis” benefits and eliminate discretion on the part of employers in treating cash allowances as tax-exempt benefits.
- **Modify the Fringe Benefits Tax (FBT) System**
- Given the reduction in the top statutory rate from 32% to 30%, there is a need to adjust the FBT rate accordingly.
 - There is also a need to re-define “Fringe Benefit” to remove the bias against rank and file employees. An amendment is also needed to make cash benefits subject to compensation withholding tax based on the employee’s actual effective tax rate, rather than to FBT, which is based on the maximum statutory tax rate.

- Current definition of “Fringe Benefit”: *“any good, service, or other benefit furnished or granted by an employer in cash or in kind, in addition to basic salaries, to an individual employee (except rank and file employee)”* [Section 2.33 (B), RR No. 3-98]
- Proposed definition: *“any good, service, or other benefit furnished or granted by an employer ~~in cash or~~ in kind, in addition to basic salaries, to an individual employee (except rank and file employee)”*

PROPOSAL 3: SIMPLIFIED TAX SYSTEM FOR BUSINESS INCOME EARNERS AND PROFESSIONALS

Background

In 2012, MSME (Micro, Small and Medium Enterprises) data from the National Statistics Office (NSO) disclosed the following:

- 97% of total establishments nationwide were MSMEs (940,886). Of these establishments, 91% were micro firms (844,764) and 9% were small firms (92,027).
- 61% of total employment was generated by MSMEs (4,930,851), of which 30% were employed by micro firms (2,316,664).
- 36% of total value-added was contributed by MSMEs, amounting to P751.9B, of which about 5% of total value-added was generated by micro firms (P103.9B).

CLASSIFICATION	ASSET SIZE	EMPLOYEES
Micro	Below P3M	1-9
Small	P3M – P15M	10-99
Medium	P15M – P100M	100-199
Large	Above P100M	More than 200

The MSME sector has long been recognized as a critical driver of the economy’s growth. Bulk of this sector consists of micro firms, which are mostly owned by individual taxpayers. Given that there are a lot of micro firms but, their contribution to the economy as a whole may not yet be that significant, there is a need to weigh the cost and benefit of imposing the same tax burden on these micro firms vis-à-vis the large firms and other SMEs.

Meanwhile, the 2013 BIR Annual Report showed the following data on registered individual taxpayers per type:

REGISTERED TAXPAYERS	Number
Compensation Income Earners	12,076,663
Professionals	234,908
Single Proprietorships	1,942,583
OFW/Non-resident Citizens	57,188
TOTAL	14,311,342

Marginal Income Earners	115,053
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Out of the 14.3M registered taxpayers, only about 2.2M (15%) represent individuals who are either engaged in business or engaged in the practice of their profession. Thus, there is a need to further expand the tax base to increase the number of registered taxpayers, who are non-compensation income earners.

In addition, out of the number of registered taxpayers, only about a handful actually filed their tax returns with the BIR.

Based on the same 2013 BIR Annual Report, the number of tax returns filed per return type is as follows:

Tax Returns Filed	Total	Computed Average
1701 – SEPs	579,349	
1701Q - SEPs	1,132,011	283,000
2550M - VAT	1,351,042	112,587
2550Q - VAT	774,163	193,540
2551M - PT	5,186,143	432,178
TOTAL		

[Computed average was derived by dividing the total by the number of returns filed by the applicable frequency during the year – e.g., if quarterly return, total divided by 4 quarters; if monthly return, total divided by 12 months]

With this, income tax and business tax compliance appears to be low even among the registered individual taxpayers. *[Note: VAT filing data would also include tax filings by corporations since no separate data was available for corporate and individual taxpayers.]*

Global Best Practice: The Simpler, The Better

An informal survey of certain tax regimes across the globe* disclosed the following in connection with the taxation of small businesses and other businesses within the informal economy:

**Survey countries: Mongolia, Italy, India, Germany, Brazil*

- Low, reasonable or just (and/or sometimes fixed) rate of taxation to encourage compliance.
- Process is simplified in order to encourage more people to avail and pay the tax.
- Sometimes, certain tax regimes permit the “no audit” advantage; some also provide an exemption to the requirement of maintaining books and records.
- Coverage in terms of activities or taxpayers is broad – i.e., not limited to small income earners but even includes professional activities. This is probably because to determine whether one may avail or not is, in itself, a disincentive for taxpayers to understand the regime and comply with tax rules all together.
- Most of the systems discussed seem to adopt the view that collection will be improved if the tax rate is just or reasonable and the system, in itself, is convenient and easy to understand and comply with. This is the opposite of the system that believes it will be able to collect more if the tax rates are high, even if the compliance rate is low because of said high tax rates and complicated procedures.

