REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE
Quezon City

BUREAU OF INTERNAL REVENUE
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REVENUE MEMORANDUM CIRCULAR NO. 11-2024

SUBJECT: Clarifying the Tax Treatment of Lease Accounting by Lessees Under Philippine Financial Reporting Standard 16 in Relation to Sections 34(A), 34(K), 106, 108, 179, 194 of the Tax Code, as Amended, Revenue Regulations (RR) No. 19-86, as Amended, and RR No. 02-98, as Amended

TO: All Internal Revenue Officials, Employees and Others Concerned

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Background:

With the implementation of Philippine Financial Reporting Standard (PFRS) 16, various concepts related to lease accounting, such as the Right-of-Use-Asset (ROUA), short-term leases and low-value assets, have been introduced in the Philippine business setting. This circular is being issued to provide guidelines with respect to the tax treatment of lease accounting by lessees under PFRS 16 in relation to Sections 34(A), 34(K), 108, 179, 194 of the Tax Code, as amended, RR No. 19-86, as amended, and RR No. 02-98, as amended.

PART I. OVERVIEW OF PFRS AND TAX TREATMENT

Particulars	PFRS		Taxation	
	General approach[1]	Lease exemption[2]	Lease	Conditional sale
1. Depreciation of Right-of-use asset	Generally recognized as expense.	Not recognized.	Not allowed as deduction.	Depreciation of leased asset can be claimed as deduction from gross income.
2. Interest on lease liability	Generally recognized as expense.	Not recognized.	Not allowed as deduction.	Interest on lease liability can be claimed as deduction from gross income.
3. Rent expense	Generally not recognized.	Recognized on a straight-line basis over the lease term.	Allowed as deduction from the gross income.	Not recognized.

[1] Recognizes the Right-of-Use Asset
[2] Option not to recognize lease as ROUA

Particulars	PFRS		Taxation	
	General approach[1]	Lease exemption[2]	Lease	Conditional sale
4. Gain or loss on lease modification	Recognized in profit or loss at the time of modification.	Not recognized but may affect the amount of rent expense to be recognized in the subsequent period/s.	Not included in the determination of taxable income.	Does not apply to leases that qualify as conditional sale.
5. Initial direct costs paid/incurred by lessee	These are included in determining the cost of the ROUA. Accordingly, they are recognized as depreciation expense over the term of the lease.	Recognized as an outright expense.	Recognized as an outright expense during the period that the same is accrued or paid.	Recognized as an outright expense during the period that the same is accrued or paid.

PART II. PFRS TREATMENT

At the inception of a contract, an entity assesses whether the contract is, or contains, a lease based on the substance of the transaction. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. [PFRS 16.9].

A. Initial recognition

At the commencement date, a lessee recognizes a ROUA and a lease liability. (PFRS 16.22). This applies to all leases unless the lessee elects the short-term lease and/or lease of low-value asset recognition exemptions available in PFRS 16.

B. Initial measurement

A lessee initially measures the lease liability at the present value of the future lease payments discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee uses its incremental borrowing rate. (PFRS 16.260).

The ROUA is recognized initially at the amount of lease liability adjusted for:

- Any payments made to the lessor at or before the commencement date of the lease, less any lease incentives received;
- Any initial direct costs incurred by the lessee; and/or
- An estimate of any decommissioning costs.

C. Subsequent measurement

After the commencement date, a lessee measures the lease liability by increasing the carrying amount to reflect interest on the lease liability and reducing the carrying amount to reflect the lease payments made (PFRS 16.37). A lessee recognizes in profit or loss any interest incurred on lease liability. (PFRS 16.38).

ROUA is generally measured in the statement of financial position at cost less accumulated depreciation and accumulated impairment losses.

The depreciation of the right-of-use asset is also recognized in profit or loss, unless depreciation is permitted to be capitalized (e.g. to inventory) under other PFRS.

