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NIRC – ALLOWABLE DEDUCTIONS (Notes)
TRAIN LAW not yet implemented

Sec. 34. Deductions from Gross Income

Applicable only in computing the taxable income of the following taxpayers derived from trade or business, or practice of profession:

- a. Individual resident and nonresident citizens
- b. Individual resident aliens
- c. Non-resident alien individual engage in trade or business within PH
- d. GPP and partners
- e. Domestic corporation, including proprietary educational institutions and hospital; and GOCC, agencies, or instrumentalities
- f. Resident foreign corporations in general

Note that allowable deductions are not applicable to taxpayers earning compensation income arising from personal services rendered under employer-employee relationship

Construed strictly against taxpayer and liberally in favor of taxing authority.

General rules for deductibility of transactions from gross income.

- a. Deductions must be paid or incurred in connection with the taxpayer's trade, business, or exercise of profession;
- b. Deductions must be paid or incurred during the taxable year
- c. Deductions must be supported by adequate receipts or invoices
- d. Deductible expenses must have been subjected to withholding tax

Return of capital (cost of goods sold/services) is deducted from gross sales/revenue and is not subject to income tax.

Allowable Deductions:

- a. Expenses
- b. Interest
- c. Taxes
- d. Losses
- e. Bad Debts
- f. Depreciation
- g. Depletion of Oil and Gas Wells and Mines

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- h. Charitable and Other Contributions
 - i. Research and Development
 - j. Pension Trusts
 - k. Additional Requirements for Deductibility of Certain Payments
 - l. Optional Standard Deductions
 - m. Premium Payments on Health or Hospitalization Insurance of Individual Taxpayer
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Sec. 34(A). Expenses

1. Ordinary and Necessary Trade, Business, or Professional Expenses –

a. Directly attributable to the development, management, operation, or conduct of trade, business, or exercise of profession, including:

i. Salaries, wages, and other forms of compensation for personal services actually rendered, including de minimis benefits, or grossed-up monetary value of fringe benefit, PROVIDED FINAL WITHHOLDING TAX (fringe benefit tax) UNDER SEC. 38 HAS BEEN PAID.

1. Test: Whether reasonable, and are payments purely for service.

2. Bonuses to employees are allowable deductions if made in good faith and as additional compensation for services actually rendered by employees. Must be reasonable.

3. Amounts paid for pensions to retired employees, or compensation for injuries, are proper deductions.

ii. Travel expenses in pursuit of trade, business, or profession

1. Include transportation expenses, and meals and lodging incurred solely on business.

2. Requisites:

a. Expense must be reasonable and necessary

b. Paid or incurred while away from home

c. Paid or incurred in conduct of trade or business, or exercise of profession

iii. Rentals and other payments (for use or possession of property)

1. Requisites:

a. Rentals must be ordinary and necessary

b. Paid or incurred during taxable year

c. Paid or incurred in carrying trade or business of taxpayer

d. Supported by receipts

e. Required as a condition for the continued use or possession of the property being leased

f. Taxpayer has not taken title to the property, or has no equity other than that of lessee/user

g. Rentals are subject to expanded withholding tax of 5% of rental charge, net of VAT, if any.

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2. Expenses under lease agreement: may take as deduction in his return an aliquot part of sum each year, based on the number of years the lease has to run
 3. Taxes paid by a tenant to a landlord for business property are additional rent and are deductible
 4. Cost borne by a lessee in erecting buildings are improvements, and hence, capital investment (not deductible)
- iv. Entertainment, amusement, and recreation expenses, PROVIDED THAT EXPENSES FOR ENTERTAINMENT, AMUSEMENT, OR RECREATION CONTRARY TO LAW xxx ARE NOT ALLOWED AS DEDUCTION.
1. Representation expenses are allowable deduction.
 2. For country, golf, sports club, etc, where the employee of taxpayer is registered member and the expenses incurred in relation thereto are paid for by the taxpayer, the presumption is that there are fringe benefits subject to FBT, UNLESS the taxpayer can prove that these are actually representation expenses.
 3. Requisites:
 - a. Must be paid or incurred during the taxable year
 - b. Reasonable
 - c. Directly connected to development, management, and operation of taxpayer's trade, business or profession
 - d. Not contrary to laws, morals, xxx
 - e. Not a bribe/kickback or similar payment
 - f. Not exceed ceiling of 0.50% net sales for sellers of goods, or 1% of net revenues for seller of services
 - i. Net Sales = Gross Sales less Sales Returns/Allowances and Sales Discounts
 - ii. Net Revenue = Gross Revenue less Discounts
 - g. Substantiated
 - h. Withholding tax has been withheld and paid to BIR
 4. Excluded from entertainment, amusement, and recreation expenses
 - a. Expenses treated as compensation or fringe benefits under employer-employee relationship

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- b. Expenses for charitable or fund-raising events
- c. Expenses for bona fide business meeting of stockholders, partners, or directors
- d. Expenses for attending or sponsoring an employee to business league/professional organization meeting
- e. Expenses for events for promotion, marketing, advertising, etc.
- v. Minor/Ordinary/Incidental repairs
 - 1. Cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operation condition may be deducted as expense
 - 2. MAJOR OR EXTRAORDINARY (REPLACEMENT) REPAIRS ARE NOT DEDUCTIBLE AS THEY ARE CAPITAL EXPENDITURES
 - a. These should be charged/debited against depreciation reserves if such account is kept
- vi. Cost of materials and supplies
- vii. Advertising expenses and other selling expenses
 - 1. Two kinds (ASKED IN BAR:
 - a. Advertising to stimulate current sale of merchandise or use of services
 - i. Deductible, as these are ordinary expense
 - b. Advertising designed to stimulate future sale
 - i. NOT DEDUCTIBLE; they should be spread out over a reasonable period of time; like major repair, these are charged against depreciation; in the nature of capital expenses.
- viii. Professional services
 - 1. Hiring services of professionals are deductible expenses but shall be subject to expanded withholding tax, EXCEPT IF PROFESSIONAL IS MEMBER OF GPP
 - a. GPP is not subject to income tax; only partners on their distributable share
 - b. The customer do not withhold the tax of partner; it is the GPP who withholds from partner (10/15%)
 - c. If services rendered by professional is not subject to withholding tax (e.g. GPP), then you do not withhold. Otherwise, you withhold. RR2-98, services rendered by professional is 10%/15% based on gross income. These professionals need to submit

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sworn tax declaration to RDO, stating that they have reached the 720k limit. Jan1-
June30 = Jul1-15.