TMAP proposes the simplification of the tax system for business income earners and professionals alike to enhance compliance, expand the tax base and, consequently, provide additional revenues to the Government. This is one significant area of tax reform, which is needed by a developing country like the Philippines.

Simplification, which reduces compliance costs on the part of the taxpayer, has the following benefits:

- It results to cost savings and greater ease of doing business, which encourages the growth of existing businesses and the creation of new ones.
- It encourages businesses in the informal sector to move out into the formal sector.
- It reduces corruption by increasing transparency and minimizing the points of contact between taxpayers and tax authorities.
- It improves compliance on the part of the taxpayer and reduces the cost of collection on the part of the tax authority.

With this in mind, TMAP proposes the following to simplify the tax system for individuals engaged in business and in the practice of their profession:

▪ **SIMPLIFIED TAX BASE:**

Prefer the use of the Optional Standard Deduction (OSD) Method by providing the following incentives --

Methods	Deduction	AFS	Tax Filing	Tax Audit
OSD*	40% of <u>Gross Income**</u>	X	Quarterly OR Annual	X [Last Priority]
Itemized	Deductible Expenses (same as corporations)	✓ .	Quarterly AND Annual	✓ .

** To minimize discretion on the part of the taxpayer claiming the expense and the tax authority upon examination/audit*

*** Gross Sales/Receipts less Direct Costs (same OSD base as corporations)*

▪ **SIMPLIFIED VAT SYSTEM:**

- For an efficient VAT system, it is important to set the VAT-exempt threshold at a point where collection costs saved is equivalent to foregone revenues. The higher the threshold, the more efficient the system is.
- To work on the current VAT system, TMAP proposes to provide for a presumptive VAT regime, which will help transition VAT-exempt taxpayers to the regular VAT system.

Annual Sales	VAT Regime**	Books of Accounts	Invoicing/Receipting	Designated Wtax Agent
Below P2M	VAT-Exempt	Simplified	Optional-Simplified	X
P2M – P10M	Presumptive VAT*	Simplified	Mandatory-Simplified	X
Above P10M	Regular VAT	Regular	Mandatory-Regular	✓ .

** With presumptive input VAT pegged at a certain % resulting to a net presumptive VAT rate (e.g., fixed net VAT payable of 2%?)*

*** Maintain option by taxpayer to register under regular VAT regime, even if annual sales is P10M or below*

- For those with annual sales below P2M: including marginal income earners
 - Exempt from 3% Percentage Tax: delete Section 116 of the Tax Code
 - Annual BIR Registration Fee of P500 only
- For those with annual sales from P2M to P10M:
 - Need for VAT registration
 - File quarterly VAT returns only (Note: No monthly VAT returns) and pay presumptive VAT based on sales

- c. Required to issue VAT invoice/OR for sales/receipts to document output VAT and submit Summary List of Sales (SLS)
- d. Exempt from input VAT substantiation and submission of Summary List of Purchases/Importations (SLP/SLI)