When a lessee depreciates the ROUA on a straight-line basis, the total periodic expense (i.e. the sum of interest and depreciation expense) is generally higher in the early periods and lower in the later periods. Because a constant interest rate is applied to the lease liability, the interest expense decreases as cash payments are made during the lease term and the lease liability decreases. Therefore, more interest expense is incurred in the early periods and less in the later periods. This trend in the interest expense, combined with straight-line depreciation of the right-of-use asset, results in a front-loaded expense recognition pattern.

D. Lease Modification

A lease modification is a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease (PFRS 16. Appendix A). Examples of lease modifications are adding or terminating the right to use one or more underlying assets or extending or shortening the contractual lease term.

A lease modification that does not decrease the scope of a lease will normally require recalculation of lease liability with a corresponding adjustment to the ROUA. This type of modification will not normally result in any gain or loss in the statement of income. In contrast, a lease modification that decreases the scope of a lease will require a partial de-recognition of the ROUA and lease liability. The difference between the amounts of reduction in the right-of-use asset and lease liability is recognized immediately in profit or loss.

E. Lease Exemptions

PFRS 16 provides a recognition exemption for short-term leases and leases of low-value items. PFRS 16 defines a short-term lease as a lease with a lease term of 12 months or less, but takes into consideration lease renewal options. A lease of low-value item, on the other hand, is a lease for which the underlying asset is of low value (per the standard, with a value of US$5,000.00 or the equivalent for new similar asset).

Lessees who avail of these exemptions do not have to recognize ROUA and the related lease liability in the statements of financial position. Instead, lease payments are recognized as expense, on a **straight-line basis**, or another systematic basis, if that basis is more representative of the pattern of the lessee's benefit.

PART III. TAX TREATMENT

Q1: For Income Tax Purposes, how are operating leases and finance leases defined?

A1: An operating lease is a contract under which the asset is not wholly amortized during the primary period of the lease, and where the lessor does not rely solely on the rentals during the primary period for his profits, but looks for the recovery of the balance of his costs and for the rest of his profits from the sale or re-lease of the returned asset of the primary lease period.

"Finance lease" or full payout lease, on the other hand, is a contract involving payment over an obligatory period (also called primary or basic period) of specified rental amounts for the use of a lessor's property, sufficient in total to amortize the capital outlay of the lessor and to provide for the lessor's borrowing costs and profits. The obligatory period refers to the primary or basic non-cancellable period of the lease which in no case shall be less than 730 days. The lessee, not the lessor, exercises the choice of the asset and is normally responsible for maintenance, insurance and such other expenses pertinent to the use, preservation and operation of the asset. Finance leases may be extended, after the expiration of the primary period, by non-cancellable secondary or subsequent periods with the rentals significantly reduced. The residual value shall in no instance be less than five percent (5%) of the lessor's acquisition cost of the leased asset.

Q2: What are the similarities and differences between the income tax treatment of operating and finance leases?

A2: Under an operating lease, the lessee may deduct the amount of rent paid or accrued, including all expenses which, under the terms of the agreement, the lessee is required to pay to or for the account of the lessor. If the payments are so arranged as to constitute advance rentals, such payments shall be duly apportioned or applied over the lease term.

The foregoing income tax treatment also applies to a finance lease, except that the lessor may be allowed a depreciation during the primary lease period, but such period shall not be less than sixty percent (60%) of the depreciable life of the property. For income tax purposes, the interest expenses computed based on the amortization are not accounted for separately from the principal payments.

Q3: For income tax purposes, how is a finance lease differentiated from a conditional sale?

A3: Notwithstanding the foregoing definition of finance lease in A1, when an agreement, which in form is a lease, but in substance a conditional sales contract based upon the intent of the parties as evidenced by the provisions of the agreement, read in the light of the facts and circumstances existing at the time the agreement was executed, such contract shall be considered as a conditional sale.