- ix. Insurance premiums against calamities or losses
- x. Organizational and operating expenses
- xi. Management expenses
- xii. Training expenses
 - 1. If training expenses in present time, deductible.
 - 2. If training expense in future, NONDEDUCTIBLE as these are capital expenditures
- xiii. Other necessary expenses.
- b. Substantiation requirements: amount, and direct connection or relation to the development, management, operation, and conduct of trade or business or profession of taxpayer
- c. Bribes, Kickbacks, and other Similar Payment – NOT ALLOWED AS DEDUCTION if it constitutes a bribe or kickback, and is made to an official or employee of national government, local government, GOCC, foreign government, private corporation
 - i. However, of the part of approving official, who received the amount as bribe, the amount would constitute taxable income. All income from legal or illegal sources whatsoever are taxable absent any clear provision of law. Illegally acquired income constitutes realized income under the claim of right doctrine.
 - ii. Insurance premium on the life of Government Official is NOT DEDUCTIBLE expense by a private firm-payor, because “not ordinary expense”.
 - iii. Political campaign expenses or contributions to a candidate in an election NOT DEDUCTIBLE because “not directly attributable to development, management, xxx”.
- 2. Expenses Allowable to Private Educational Institutions – defined in Sec. 27B. It may opt to: a) deduct expenditures otherwise considered as capital outlays of depreciable assets incurred during the taxable year for the expansion of school facilities, or b) deduct allowance for depreciation thereof under 34F.

Business expenses – related to conduct of business of taxpayer and deductible in the year incurred;

Capital expenses – expenditures that improve or add to value of property or equipment of business; not immediately deductible but may be deducted overtime in the form of “Allowance for depreciation”

Capital Expenditures are non-deductible during the year but can be amortized

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1. Equipment needed in trade or business
2. Organizational and pre-operating expenses
 - a. Taxpayers who incur these expenses and subsequently enter the trade or business to which the expenditures relate can elect to amortize these expenditures over a period of not less than 60 months

Requisites for the deductibility of business and professional expenses:

1. Expenses must be ordinary and necessary
 - a. Ordinary is normal in relation to business. Necessary is appropriate and helpful in development of business.
 2. Must be paid or incurred during taxable year
 - a. In accrual method, expenses not claimed as deduction in current year when they are incurred, cannot be claimed as deduction from income for the succeeding year.
 3. Must be paid or incurred in carrying the trade or business or exercise of profession by a taxpayer, or attributable to development, management, or operation of trade, business, or profession.
 4. Amount is reasonable
 5. Substantiated by sales invoices, etc
 6. If subject to withholding tax, should be properly withheld and remitted to BIR thru AAB
 7. Legitimately paid, and not in form of bribe, kickbacks, etc.
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Sec. 34(B). Interest

1. In General – Amount of interest within a taxable year on indebtedness in connection with the taxpayer's profession, business, or trade is deductible, PROVIDED THAT THE TAXPAYERS' OTHERWISE ALLOWABLE DEDUCTION FOR INTEREST EXPENSE SHALL BE REDUCED BY 33%.
 - a. Deductible interest expenses
 - i. Interest on Taxes
 - ii. Interest paid on mortgage upon real property of which the corporation is the equitable owner
 - iii. Interest on deposits paid by banks to depositors
2. EXCEPTIONS – No deductions in:
 - a. If within taxable year, individual taxpayer on cash basis incurs an indebtedness on which an interest is paid in advance through discount or otherwise; PROVIDED such interest shall be allowed as deduction in the year the indebtedness is paid; PROVIDED FURTHER if indebtedness is payable in periodic amortizations, 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;
 - i. Interest paid in advance is NOT DEDUCTIBLE because it is not yet due. However, it is allowed as deduction in the year when he has fully paid his liability. On the otherhand, even if the interest expense is paid in advance, but the indebtedness is payable in periodic amortization, the interest expense xxx shall only be allowed as deduction in such respective taxable years.
 - b. If taxpayer and the person to whom payment has been made are persons under Sec. 36(B) – related taxpayers.
 - i. Between members of family
 - ii. Between individual and a corporation whose more than 50% of outstanding stock is owned by individual
 - iii. Between 2 corporations more than 50% in value of outstanding stock is owned by the same individual
 - iv. Between grantor and fiduciary of trust
 - v. Between fiduciary of trust and fiduciary of another trust if the same person is a grantor
 - vi. Between fiduciary of trust and beneficiary of trust
 - c. If indebtedness is incurred to finance petroleum exploration
 - d. Other cases of nondeductible interest expense

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- i. Interest imposed on taxpayer as penalty for failure to pay donor's tax on time, because it is in the nature of penalty and cannot be considered as in connection with taxpayer's trade
 - ii. Declared dividends on preferred shares of stock, because preferred shares are considered as capital
 - iii. Interest on capital, because it does not represent a charge arising under an interest-bearing obligation
3. Optional Treatment of Interest Expense – At option of taxpayer, interest incurred to acquire property used in trade xxx may be: a) allowed as deduction; or, b) treated as capital expenditure (periodic amortization/depreciation).

