

**THE HONGKONG & SHANGHAI BANKING CORPORATION,
PLAINTIFF AND APPELLANT, VS. JAMES J. RAFFERTY, AS
COLLECTOR OF INTERNAL REVENUE OF THE PHILIPPINE ISLANDS,
DEFENDANT AND APPELLANT.**

G.R. No. 13188. November 15, 1918

Ponente: MALCOLM, J.

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MALCOLM, J.:

The important subject of tax liens is to be discussed on this appeal.

FACTS.

During the years 1912-1915 inclusive, Pujalte & Co., a general mercantile partnership, was engaged in the business of lumbering in Mindanao. The company removed from the forests and milled at its saw mills during this period, a total of 6,087.54 cubic meters of timber. The forest charges amounted to P8,328.93. Upon the execution of bonds in the aggregate sum of P2,000 to secure the payment of the forest charges due the government, the Collector of Internal Revenue permitted Pujalte & Co. to remove this timber from the public forests for shipment by sea on saw mill invoices without prior payment of the forest charges. From the timber so removed, by Pujalte & Co., railroad ties were manufactured in its saw mills at Manila for the Manila Railroad Co. Six thousand three hundred and five railroad ties so manufactured were rejected by the Manila Railroad Co.

In February, 1915, the firm of Pujalte & Co. was indebted to the Hongkong and Shanghai, Banking Corporation in a large sum of money. Being unable to pay its debt in specie, the company assigned to the bank, among other things, a large quantity of the railroad ties manufactured at its mills. The bank sold and disposed of these ties at various times until in May, 1916, there remained with it some 2,000 railroad ties of the lot acquired.

The internal revenue charges on the forest products removed from the public forests of Mindanao by Pujalte & Co. not having been paid, on May 2, 1916, the Collector of Internal Revenue caused delinquency proceedings to be commenced and had issued a distress warrant. Later, on May 15, 1916, the Collector of Internal Revenue caused an additional distress levy to be made upon the 6,305 ties; which it will be remembered, had been assigned by Pujalte & Co. to the Hongkong & Shanghai Banking Corporation. Proceeding in accordance with this action, the Collector of Internal Revenue seized the 2,000 ties in the possession of the bank. Until the date last mentioned, the bank had no notice of the tax.

Payment under protest, institution of complaint to recover back the sum paid, answer by the Government, trial, and judgment followed in due course. In this judgment, handed down by the Honorable James A. Ostrand, it was declared that a lien for taxes existed on the 2,000 railroad ties levied upon by the Collector of Internal Revenue and claimed as its property by the Hongkong & Shanghai Banking Corporation, not for the full sum of P8,328.93 due as forest charges on the timber removed from the forests of Mindanao by Pujalte & Co., but only for the sum of P316.43, which is the tax upon the timber used for the manufacture of the ties. The court ordered the Collector

of Internal Revenue to refund to the Hongkong and Shanghai Banking Corporation the sum of P8,012.50, with interest at 6 per cent per annum from February 1, 1917. No costs were allowed. Following timely motions for a new trial, JJenial, and exceptions thereto, both parties have appealed.

This brings us to a statement of the

LAW.

Among the sources of taxes, fees, and charges, in the nature of internal revenue taxes, the Internal Revenue Law enumerates charges for forest products. (Sec. 21 (f), Act 2339, now sec. 1438 (f), Administrative Code of 1917.) The Internal Revenue Law of 1914 also contains the following provisions relative to the nature and extent of tax liens:

"Every internal-revenue tax on property or on any business or occupation and every tax on resources and receipts, fd any increment to any of them incident to delinquency, all constitute a lien superior to all other charges or liens not only on the property itself upon which such tax may be imposed but also upon the property used in any business or occupation upon which the tax is imposed and upon all property rights therein.

"The lien of the tax on inheritances, legacies and other acquisitions mortis causa shall have preference over any real right created thereon subsequent to the death of the predecessor, but this preference will be extinguished at the end of five years from' the date when the tax becomes payable upon real property, and three years upon any other kind of property." (Sec. 149, Act No. 2339, now section 1588, Administrative Code of 1917.)

