IMPLEMENTING SECTION 34(B) OF THE TAX CODE OF 1997 ON THE REQUIREMENTS FOR DEDUCTIBILITY OF INTEREST EXPENSE FROM THE GROSS INCOME OF A TAXPAYER

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SECTION 1. Scope - Pursuant to the provisions of Section 244 of the Tax Code of 1997, these Regulations are hereby promulgated to implement the provisions of Section 34(B) of the same Code on the requirements for deductibility of interest expense from the gross income of a corporation or an individual engaged in trade, business or in the practice of profession.

SEC. 2. Definition of Terms - For purposes of these Regulations, the following words and phrases shall have the following meaning, viz:

(a) Interest - shall refer to the payment for the use or forbearance or detention of money, regardless of the name it is called or denominated. It includes the amount paid for the borrower's use of money during the term of the loan, as well as for his detention of money after the due date for its repayment.

(b) Taxpayer- shall refer to a person, whether natural or juridical, engaged in trade, business or in the exercise of profession, except one earning compensation income arising from personal services rendered under an employer-employee relationship.

SEC. 3. Requisites for Deductibility of interest Expense - In general, subject to certain limitations, the following are the requisites for the deductibility of interest expense from gross income, viz:

(a) There must be an indebtedness;

(b) There should be an interest expense paid or incurred upon such indebtedness;

(c) The indebtedness must be that of the taxpayer;

(d) The indebtedness must be connected with the taxpayer's trade, business or exercise of profession;

(e) The interest expense must have been paid or incurred during the taxable year;

(f) The interest expense must have been stipulated in writing;

(g) The interest must be legally due;

(h) The interest payment arrangement must not be between related taxpayers as mandated in Sec. 34{B)(2)(b), in relation to Sec. 36(B), both of the Tax Code of 1997;

(i) The interest must not be incurred to finance petroleum operations; and

(j) In case of interest incurred to acquire property used in trade, business or exercise of profession, the same was not treated as a capital expenditure.

SEC. 4. Rules on the Deducibility of Interest Expense

(a) General Rule - In general, the amount of interest expense paid or incurred within a taxable year on

indebtedness in connection with the taxpayer's trade, business or exercise of profession shall be allowed as a deduction from the taxpayer's gross income.

(b) Limitation - The amount of interest expense paid or incurred by a taxpayer in connection with his trade, business or exercise of a profession from an existing indebtedness shall be reduced by an amount equal to the following percentages of the interest income earned which had been subjected to final withholding tax depending on the year when the interest income was earned, viz:

Forty-one percent (41%) beginning January 1, 1998;
Thirty-nine percent (39%) beginning January 1, 1999; and

Thirty-eight percent (38%) beginning January 1, 2000 and thereafter.

This limitation shall apply regardless of whether or not a tax arbitrage scheme was entered into by the taxpayer or regardless of the date when the interest bearing loan and the date when the investment was made for as long as, during the taxable year, there is an interest expense incurred on one side and an interest income earned on the other side, which interest income had been subjected to final withholding tax. This rule shall be observed irrespective of the currency the loan was contracted and/or in whatever currency the investments or deposits were made.

Illustration: Supposing on January 15, 1998, Company A, Who has a deposit account with BCD Bank, obtained a loan from XYZ Financing Corporation in connection with the operation of its business. Assume that Company A's net income for the year 1998 before the deduction of the interest expense amounted to P1,000,000. For the year 1998, the interest income it derived from the said deposit with BCD Bank amounted to P180.000 on which a final tax of P36.000 had been withheld. Its interest expense on the loan obtained from XYZ Financing Corporation during the same year amounted to P150,000.

Under this illustration, the deductible interest expense, the taxable income and the income tax due of Company A shall be computed as follows:

1998

Net income before interest expense

P 1,000,000

Less: Interest Expense

P150,000

Less: 41% of interest income from Deposit (41% x P180,000)

73,800

Deductible interest expense

76,200

Taxable income

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P 923.800

Income tax due for taxable year 1998 (34%)

P 314.092

(c) lnterest on Unpaid Taxes - Provisions of Sec. 4(b) hereof to the contrary notwithstanding, interest incurred or paid by the taxpayer on all unpaid business-related taxes shall be fully deductible from gross income and shall not be subject to the limitation on deduction heretofore mentioned. Thus, such interest expense incurred or paid shall not be diminished by the percentage of interest income earned which had been subjected to final withholding tax.