Requisites for deductibility of interest expense

1. There must be indebtedness, connected with business
 - a. There must be debtor-creditor relationship based on valid and enforceable obligation; if there exists no obligation or where the obligation is unenforceable, interest is not deductible
 2. There should be interest expense paid or incurred upon such indebtedness during taxable year
 3. Indebtedness must be that of taxpayer (i.e. taxpayer is the creditor)
 4. Indebtedness must be connected with the taxpayer's trade, business, or exercise of profession
 5. Interest must be stipulated in writing
 6. Interest must be legally due
 7. Interest payment arrangement must NOT be between related taxpayers (Sec. 36B).
 8. Interest must NOT be incurred to finance petroleum operations.
 9. In case of interest incurred to acquire property used in trade, business, or exercise of profession, it was NOT treated as a capital expenditure
 - a. Because if property acquired is treated as capital expenditure, taxpayer may claim only as deduction the periodic amortization of such expenditure
 10. That the allowable deduction for interest expense shall be reduced by 33% of the interest income subjected to final tax
 - a. Taxable Income = Net Income LESS Deductible Interest Expense
 - i. Deductible Interest Expense = Interest Expense LESS 33% of Interest Income
 11. That interest is not expressly disallowed by law to be deducted from gross income of taxpayer
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Sec. 34(C). Taxes

1. In General – taxes paid or incurred within the taxable year in connection with the taxpayer's profession, trade, or business is allowed as deduction, EXCEPT:
 - a. Income tax provided under this Title
 - i. These taxes are excluded because these are direct taxes. In direct taxes, you are liable. You cannot impose it to anyone else.
 - ii. The law does not permit the deduction of income tax paid in favor of PH, and in no case may the taxpayer avail of such deduction
 - iii. Surcharges (e.g. penalty for nonpayment of tax) are not deductible. If principal is not deductible, the accessory is not deductible. No deductions should be allowed for amounts representing interest, surcharge, or penalties incident to delinquency.
 - b. Income taxes imposed by authority of foreign country, and this deduction shall be allowed in the case of a taxpayer who does not signify in his return his desire to have the benefits of par. 3 of this subsection (relating to credits for taxes of foreign countries)
 - c. Estate and donor's taxes
 - d. Taxes assessed against local benefits of a kind tending to increase the value of the property assessed PROVIDED that taxes allowed under this Subsection, when refunded or credited, shall be included as part of gross income in the year of receipt to the extent of income tax benefit of such deduction.
 - e. General rule is all taxes are deductible. The following are samples of exception (nondeductible):
 - i. Philippine income tax, except fringe benefit tax
 - ii. Foreign income taxes imposed by authority of any foreign country, EXCEPT when a resident citizen, domestic corporation, or estate signifies in his return his desire to have the benefits of crediting against his taxes payable in PH the taxes he paid in foreign countries
 - iii. Estate tax
 - iv. Donor's tax
 - v. Tax on sale, barter, or exchange of shares of stock listed and traded through the local stock exchange or through IPO
 - vi. Taxes assessed against local benefits of a kind tending to increase the value of the property assessed
 - vii. Taxes not connected with trade, business, or exercise of profession of taxpayer
 - viii. Energy tax on electrical power consumption imposed by BP 36

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- ix. Final withholding taxes on passive income, since it is in a nature of income tax
 - f. Tax treatment of special assessment (local tax): When a tax is considered assessed against local benefits which increase the value of the property assessed, is it NOT deductible, because they are in nature of capital expenditure.
 - g. Bar question: TAX BENEFIT RULE:
 - i. General Rule: Recovery of amounts deducted in prior years would result to income. But if the deduction did not result in tax benefit, the subsequent recovery is not taxable income.
 - ii. Also applies to taxes previously deducted from gross income but which were subsequently refunded or credited. The taxpayer is also required to report as taxable income the subsequent tax refund/credit granted to the extent of the tax benefit the taxpayer enjoyed when such taxes were previously claimed as deduction from income. It follows that taxes paid which are not allowed as deduction from gross income (e.g. income tax, donor and estate tax) are not taxable even when refunded.
 - 2. Limitations on Deductions – In case of nonresident alien individual engaged in trade or business in PH and a resident foreign corporation, the deductions for taxes shall be ALLOWED ONLY IF and to the extent that they are connected with income from sources within the PH.
 - 3. Credit* Against Tax for Taxes of Foreign Countries – If taxpayer signifies in his return his desire to have the benefits of this paragraph, the tax shall be credited with:
 - a. Citizen and Domestic Corporation – amount of income taxes paid and incurred during the taxable year to any foreign country
 - b. Partnership and Estates – his proportionate share of such taxes of GPP or estate or trust paid or incurred during the taxable year to any foreign country
- EXCEPTION: An alien individual and a foreign corporation shall not be allowed the credits against tax in PH for the taxes of foreign countries. Reason: They are subject to PH income tax only on income derived from sources within the PH.
- *Tax credit is the right of an income taxpayer to deduct from income tax payable in PH the income tax he has paid to foreign country.
- 4. Limitations on Credit
 - a. The amount of credit in respect to tax paid to any country shall not exceed the same proportion of the tax against which such credit is taken.

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- b. The total amount of credit shall not exceed the same proportion of the tax against which such credit is taken
- 5. Adjustments on Payment of Incurred Taxes – If accrued taxes paid differ from the amounts claimed as credits, or if tax paid is refunded in whole or in part, taxpayer shall notify Commissioner, who shall re-determine the amount of tax. Commissioner, as a condition precedent for the allowance of credit, may require taxpayer to give bond with sureties.
- 6. Year In Which Credit Taken. – The credit for taxes of foreign country may be taken either in the return for the year in which the taxes (of foreign country) accrued or paid, at the option of taxpayer. An election thus made must be followed in returns for all subsequent years, and no portion of any such taxes will be allowed as deduction from gross income.
- 7. Proof of Credits
 - a. Total amount of income derived from sources without PH
 - b. Amount of income derived from each country, the tax paid which is claimed as credit
 - c. All other information necessary for verification

Requisites for deductibility of taxes:

- 1. Taxes must be paid or incurred in connection with the taxpayer's trade or business or exercise of profession
 - 2. Tax must be imposed by law directly on taxpayer
 - 3. Taxes must be paid or incurred during the taxable year
 - 4. Taxes must be those allowed and not disallowed to be deducted from gross income
 - 5. Substantiated
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Sec. 34(D). Losses