The succeeding section of the same law authorizes two civil remedies for the collection of internal revenue taxes: (a) by distraint of personal property and upon exhaustion thereof by levy upon real property, and (b) by legal action. (Sec. 150, Act No. 2339, now section 1589, Administrative Code of 1917.) Relative to the first remedy by distraint of personal property, the same law in section 151 provides:

"The remedy by distraint shall proceed as follows: Upon the failure of the person owing any delinquent tax or delinquent revenue to pay the same, at the time required, the Collector of Internal Revenue or his deputy may seize and distrain any personal property belonging to such person or any property subject to the lien in sufficient quantity to satisfy the tax, or charge, together with any increment thereto incident to delinquency, and the expenses of the distraint." (Now section 1590, Administrative Code of 1917.)

One fact stands out prominently on examination of these provisions of the Internal Revenue Law—the internal revenue tax constitutes a paramount lien either on the property upon which the tax is imposed or on any other property used in any business or occupation upon which the tax is imposed. The government has here chosen to levy on the property itself—in the hands of a purchaser for value.

This brings us to a statement of the

ISSUES.

Does the lien follow the property subject to the tax into the hands of a third party when at the time of transfer, no demand for payment had been made and when the purchaser had no notice of the existence of the lien? Counsel for plaintiff argues that it does not. Or, does the lien follow the property subject to the tax even though transferred to a third party who had no notice of the existence of the lien so as to make this property respond for the specific unpaid internal revenue taxes due on it? The trial court so found. Or, does the lien follow the property subject to the tax even though transferred to a third party who had no notice of the existence of the lien so as to make this property respond for all the unpaid internal revenue taxes due from the vendor? The government so opines.

This brings us to a statement of the following

OPINION.

1. Major Issue; Tax Liens.—Taxation is an attribute of sovereignty. The power to tax is the strongest of all the powers of government. If approximate equality in taxation is to be attained, all property subject to a tax must respond, or there is resultant inequality. Under the most favorable circumstances, an enormous amount of property escapes taxation altogether. To prevent such a lamentable situation, the law ordains that the claim of the State upon the property of the tax debtor shall be superior to that of any other creditor.

A lien in its modern acceptance is understood to denote a legal claim or charge on property, either real or personal, as security for the payment of some debt or obligation. Its meaning is more extensive than the *jus retentionis* (*derecho de retention*) of the civil law. (2 Giorgi, *Teoria de las Obligaciones*, 419; *Ames vs. Dyer*, 41 Me., 397.) Unless the statute is otherwise, the rule is that a valid lien created on real or personal estate is enforceable against property in the hands of any person, other than a bona fide purchaser for value without notice, who subsequently acquires the estate. (25 Cyc., 680, citing cases.)

The general rule of the Civil Law may be different. Possession of movables is not necessary to the validity of a lien, whether created by contract or by act of law. Such lien will attach upon movable property, even in the hands of a bona fide purchaser without notice. (*Tatham vs. Andree* [1863], 1 Moore, P. C. [N. S.], 386; *The Bold Buccleugh* [1850], 7 Moore, P. C., 267.)

The law of taxation establishes principles which generally, although not exactly, conform to the law of liens. The tax lien does not establish itself upon property which has been transferred to an innocent purchaser prior to demand. In a decision relating to the United States Internal Revenue Law, Mr. Justice Miller held that a demand is necessary to create and bring the lien into operation. (*U. S. vs. Pacific Railroad Co.* [1877], Fed. Cas. No. 15, 984; *U. S. vs. Pacific Railroad Co.* [1880], 1 Fed., 97.) Where a statute makes taxes on personal property a lien thereon, a purchaser of such property takes the same free from any lien for taxes if the title passes before such a lien attaches by levy, distraint, or otherwise. (*Shelby vs. Tiddy* [1896], 118 N. C., 792.)

In order that the lien may follow the property into the hands of a third party, it is further essential that the latter should have notice, either actual or constructive. The reason is the benevolence of our Constitution which prohibits the taking of property without due process of law. In the case of real estate or special assessment taxation a man cannot get rid of his liability to a "tax by buying without notice. (*City of Seattle vs. Kelleher* [1904], 195 U. S., 351.) The rule, however, is different where the vendee has no knowledge of the taxes on personalty existing at the time, or had no means of knowing from the public records that such taxes had accrued.

The authorities relied upon by the Government will be found on examination to concern real estate taxation.