In this regard, Section 4.03/2 and Section 4.03/3 of RR No. 19-86 set the following criteria for characterizing the transaction:

1. Compelling Persuasive Factors: A contract or agreement purported to be a lease shall be treated as conditional sales contract if one or more of the following compelling persuasive facts are present:

    a) The lessee is given the option to purchase the asset at anytime during the obligatory period of the lease, notwithstanding that the option price is equivalent to or higher than the current fair market value of the asset;
    b) The lessee acquires automatic ownership of the asset upon payment of the stated amount of "rentals" which, under the contract, he is required to make;
    c) Portions of the periodic rental payments are credited to the purchase price of the asset;
    d) The receipts of payment indicate that the payments made were partial or full payments of the asset.

2. In the absence of the above compelling persuasive factors or contrary implication, an intent warranting treatment of a transaction for tax purposes as a purchase and sale rather than as a lease or rental agreement may in general be said to exist if, for example, one or more of the following conditions are present:

    a) Portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee.
    b) The property may be acquired under a purchase option, at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made.

Q4: What shall be the tax treatment of the depreciation on ROUA and the corresponding interest expense on lease liability for Income Tax Purposes?

A4: Under PFRS 16, no distinction is made between operating and finance leases, but rather, lessees are required to recognize the ROUA and the corresponding lease liability to the lease contract at the inception of the lease. Depreciation is then recognized on the value of the ROUA, together with the recognition of interest expense on the outstanding lease liability, both of which are recognized in the Income Statement.

However, for income tax purposes, the depreciation expense pertaining to the ROUA and the interest expense that is recognized for financial accounting purposes shall not be treated as deductible expenses. As such, only the actual amount of rent paid or incurred, including any other payments to lessors, based on the lease agreements, shall be allowed as deductions in arriving at the net taxable income pursuant to Section 34(A)(1)(a)(iii) of the Tax Code, as amended.

Q5: For reporting purposes on leases, what are the disclosures in the Notes to Financial Statements (NTFS) accompanying the Audited Financial Statements?

A5: Taxpayers may disclose the following information in the NTFS, in relation to leases, to wit:

- Depreciation charge for right-of-use assets by class of underlying asset;
- Interest expense on lease liabilities;
- The expense relating to short-term leases. This expense need not include the expense relating to leases with a lease term of one month or less;
- The expense relating to leases of low-value assets. This expense shall not include the expense relating to short-term leases of low-value assets;
- The expense relating to variable lease payments not included in the measurement of lease liabilities;
- Income from subleasing right-of-use assets;
- Total cash outflow for leases;
- Additions to right-of-use assets;
- Gains or losses arising from sale and leaseback transactions; and
- The carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset.

Q6: What shall be the income tax treatment of initial direct costs paid by the lessee in relation to the lease of an asset?

A6: For purposes of taxation, Initial Direct Costs shall be defined as payments which are directly related to the negotiation and execution of a lease agreement. The initial direct cost paid or incurred by the lessee in relation to the lease agreement shall be claimed as outright expenses in the year it was paid or incurred subject to substantiation and withholding requirements pursuant to Section 34 of the Tax Code, as amended.

Q7: What shall be the income tax treatment of expenses paid or incurred by the lessee which are properly for the account of the lessor?

A7: The amounts paid by the lessee for certain expenses, which are properly for the account of the lessor as indicated in the contractual agreement between the parties, shall be allowed as deductions during the year the same has been paid or accrued pursuant to Section 34 of the Tax Code, as amended. Provided, however, that the lessor shall issue invoices/receipts in the name of the lessee (e.g., realty tax, association dues, etc.).

Q8: What shall be the income tax treatment of short-term leases and lease of low-value assets?

A8: For purposes of taxation, short-term lease and lease for low-value assets shall be accounted for as an operating lease. Hence, only the actual rentals paid or accrued during the taxable year, in relation to the lease contracts, shall be recognized by the lessee as deductible expenses.

Q9: What shall be the income tax treatment of gains and losses from lease modifications?