1. In General – Losses actually sustained during the taxable year and NOT compensated for by insurance or other forms of indemnity shall be allowed as deductions (casualty losses):
 - a. If incurred in trade, profession, or business
 - b. Of property connected with trade, business, or profession, if the loss arises from fires, storms, shipwreck, or other casualties or from robbery, theft, or embezzlement
 - i. Time limit: >30days and <90days from date of discovery of casualty, or robbery, theft, or embezzlement.
 - ii. Sworn declaration of loss must be filed within 45 days after date of occurrence of loss
 - c. NOT DEDUCTIBLE if at the time of the filing of return, loss has been claimed as deduction for estate tax purposes in the estate tax return.
 - d. NOTES:
 - i. Types of Losses:
 1. Casualty losses – complete or partial destruction of property resulting from identifiable event of sudden, unexpected, or unusual nature, e.g. fire
 2. NOLCO – excess of allowable deduction over gross income in a taxable year, carried over as deduction from gross income for the next 3 consecutive taxable years following such loss.
 3. Capital losses and securities becoming worthless – capital losses are losses from sales or exchanges of capital assets; securities considered as worthless refers to shares of stocks, when offered for sale or requested for share redemption, no amount can be realized by the owner of share
 4. Special losses
 - a. Losses from wash sales of stocks or securities – sale or other disposition of stock where taxpayer has acquired identical stocks within 61-day period, beginning 30 days before sale and ending 30 days after sale.
 - b. Wagering losses
 - c. Abandonment losses
2. Proof of Loss – If nonresident alien or foreign corporation, losses shall be within the PH and not compensated by insurance or other forms of indemnity. Time limit >30 days and <90 days from date of discovery of casualty, robbery, theft, or embezzlement.

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3. Net Operating Loss Carry-Over. The loss of business for any taxable year immediately preceding the current taxable year, which has not been previously offset as deduction from gross income, shall be carried over as deduction from gross income for the next 3 consecutive taxable years immediately following the year of such loss. PROVIDED that any loss incurred in a taxable year when the taxpayer was exempt from income tax shall NOT BE DEDUCTIBLE; PROVIDED FURTHER that NOLCO shall be allowed ONLY IF there has been NO SUBSTANTIAL CHANGE IN THE OWNERSHIP OF BUSINESS in that:
- a. Not <75% in nominal value of outstanding issue shares is held by the same persons, or
 - b. Not <75% of paid-up capital of corporation is held by the same persons.
 - i. Net Operating Loss = Excess of allowable deduction over gross income of business in the taxable year
 - ii. No actual change on ownership is involved in case the transfer involves change from direct ownership to indirect ownership, or vice versa; or in the case of merger of a subsidiary into the parent company
 - iii. The 75% ownership rule shall only apply to a transfer or assignment of the taxpayer's NOLCO as a result of taxpayer's merger or consolidation or business combination with another person.
 - iv. Determination of substantial change in business: determined as of the end of taxable year
 - c. PROVIDED that for mines other than oil and gas wells, a loss without the benefit of incentives provided under EO 226 (1987 Omnibus Investments Code) incurred in any of the first 10 years of operation may be carried over as deduction for the next 5 years immediately following the year of the loss.
 - d. NOTES:
 - i. Requisites:
 1. Taxpayer was not exempt from income tax in the year the loss was incurred
 - a. NOLCO is also NOT applicable to those who are exempt or partly exempt from income tax, or enjoying preferential tax treatment
 2. No substantial change in ownership of business
 3. Carried over for next 3 consecutive taxable years
 - a. Exception for mines other than oil and gas wells (see codal below)
 - ii. An individual engaged in trade/business may also claim deduction; PROVIDED HOWEVER, an individual who claims OSD cannot claim deduction of NOLCO; PROVIDED FURTHER that the 3-year reglementary period shall continue to run even if the individual availed OSD during such period

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- iii. A corporation cannot enjoy the benefit of NOLCO for as long as it is subject to MCIT in any taxable year; the running of 3-year period for NOLCO is not interrupted by the fact that the corporation is subject to MCIT within the 3-year period
 - iv. Taxpayers entitled to deduct NOLCO
 1. Any individual or estates and trusts
 2. Domestic and resident foreign corporations
 - v. Taxpayers NOT entitled to deduct NOLCO
 1. OBU of foreign banking corporation
 2. Foreign corporations engaged in international shipping/air carriage business in PH
 3. Enterprise registered with BOI
 4. Enterprise registered with PEZA (RA 7916)
 5. Enterprise registered under Bases Conversion and Development Act of 1992 (RA 7227)
 6. Any person enjoying tax exemption from income tax
4. Capital Losses
- a. Limitations – Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in Sec. 39
 - i. Sec. 39. Capital losses from sales/exchanges of capital assets are deductible only to the extent of capital gains from such sales/exchanges. If the dealings in capital assets result in net capital loss, it is NOT DEDUCTIBLE, because capital losses are allowable only to the extent of capital gains.
 - ii. When usefulness in business of a capital asset is suddenly terminated, resulting to permanent discarding of said asset from business, taxpayer may claim as deduction the actual loss sustained.
 - iii. Losses due to voluntary removal of building incident to renewal or replacements are deductible. But if taxpayer buys land with building, with a view of erecting another building, the value and cost of demolishing the old building is NOT DEDUCTIBLE but added instead to cost of land.
 - b. Securities becoming worthless – If securities as defined in Sec.22T become worthless during the taxable year and are capital assets, the loss resulting therefrom shall be considered as loss from the sale or exchange of capital assets, on the last day of taxable year.
 - i. Securities becoming worthless, are shares of stock when offered for sale, no amount can be realized by the owner of the share. Securities becoming worthless, which are capital assets, shall be considered as a loss from sale/exchange of capital assets on the last day of taxable year.