Internal revenue laws are to be construed fairly for the government and justly for the citizen. They should receive a liberal construction to carry out the purposes of their enactment; they should not receive so loose a construction as to permit evasions on merely fanciful and insubstantial distinctions. "The internal revenue laws cannot be so construed as to extend their meaning beyond the clear import of the words used." (*U. S. vs. Watts* [1865], Fed. Cas. No. 16653. See also *U. S. vs. Hodson* [1870], 10 Wall., 395; *U. S. vs. Kallstrom* [1887], 30 Fed., 184; *Hubbard vs. Brainard* [1869], 35 Conn., 563, and *Mufioz & Co. vs. Hord* [1909], 12 Phil., 624.)

With such general principles in mind, we should first ascertain the legislative intention. One detail indicative of such intent is noted in the more limited scope of the law pertaining to liens for internal revenue taxes as contrasted with the law pertaining to liens for real estate taxes. The municipal law in part provides that liens for real property taxes "shall be enforceable against the property whether in the possession of the delinquent or any

subsequent owner." (Now section 364, Administrative Code of 1917.) No mention of the subsequent owner is found in the Internal Revenue Law. Nor does this law provide that the lien shall not be divested by alienation.

Again, we can very well look to the policy of the law in respect to liens. Liens, it has well been said, are of too sacred character to be impaired by vague and uncertain implications. The lien which the law favors is the specific or particular lien and not the general lien. However, the policy of the law is against upholding secret liens and charges against the property of innocent purchasers or encumbrancers for value. (See *Palmer vs. Howard* [1887], 72 Cal., 293; 17 R. C. L., 599.)

Keeping the foregoing statement of facts, issues, and law before us, the present case offers no serious difficulty. The plaintiff was not of course personally liable for any part of the internal revenue taxes due the Government from Pujalte & Co. On the date the railroad ties were transferred from Pujalte & Co. to the Hongkong & Shanghai Banking Corporation no demand for payment of the tax had been made. The bonds in favor of the Government were still presumably subsisting. No demand in fact was made until over a year later when distraint proceedings were initiated. When the Hongkong & Shanghai Banking Corporation purchased and acquired these 2,000 ties in February, 1915, there was nothing to show that Pujalte & Co. were delinquent tax payers. No public record could be consulted to protect the purchaser from loss by reason of the existence of a secret lien. A businessman of ordinary prudence could not be expected to foresee that the personal property which he had taken in satisfaction of a debt was burdened by a tax. On this date, because no demand had been made and because the plaintiff had no notice of the tax, there was no valid subsisting lien upon the ties.

2. Minor Issue; Interest upon Judgments to Recover Taxes.—Plaintiff-appellant in assignment of error No. 4 also claims interest upon the amount of the judgment from the 3d day of June, 1916, in place and instead of allowing interest thereon from the first day of February, 1917. The first date is that of the illegal exaction; the second date is that of the commencement of the action. Interest should be allowed from the day when the taxpayer lost the income from the funds by payment under protest, or not at all. (*Viuda e Hijos de Pedro P. Roxas vs. Rafferty* [1918], 37 Phil., 957; *H. E. Heacock Co. vs. Collector of Customs* [1918], 37 Phil., 970.)

On the other hand, the second assignment of error of the defendant-appellant is to the effect that no interest at all should have been allowed by the trial court because of section 1579 of the present Administrative Code. Plaintiff-appellant in answer challenges the validity of this section.

Section 1579 of the Administrative Code of 1917 in part authorizes the taxpayer who has paid an internal revenue tax under protest, at any time within two years after the payment of the tax, "to bring an action against the Collector of Internal Revenue for the recovery without interest of the sum alleged to have been illegally collected." As this provision was enacted by the Philippine Legislature subsequent to the institution of the present action in the lower court, and subsequent to the judgment therein rendered, we do not feel that the law should be given a retroactive effect. Whether section 1579 of the Administrative Code is valid or not is left for decision when a case arises after the Code became effective. In this instance, we allow interest at the legal rate from the date of payment.

3. Minor Issue; Costs Against the Government.—Plaintiff-appellant further claims that the trial court erred in declining to allow the recovery of costs.