(d) Other cases where interest expense is not deductible from gross income - No interest expense shall be allowed as deduction from gross income in any of the following cases:

(1)lf within the taxable year, an individual taxpayer reporting income on the cash basis incurs an indebtedness on which an interest is paid in advance through discount or otherwise: Provided, That such interest shall be allowed as a deduction in the year the indebtedness is paid: Provided, further, That if the indebtedness is payable in periodic amortization, the amount of interest which corresponds to the amount of the principal amortized or paid during the year shall be allowed as deduction in such taxable year.

> Illustration: Mr. Cruz, a self-employed individual, consistently employs the cash-basis accounting method in keeping his books of accounts. Assuming that on January 1, 1998, he contracted a loan of P1,000,000 from XYZ Bank for use in his business operations. Terms: Payable in two (2) years at 15% interest per annum, payable in advance. On January 1, 1998, he received from the bank the proceeds of his loan in the sum of P700,000, net of interest paid in advance in the amount of P300.000.
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> In general, the interest expense shall be taken for the taxable year in which "paid or incurred" or "paid or accrued" depending upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income, the deduction should be taken as of a different period. Thus, a self-employed individual is allowed to deduct from his gross income the entire amount of interest expense actually paid during the taxable year. However, if the interest expense is paid in advance and the accounting method used by the self-employed individual is the cash-basis accounting method, such interest expense paid in advance shall only be allowed as deduction in the year when he has fully paid his liability. So that if the said debtor has fully paid his loan as of the end of the taxable year 1999, his interest expense paid in advance on January 1, 1998 in the amount of P300,000 shall only be allowed as deduction from his gross income in the taxable year 1999.
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> On the other hand, even if the interest expense is paid in advance but the indebtedness is payable in periodic amortization, the amount of interest expense which corresponds to the amount of the principal amortized or paid during the respective years 1998 and 1999 shall be allowed as deduction in such respective taxable years.

(2) If both the taxpayer and the person to whom the payment has been made or is to be made are persons specified under Sec. 36(B) of the Tax Code of 1997, viz:

> (j) Between members of a family. For purposes of this paragraph, the family of an individual shall include only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors and lineal descendants; or
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> (ii) Between an individual and a corporation more than fifty percent (50%) in value of the outstanding stock of which is owned, directly and indirectly, by or for such individual; or
>
> (iii) Between two corporations more than fifty percent (50%) in value of the outstanding stock of each of which is owned, directly or indirectly, by for the same individual; or

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(iv) Between the grantor and a fiduciary of any trust; or

(v) Between the fiduciary of a trust and the fiduciary of another trust if the same person is a grantor with respect to each trust; or

(vi) Between a fiduciary of a trust and a beneficiary of such trust.

(3) If the indebtedness on which the interest expense is paid is incurred to finance petroleum exploration in the Philippines. The non-deductible interest expense herein referred to pertains to interest or other consideration paid or incurred by a Service Contractor engaged in the discovery and production of indigenous petroleum in the Philippines in respect of the financing of its petroleum operations, pursuant to Section 23 of P.D. No. 8, as amended by P.D. No. 87, otherwise known as "The Oil Exploration and Development Act of 1972."

(e) Optional treatment of interest expense on capital expenditure -At the option of the taxpayer, interest expense on a capital expenditure incurred to acquire property used in trade, business or exercise of a profession may be allowed as a deduction in full in the year when incurred, the provisions of Sec. 36(A}(2) and (3) of the Tax Code of 1997 to the contrary notwithstanding, or may be treated as a capital expenditure for which the taxpayer may claim only as a deduction the periodic amortization of such expenditure.

SEC. 5. Repealing Clause - The provisions of any revenue regulation or any revenue issuance or ruling inconsistent with these Regulations are hereby repealed, amended, or modified accordingly.

SEC. 6. Effectivity Clause - These Regulations shall take effect immediately.

Adopted: 20 Nov. 2000

(SGD.) JOSET. PARDO
Secretary of Finance

RECOMMENDING APPROVAL:

(SGD.) DAKILA B. FONACIER
Commissioner of Internal Revenue

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