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1. However, the loss is not deductible against the capital gains realized from sale xxx of shares of stock during the taxable year, but must be claimed against other capital gains to the extent provided in Sec. 34.
 2. Worthless securities, which are ordinary assets, are NOT DEDUCTIBLE from gross income because the loss is not realized. If capital assets, deductible.
 3. Loss in the shrinkage in value of stock through fluctuation in the market is NOT DEDUCTIBLE from gross income. The loss allowable in such case is that actually suffered when the stock is disposed of.
5. Loss From Wash Sales of Stock or Securities – As provided in Sec. 38
- a. NOT DEDUCTIBLE, EXCEPT if it is a loss incurred by a dealer in securities in the ordinary course of business.
 - b. Requisites of wash sale:
 - i. Sale or disposition of stock resulted to loss
 - ii. There was an acquisition or contract or option for acquisition of stock within 30 days before the sale or 30 days after the sale
 - iii. The stock or securities sold were the same as those acquired within 61-days
6. Wagering Losses – Shall be allowed only to the extent of gains from such transactions
7. Abandonment Losses –
- a. If petroleum operations are partially or wholly abandoned, all accumulated exploration and development expenditures shall be allowed as deduction
 - b. In case a producing wells is subsequently abandoned, its unamortized costs and depreciated costs of equipment used therein shall be allowed as deduction in the year that such well, equipment, or facility is abandoned by contractor, PROVIDED that if such abandoned well is reentered and production is resumed, the costs shall be included as part of gross income in the year of resumption or restoration, and shall be amortized or depreciated as the case may be.

For examples of cases when no loss can be recognized, see Casasola's NIRC, page 343.

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Sec. 34(E). Bad Debts

1. In General – Debts due to taxpayer actually ascertained to be worthless and charged off within the taxable year, EXCEPT THOSE NOT CONNECTED WITH trade xxx AND THOSE ENTERED INTO BETWEEN PARTIES mentioned in Sec. 36(B); PROVIDED that recovery of bad debts previously allowed as deduction in preceding years shall be included as part of gross income for the year of recovery to the extent of income tax benefit of the said deduction.
 - a. In Bad Debt, the company must send demand letter to debtor.
 - i. Worthlessness depends on exercise of sound business judgment. Good faith does not require that the taxpayer be “incorrigible optimist” but on the otherhand, he may not be unduly pessimistic. Good faith on the part of taxpayer is not enough. He must show that he had reasonably investigated the relevant facts and had drawn a reasonable inference from the information thus obtained by him.
 - b. You cannot claim a bad debt by default. You must “charge off” from book of accounts.
 - i. It means that the amount of money lent by taxpayer to his debtor has been recorded in his books of account as a receivable, and that it has actually become worthless as of the end of taxable year, and that the said receivable has been cancelled and written-off from the said taxpayer’s books of accounts.
 - c. Asked in bar: TAX BENEFIT RULE or Equitable Doctrine of Tax Benefit
 - i. The recovery of bad debts previously allowed as deduction in preceding year shall be included as part of taxpayer’s gross income in the year of such recovery to the extent of the income tax benefit of said deduction.
 1. Conversely, if the taxpayer did not benefit from the deduction of said bad debt written-off because it did not result to any reduction of his income tax in the year of such deduction, then his subsequent recovery thereof shall be treated as mere recovery or return of capital, hence, not treated as receipt of realized taxable income.
 - d. Reserves for bad debts are not allowed as deduction. Advances cannot be claimed as deduction.
2. Securities Becoming Worthless – If securities are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom, shall be considered as loss from sale/exchange of capital assets, on the last day of such taxable year.
 - a. Not applicable to taxpayers who are bank or trust company under the laws of PH, a substantial part of whose business is the receipt of deposits
 - b. General Rule: Worthless securities, which are ORDINARY ASSETS, are NOT allowed as deduction from gross income because the loss is not realized.

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- i. However, if these worthless securities are CAPITAL ASSETS and charged off within taxable year, the owner is said to have incurred a capital loss from the sale/exchange of capital assets as of the last day of taxable year, and therefore, DEDUCTIBLE to the extent of capital gains.

Requisites of deductibility of bad debt:

1. Existing indebtedness due to taxpayer, which must be valid and legally demandable.
 2. Bad debt must be connected with taxpayer's trade, business, or practice of profession.
 3. Bad debt must not be sustained in a transaction entered into between related parties under Sec. 36(B).
 4. Bad debt must be actually charged off in the books of accounts of taxpayers as of the end of taxable year.
 5. Bad debt must be actually ascertained to be worthless and uncollectible as of the end of taxable year and in the future
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Sec. 34(F). Depreciation

1. General Rule – Allowed as deduction a reasonable allowance for exhaustion, wear and tear, and obsolescence of property used in trade or business. If the property is held by one person for life, with remainder to another person, deduction shall be allowed to the life tenant as if he is the absolute owner of the property. If the property is held in trust, deduction shall allowed and apportioned between income beneficiaries and trustees.
 - a. General Rule: It cannot be presumed that the purchase of vehicle is purchase of property used in the business. Hence, NO deduction, UNLESS substantiated. Only one vehicle for land transport is allowed for use of official/employee, value of which shall not exceed P2.4M. No depreciation allowed for yachts, helicopters, aircrafts, or land vehicles exceeding the P2.4M amount, unless taxpayer's line of business is transport operations.
 - b. Law does not authorized depreciation of asset beyond its acquisition cost. Deduction over and above cost cannot be claimed and allowed. No depreciation is allowable on the appraisal increase of the fixed assets. Any foreseeable salvage value is to be deducted from the cost of the asset in determining the basis of depreciation.
2. Use of Certain Methods and Rates - "Reasonable allowance" under any of the following methods:
 - a. Straight-line method;
 - b. Declining-balance method
 - c. Sum-of-the-years-digit method
 - d. Any other method prescribed by Sec. of Finance
 - i. In the syllabus of SC, no need to know how to compute. You just need to know the methods.
3. Agreement as to useful Life on which Depreciation Rate is Based – Taxpayer and Commissioner may enter into an agreement in writing dealing with the useful life and rate of depreciation of any property. The rate shall be binding on both of them. Any change in the agreed rate and useful life shall not be effective for taxable years prior to taxable year in which notice in writing is served by the party.

PROVIDED, however, if taxpayer has adopted such useful life and depreciation rate and claimed the depreciation expenses as deduction from gross income, without objection from Commissioner, such life/rate shall be binding.