The right to recover costs is governed by statute. In the United States, the rule is that unless expressly authorized by statute, a judgment for costs, either in a civil or a criminal case, cannot be rendered against the United States or a State. The principle is that the sovereign power is not amenable to judgments for damages or costs without its consent. (*U. S. vs. Barker* [1817], 2 Wheat., 395; *Stanley vs. Schwalby* [1896], 162 XL S., 255; *State vs. Williams* [1905], 101 Md., 529; 4 A. & E. Ann. Cas., 970; *Deneen vs. Unverzagt* [1907], 225 111., 378; 8 A. & E. Ann.

Cas., 396 and note; Townsend's Succession [1888], 40 La. Ann., 66.)

The Code of Civil Procedure of the Philippine Islands provides that costs shall ordinarily follow the result of the suit. They are to be recovered by "the prevailing party." (Code of Civil Procedure, chapter 21.) In the ordinary case between private individuals or entities, or where the government is successful, no particular difficulty is experienced in applying the Code provisions. The practice has, however, been not to allow costs in cases in which the Government of the Philippine Islands or a nominal representative of the Government is the unsuccessful party. And this is right—for the Government of the Philippine Islands is sovereign in the sense that a State of the American Union or Porto Rico is sovereign, and this paramount power has not by statute permitted itself to be taxed with costs.

No costs should be allowed plaintiff in either instance.

This brings us to a statement of the

JUDGMENT.

Judgment is reversed and the plaintiff shall have and recover from defendant the full amount sued for, P8,328.93, with interest at the legal rate from June 3, 1916, until paid, and without costs in either instance. So ordered.

Torres, Johnson, Carson, and Araullo, JJ., concur.

DISSENTING AND CONCURRING OPINION

STREET, J., dissenting and concurring in part:

The lien created by law for the enforcement of the tax on land is expressly declared to be enforceable against the property in the hands of any person, whether the delinquent or any subsequent owner. (See sec. 364, Administrative Code, 1917; section 2497, *id.*, for city of Manila.) On the other hand, that section of the Internal Revenue Law which declares a lien for internal-revenue taxes merely says that such lien shall be superior to all other charges or liens. (Sec. 1588, Administrative Code, 1917.) From this it can be fairly, though not, I think, conclusively argued that the lien for the enforcement of internal revenue taxes was not intended to be effective against subsequent owners. Acceding to the force of this argument, I should perhaps have yielded my own views and expressed my conformity with the decision upon this as upon other points involved in the case. Nevertheless I cannot refrain from expressing my regret that the court should have reached the conclusion it has announced with respect to the lien declared in section 1588 of the Code, and it is my opinion that the lien created in this section has the same effect and range as the lien which is created in support of the land tax.

The obvious effect of the decision on the point in question is to destroy the practical utility of the lien created by section 1588; because so long as the property subject to the tax is in the hands of the person primarily liable for the tax, it can be seized by the Collector of Internal Revenue under process of distraint and thus subjected to the payment of the tax (section 1690, Administrative Code, 1916). No lien is therefore necessary to enable the government to take the property and enforce its rights as. against him. It is only when the property passes into the hands of some other person than the one primarily liable that the existence of a lien becomes of any importance.

It is inherent in the nature of a lien, as a real obligation fixed on the property, that it should remain as a burden thereon regardless of mutations in the ownership; and a lien, like this, created by express provision of law and made superior to all other charges and liens, necessarily continues to subsist regardless of whether the subsequent owner or purchaser of the property has notice of the lien or not. I am not convinced by the citation of the

American authorities, referred to in the opinion of the Court, and I think that the deductions drawn by the Court from those cases is unwarranted. It is well known that mere equitable liens, as recognized in American jurisprudence, are not enforceable against purchasers without notice; but this doctrine I consider to be inapplicable to a statutory lien, such as is involved in this case.

The possibility of the existence of some hidden lien like this was recognized by the Hongkong & Shanghai Bank at the time it bought these rails, for the very contract of transfer, or assignment, by which it acquired the property contains a provision whereby Pujalte & Company warranted that, at the date of the transfer, the rails were the absolute property of that company and were "free and clear of any liens, charges, and encumbrances," and warranted the title against all lawful claims of all persons whomsoever. It is obvious that Pujalte & Company would be liable upon this warranty, if the lien should be enforced; and I think this the simplest solution that can be made of the case.

I am, therefore, constrained to express my disagreement with the conclusion of the court with respect to the liability of the rails in question for the tax due upon them; and I think that the trial court committed no error in refusing a refund of the amount thereof (P316.43). Upon other points I concur.

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