▪ **SPECIAL WITHHOLDING VAT REGIME FOR INDIVIDUALS:**

- TMAP proposes to introduce this option for a VAT-registered individual taxpayer, which has VAT-registered corporate clients. This will be most apt for individuals engaged by their corporate clients as management/technical consultants, talents, professional athletes, etc.
- Condition: VAT-registered individual taxpayer should be willing to forego claim of input VAT for exemption from VAT compliance requirements (i.e., need to sign a waiver/authorization)
- Mechanics:
 - a. Individual taxpayer opts to register solely under Withholding VAT system.
 - b. VAT-registered corporate client to remit the 12% withholding VAT on behalf of the individual taxpayer and provide a withholding VAT certificate as proof of remittance.
 - c. Individual taxpayer to prepare an annual withholding VAT summary return to report all receipts subject to withholding VAT, with withholding VAT certificates attached to the annual return.
- Benefits:
 - a. Ease of compliance for VAT-registered individuals – i.e., No need for printing and issuance of VAT receipts, filing of monthly/quarterly tax returns, and submission of VAT reportorial requirements.
 - b. Ease of input VAT documentation for VAT-registered corporate clients

▪ **SIMPLIFIED BOOKKEEPING AND INVOICING/RECEIPTING REQUIREMENTS**

- Applicable to VAT-Exempt and Presumptive VAT taxpayers with gross sales P10M and below (as recommended above)
- Simplified Bookkeeping: require simple books of accounts on cash basis; no need for Audited Financial Statements (AFS). Current Tax Code requires an AFS for taxpayers with at least P150,000 gross quarterly sales.
- Simplified Invoicing/Receipting Requirement: increase threshold for invoicing/receipting requirement from P25 (under the current Tax Code) to P100.
- Administrative Proposal: Issue a “BIR Tax Kit,” which provides one (1) cash ledger for receipts and disbursements, and pre-printed cash invoice/OR to taxpayers for a reasonable fee

▪ **TAX AMNESTY FOR INDIVIDUAL TAXPAYERS**

- One important component of this tax reform proposal is the grant of tax amnesty. This is to enable taxpayers to start with a clean slate once they become part of the system, without fear of being harassed for non-compliance in prior years.
- Condition: Those availing of the amnesty need to pay a certain amount to BIR to be fair with those who have long been compliant and help generate one-time revenues for the Government in the year of implementation; examples –
 - a. Declare should-be taxable income and pay income tax (without interest/penalties) for the past 3 years;
 - b. Fixed percentage of net worth or fixed amount, whichever is higher.
- Mechanics:
 - a. Application and declarations subject to review by the BIR; it will be deemed approved within 180 days if no action is undertaken by the BIR.
 - b. BIR to issue a Certificate of Availment as proof of availment.

PROPOSAL 4: REVENUE MEASURE -- INCREASE IN CAPITAL GAINS TAX (CGT) RATE FOR SALE OF UNLISTED SHARES

A survey of ASEAN countries disclosed the following in terms of the taxation of capital gains on unlisted shares of stocks:

- Several countries do not impose CGT: Brunei, Laos, Malaysia and Singapore
- Several countries tax capital gains as ordinary profit: Cambodia, Indonesia, Myanmar (10%) and Thailand
- The Philippines is the only country which taxes it separate from ordinary income.
- The only other exception is Vietnam, which taxes it either at 20% of the net profit or at 0.1% of the transfer price, whichever is higher.

Country	Capital Gains Tax
Brunei	none
Cambodia	Taxed as profit - 20% max rate
Indonesia	Taxed as ordinary income
Laos	none
Malaysia	none
Myanmar	Taxed as ordinary income: 10% - residents; 40% - nonresidents
Philippines	5% for 1st P100k; 10% in excess
Singapore	none
Thailand	Taxed as ordinary income
Vietnam	20% of net profit or 0.1% transfer price

Meanwhile, the Philippine CGT rates of 5% to 10% are far below the regular income tax rates imposed on individuals and corporations. Thus, in order to mitigate the reduction in PIT rates, this is one possible revenue measure that the Government can look into to ensure greater equity and fairness in the system. The only downside is that this type of tax is purely transactional and cannot be predicted with regularity.

In any case, TMAP proposes the increase in CGT rates on the sale of unlisted shares of stocks as follows:

CAPITAL GAINS	Tax Rate
Not over P1M	10%
In excess of P1M	15%

With this proposal, those with capital gains of P1M and below will remain to be taxed at the rate of 10% while, those with gains in excess of P1M will be taxed at the higher rate of 15%. This will bring the CGT rates closer to the effective PIT rates and still make the rates competitive within the ASEAN region (i.e., ranging from 10% to 20%).