 - a. The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. To this amount should be added from time to time the cost of improvements, additions, and betterment, and from it should be deducted from time to time the amount of any definite loss/damage sustained by property through casualty, as distinguished from gradual exhaustion of its utility which is the basis of depreciation allowance.

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4. Depreciation of Properties Used in Petroleum Operations – Allowance for depreciation of properties directly related to production of petroleum initially placed in service in a taxable year shall be allowed under the straight-line or declining-balance method of depreciation at the option of service contractor. However, if service contractor initially elects the declining-balance method, it may subsequently shift to straight-line. Useful life of properties used in/related to production of petroleum is 10 years or shorter, as permitted by Commissioner. Properties not used directly in production of petroleum is depreciated under straight-line method and estimated useful life of 5 years.
5. Depreciation of Properties Used in Mining Operations – Allowance for depreciation of properties used in mining operations, other than petroleum operations, shall be:
- a. Normal rate of depreciation if expected life is 10 years or less
 - b. Depreciated over any number of years between 5y and expected life if the latter is more than 10 years, and the depreciation thereon allowed as deduction from taxable income; PROVIDED that contractor notifies Commissioner
6. Depreciation Deductible by Nonresident Aliens Engaged in Trade or Business or Resident Foreign Corporations – Permitted only when such property is located in PH

Requisites for deductibility of allowance for depreciation

1. Must be by the person who owns or who has capital investment in property
 2. Reasonable, that the amount of depreciation is in accordance with the method adopted by the company
 3. Property is being used in trade or business
 4. Allowance for depreciation must be charged off during the taxable year
 5. Property must have a limited useful life
 6. Allowance for depreciation should not exceed the cost of property
 7. Schedule of allowance must be attached to return
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Sec. 34(G). Depletion of Oil and Gas Wells and Mines

NOTE: I am skipping this part because it is not included in SC syllabus.

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Sec. 34(H). Charitable and Other Contributions

1. In General – Contributions or gifts within taxable year, paid, or made, for the use of Government or its agencies or political subdivision exclusively for public purposes, or to accredited domestic corporation/associations organized and operated exclusively for religious/charitable/scientific/youth and sports development/cultural/educational purposes, or for rehabilitation of veterans, or to social welfare institutions, or to NGO; No part of net income must inure to the benefit of any private stockholder or individual; in an amount <10% in case of individual or 5% in case of corporation; of the taxpayer's taxable income derived from trade/business/profession.

a. Priority projects are fully deductible (p.378). Nonpriority projects has limits (p.375)

2. Contributions deductible in FULL

a. Donations to Government – government, any of its agencies or political subdivisions, including fully-owned GOCC, EXCLUSIVELY to finance, to provide for, or to be used in undertaking PRIORITY activities in EDUCATION/HEALTH/YOUTH AND SPORTS DEVELOPMENT/HUMAN SETTLEMENTS/SCIENCE AND CULTURE/ECONOMIC DEVELOPMENT according to National Priority Plan determined by NEDA; PROVIDED that any donations NOT in accordance with the said annual priority plan shall be subject to limitations prescribed in par. 1 of this Subsection.

b. Donations to Certain Foreign Institutions or International Organizations – Donations which are fully deductible in pursuance/compliance with agreements, treaties, or commitments entered into by PH and foreign institutions, international organizations, or in pursuance of special laws.

c. Donations to Accredited NGOs – NGO means a nonprofit domestic corporation

i. Organized and operated exclusively for scientific/research/educational/character-building and youth and sports development/health/social welfare/cultural/charitable purposes, or combination thereof, NO PART of net income of which insures to benefit of any private individual

ii. Which, NOT LATER THAN 15th day of 3rd month after the close of NGO's taxable year in which the contributions are received, makes utilization directly for the active conduct of activities constituting the purpose for which it is organized, unless extended period is granted by Sec. of Finance

iii. Level of administrative expense shall annually conform with regulations of Sec. of Finance, but shall NOT EXCEED 30% of total expenses.

iv. If dissolved, its assets shall be distributed to another nonprofit domestic corporation organized for similar purposes, or to State for public purpose, or shall be distributed by court to another organization

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to be used in such manner as in the judgment of said court shall best accomplish the general purpose for which the dissolved organization was organized

Utilization means:

1. Any amount in cash or in kind (INCLUDING ADMINISTRATIVE EXPENSES) paid or utilized to accomplish the purpose
2. Any amount paid to acquire an asset used directly in carrying out the purpose

An amount set aside for a specific project may be treated as a utilization, if the NGO has established to the Commissioner that the amount will be paid for the project within the period prescribed by Sec. of Finance, but must not exceed 5 years, and the project is one which can be better accomplished by setting aside such amount than by immediate payment of funds.

1. NOTES:

- a. Compare with 34H1. If not within 34(2)(C)(1), it is NOT FULLY deductible; the only donations which are FULLY DEDUCTIBLE should be those which are “priority”; all those which are not priority are subject to 10%/5% limitation.
 - b. Entities are accredited by Philippine Council for NGO Certification (PCNC). For educational institutions, DoE/CHED/TESDA. The accrediting entity forwards to BIR Commissioner the Certificate of Accreditation for Tax Exemption
3. Valuation – Based on acquisition cost of property
 4. Proof of Deductions – Only allowed as deduction if verified under rules prescribed by Sec. of Finance

Requisites for deductibility of charitable and other contributions

1. Contribution must have been actually made to entities specified by law
2. Contribution made within taxable year
3. Evidenced by receipts and records
4. For contributions other than money, amount shall be based on acquisition cost of property, NOT FMV at time of contribution
 - a. Acquisition cost =
 - i. Purchase price, if bought
 - ii. If inherited, Sec. 6e – FMV of Commissioner or Assessor, whichever is higher, at the time of inheritance
 - iii. If it has improvement, tax declaration

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5. For contributions subject to statutory limitations, it must NOT EXCEED 10%(ind)/5%(corp) of said taxpayer's taxable income before deducting charitable contributions

Other Notes:

Contributions subject to statutory limits (not exceeding 10%/5% of taxpayer's gross income)