A9: For income tax purposes, gains or losses from lease modifications shall not be included in the determination of taxable income as defined under Section 31 of the Tax Code, as amended.

Q10: What shall be the income tax treatment of security deposits paid in relation to a lease contract?

A10: For income tax purposes, if the advance payments made pursuant to a lease contract are in the nature of a security deposit for the faithful performance of certain obligations of the lessee, the same shall only be recorded as an asset in the year the advance payment is received. However, if the advance payment is a security deposit and the conditions which make the security deposit the property of the lessor occur, then the lessee shall be entitled to a deduction based on the amount of security deposit applied to the lease.

Q11: What shall be the income tax treatment of estimated restoration costs incurred relative to leased properties?

A11: For income tax purposes, estimated costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease shall only be considered as deductible expenses during the taxable year that the same has been actually paid or incurred pursuant to Section 34(A)(1)(a) of the Tax Code, as amended.

Q12: What are the business tax implications relative to leases?

A12: For business tax purposes, the following guidelines ***shall still*** be observed:

1. The corresponding input VAT shall only be creditable to the lessee upon payment of the rentals, which shall be evidenced by a VAT Official Receipt pursuant to Section 110 in relation to Section 113 of the Tax Code, as amended.

2. For transactions considered as conditional sale of real property rather than a lease, the following rules on installment sale of real property shall apply:

   a) In cases when the initial payment during the year of sale exceeds 25% of gross selling price, the same shall be considered as a cash sale which makes the entire selling price taxable in the year of sale;
   b) For installment sales where the initial payments in the year of sale do not exceed twenty-five percent (25%) of the gross selling price, the corresponding VAT shall be recognized on the installment payments, including interest and penalties, actually and/or constructively received by the seller.
   c) In all cases, the lessee/buyer can only claim the input tax in the same period as the lessor/seller recognized the output tax.

Q13: What are the withholding tax implications of leases?

A13: For contracts considered as leases, only the actual rental paid or accrued shall be subject to five percent (5%) Expanded Withholding Tax (EWT) pursuant to Section 2.57.2 (B) of RR No. 02-98, as amended. Hence, only the actual rental paid or accrued shall be considered as the tax base for EWT purposes, without regard to the depreciation expense from the ROUA.

For transactions considered as conditional sale of personal property, the same shall be considered as sales of goods, to the extent such amounts do not represent interest and other charges, the applicable EWT rate of which is one percent (1%) on income payments made by the Top Withholding Agents (TWA) to their local/resident supplier of goods pursuant to Section 2.57.2 (I) of RR No. 02-98, as amended. The interest related thereon shall be subject to fifteen percent (15%) EWT rate on interest income from any other debt instruments not within the coverage of deposit substitutes pursuant to Section 2.57.2 (S) of RR No. 02-98, as amended.

On the other hand, if the subject of the conditional sale is a real property, then the rules of withholding on the sale of real property pursuant to Section 2.57.2(F) of RR No. 02-98, as amended, shall apply.

Q14: What shall be the tax treatment of lease transactions for Documentary Stamp Tax purposes?

A14: For Documentary Stamps Tax (DST) purposes, lease transactions which qualify as finance lease transactions pursuant to the provisions of Republic Act (RA) No. 5980, as amended by RA No. 8556, shall be subject to the applicable DST rates on debt instruments pursuant to Section 179 of the Tax Code, as amended. Otherwise, the same shall be considered as operating lease transactions subject to DST on Lease Agreements pursuant to Section 194 of the Tax Code, as amended.

Illustrations and Accounting Entries are reflected in the Annex "A" hereof, as guide for recording and reporting of lease accounting by lessee.

All revenue issuances and BIR rulings inconsistent herewith are hereby considered amended, modified or revoked accordingly.

All internal revenue officers, employees and others concerned are hereby enjoined to strictly implement the provision of this Circular.

This Circular takes effect immediately.

ROMEO D. LUMAGUI, JR.
Commissioner of Internal Revenue

C (pfrs project)