1. Contributions for NON-PRIORITY ACTIVITIES or gifts actually paid or made xxx to Government or any of its agencies or political subdivisions exclusively for public purposes
2. Donations, contributions, or gifts actually paid or made xxx to ACCREDITED NON-STOCK NON-PROFIT corporations organized and operated EXCLUSIVELY for religions/charitable/scientific/youth and sports development/cultural /educational purposes/rehabilitation of veterans/social welfare institutions/NGOs; No part of net income of which inures to the benefit of private stockholder/individual shall be allowed LIMITED DEDUCTIBILITY IN AN AMOUNT <10% for individual donor/5% for corporate donor, OF DONOR'S TAXABLE INCOME derived from trade xxx.
 - a. See page 378 for illustrative example:
 - i. $\text{Gross Income} - \text{Allowable Deduction} = \text{Taxable Income}$
 - ii. $\text{Allowable deductible donation (10\% of taxable income)} + \text{Allowable Deduction} = \text{Total Allowable Deduction}$
 - iii. $\text{Gross Income} - \text{Total Allowable Deduction} = \text{Taxable Income}$

Contributions/donations deductible in FULL

1. Donations to Government – xxx to be used in undertaking PRIORITY activities xxx according to NATIONAL PRIORITY PLAN by NEDA
 2. Donations to Certain Foreign Institutions or International Organizations
 3. Donations to Accredited NON-STOCK NON-PROFIT CORPORATIONS/NGOs
 - a. See requisites above (Sec. 34H(2c))
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NIRC – ALLOWABLE DEDUCTIONS (Notes)
TRAIN LAW not yet implemented

Sec. 34(I). Research and Development

1. In General – Research or development expenditures in connection with trade xxx as ORDINARY AND NECESSARY EXPENSES which are NOT chargeable to CAPITAL ACCOUNT is allowed as deduction.
2. Amortization of Certain Research and Development Expenditures – At the election of taxpayer, the following research and development expenditures may be treated as deferred expenses:
 - a. Paid in connection with trade xxx
 - b. Not treated as expenses under par. 1
 - c. Chargeable to capital account but not chargeable to property of a character which is subject to depreciation or depletion

Such deferred expense is allowed as deduction ratably distributed over <60 months as elected by taxpayer, beginning with the month in which taxpayer first realizes benefits from such expenditures.

Such election may be made for any taxable year, but only if made not later than the time prescribed by law for filing the return for such taxable year. The method/period selected by taxpayer shall be adhered to for xxx all subsequent taxable years unless, with approval of Commissioner, a change to a different method is authorized. The election shall not apply to any expenditure paid during any year prior to the taxable year for which the taxpayer makes the election.

3. Limitations on Deduction – SHALL NOT apply to:
 - a. Expenditure for acquisition/improvement of land/property, to be used in connection with research and development of character which is subject to depreciation and depletion.
 - b. Expenditure paid or incurred for purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral.

Requisites for charging of research and development expenditure:

1. R&D expense were paid in connection with taxpayer's trade
 2. It has been paid or incurred during taxable year as ORDINARY AND NECESSARY EXPENSES
 3. NOT charged to capital account
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NIRC – ALLOWABLE DEDUCTIONS (Notes)
TRAIN LAW not yet implemented

Sec. 34(J) Pension Trusts – For employers establishing/maintaining pension trust to provide for payment of reasonable pensions to employees are allowed as deductions (in addition to contributions to such trust during the year to cover pension liability accruing during the year) a reasonable amount transferred/paid into such trust during the taxable year in excess of such contributions, but only if such amount:

1. Has not theretofore been allowed as deduction
2. Is apportioned in equal parts over a period of 10 consecutive years beginning with the year in which transfer/payment is made
 - a. “Pension trust” is a trust established/maintained by the employer to provide for the payment of reasonable pensions to its employees
 - b. “Pension trust contribution” is a deduction applicable only to the employer on account of its contribution to a private pension plan for the benefit of its employees
 - c. “Normal cost” refers to contributions during the taxable year into the pension plan to cover the pension liability accruing during the taxable year. It is allowed as deduction as ORDINARY AND NECESSARY BUSINESS EXPENSE.
 - d. “Past service cost” refers to amount in excess of the above contribution. It represents 1/10th of the reasonable amount paid by the employer to the trust during the taxable year to cover the pension liability applicable to the years prior to the taxable year, or so paid to place the trust in sound financial basis.
Allowed as deduction IF
 - i. Such amount has not yet been allowed as deduction
 - ii. Such amount has been apportioned in equal parts over a period of 10 consecutive years beginning with the year in which the payment is made

Requisites for deductibility of Past Service Cost.

1. Employer has established a pension or retirement plan to provide for the payment of reasonable pensions to his employees
2. Pension plan is reasonable and sound
3. Funded by employer
4. Amount contributed must no longer be subject to the control and disposition of employer
5. Payment has not yet been allowed as deduction

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6. Deduction is apportioned in equal parts over a period of 10 consecutive years beginning with the year in which the transfer of payment is made
 7. Employer shall BE ALLOWED TO DEDUCT FROM GROSS INCOME REASONABLE AMOUNTS PAID TO SUCH TRUST, IN ACCORDANCE WITH PENSION PLAN, as follows:
 - a. If plan contemplates the payment to the trust, in advance of the time when pensions are granted, of amounts to provide for future pension payments, then:
 - i. Reasonable amounts paid to trust during the taxable year representing the pension liability applicable to such year, determined in accordance with the plan, shall be allowed as deduction for such year as AN ORDINARY AND NECESSARY BUSINESS EXPENSE; and in addition
 - ii. 1/10th of reasonable amount transferred/paid to trust to cover THE PENSION LIABILITY APPLICABLE TO THE YEARS PRIOR TO TAXABLE YEAR shall be allowed as deduction FOR THE TAXABLE YEAR AND FOR EACH OF 9 SUCCEEDING TAXABLE YEARS
 - b. If the plan does not contemplate the payment to trust, in advance of time when pensions are granted, of amounts to provide for future pension payments, then
 - i. Reasonable amounts paid to trust during the taxable year representing the PRESENT VALUE OF EXPECTED FUTURE PAYMENTS in respect of pensions granted to employees retired during the taxable year shall be allowed as deduction for such year AS ORDINARY AND NECESSARY BUSINESS EXPENSE, and in addition
 - ii. 1/10 of reasonable amount transferred/paid to trust during the year to cover the present value of EXPECTED FUTURE PAYMENTS IN RESPECT OF PENSIONS GRANTED TO EMPLOYEES RETIRED PRIOR TO TAXABLE YEAR, or so transferred or paid to place the trust on a sound financial basis, shall be allowed as deduction FOR THE TAXABLE YEAR AND FOR THE EACH OF 9 SUCCEEDING TAXABLE YEARS.
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NIRC – ALLOWABLE DEDUCTIONS (Notes)
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Sec. 34(K). Additional Requirements for Deductibility of Certain Payments – Any amount paid which is otherwise deductible from, or taken into account in computing gross income or for which depreciation or amortization may be allowed, shall be allowed as deduction ONLY IF it is shown that the tax required to be deducted and withheld therefrom has been paid to BIR in accordance with this Section, Sec. 58, and 81 of this Code.

1. NOTES

- a. A taxpayer has the right to deduct all authorized allowances and it follows that if he does not within any year deduct certain of his expenses, losses, interests, taxes, or other charges, he cannot deduct them from the income of the succeeding year.
 - b. If in case of overlapping items, as long as these do not materially distort the income, they may be included in the year in which the taxpayer takes them into his accounts.
 - c. Judgments are deductible from gross income when the claim is adjudicated or paid.
 - d. If subsequent to its occurrence, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may tender an amended return for such preceding taxable year including such amount of loss in the deduction from gross income; and may in proper cases, file a claim for refund of excess tax paid by reason of the failure to deduct such loss in the original return.
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Sec. 34(L). OPTIONAL STANDARD DEDUCTION (OSD)

Instead of deductions allowed under preceding subsections (itemized deductions);

an INDIVIDUAL under Sec. 24, other than nonresident alien, may elect a standard deduction in an amount <40% of his gross sales or gross receipts, as the case maybe.

In case of a CORPORATION under Sec. 27A and 28A1, it may elect a standard deduction in an amount <40% of gross income.

Unless the taxpayer signifies in his return his intention to elect OSD, he shall be considered as having availed himself of deductions allowed in preceding Subsections.

Such election is irrevocable for the taxable year for which the return is made.

PROVIDED an individual who is entitled to and claimed for the OSD shall not be required to submit with his tax return such financial statements otherwise required under this Code

PROVIDED FURTHER, that except when Commissioner otherwise permits, the individual shall keep such records pertaining to his gross sales or gross receipts, or said corporation, shall keep such records pertaining to his gross income during the taxable year.

Who may avail OSD:

1. Individuals and taxable estates and trusts, EXCEPT individuals earning pure compensation income and nonresident aliens.
2. Corporations, EXCEPT nonresident foreign corporations

Requisites for individuals who want to avail OSD

1. Individual is a citizen or resident alien
2. Taxpayer's income is not pure compensation income
3. Individual signifies in his return filed for the 1st quarter his intention to elect OSD as deduction; otherwise, he is considered as having availed of itemized deductions
4. Election to avail OSD is irrevocable for the year in which made; however, he can change to itemized deductions in succeeding years if he opts to
5. OSD allowed shall be maximum of 40% of gross sales/gross receipts during the taxable year

Requisites for corporations who want to avail OSD

1. Domestic or resident foreign corporation

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2. Corporation signifies in his return field for the first quarter his intention to elect OSD as deduction; otherwise, it is considered as having availed of itemized deductions
3. Election to avail OSD is irrevocable for year in which made; however, it can change to itemized deductions in succeeding years if it opts to
4. The OSD allowed shall be a maximum of 40% of gross income during the taxable year

NOTES:

1. Passive income shall not form part of gross income for the purpose of computing 40% OSD.
 2. For illustrative examples and computations, page 397, NIRC of Casasola.
 3. Sec. 26 provides that for purposes of computing the distributive share of partners, the net income of GPP shall be computed in the same manner as a corporation. As such, GPP may claim either the itemized deductions under Sec. 34A-J or OSD allowed to corporations in claiming the deductions in an amount not exceeding 40% of gross income.
 - The net income determined by either claiming itemized deduction or OSD from GPP's gross income is the distributable net income from which the share of each partner is to be determined. Each partner shall report as gross income his distributive share in the net income of partnership.
 - If GPP claimed itemized deductions, the partners can only claim itemized deductions which are ordinary and necessary expenses, which were not claimed by GPP in computing its net income during the year.
 - If the GPP avails of OSD in computing its net income, the partners can no longer claim further deduction from their share in the net income.
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NIRC – ALLOWABLE DEDUCTIONS (Notes)
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Sec. 34(M). Premium Payments on Health and/or Hospitalization Insurance of Individual Taxpayer

Requisites:

1. Hospitalization insurance taken by individual taxpayer for himself and the members of his family.
 2. The individual either earns pure compensation income or earning business income or engaged in practice of profession
 3. Gross income of family of individual <P250k for the taxable year
 4. The amount of premium deductible <P25400 per family or P200 per month during the taxable year
 5. In case of married individuals, only the spouse claiming additional exemption shall be entitled to deduction.
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NIRC – ALLOWABLE DEDUCTIONS (Notes)
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Sec. 35. Allowance for Personal Exemption for Individual Taxpayer

- A. In General – For the tax as provided in Sec. 24(A), there shall be allowed basic personal exemption of P50k per each individual taxpayer.
 - a. For married individuals where only one of spouses is deriving gross income, only such spouse shall be allowed personal exemption.
 - i. In case of married individuals, the proper claimant is husband, except if there is an express waiver by husband in favor of his wife
 - 1. Wife automatically claims additional exemption if:
 - a. Husband has no income
 - b. Husband is nonresident citizen working abroad, e.g. OFW
 - c. If legally separated and has custody of the children
- B. Additional Exemption for Dependents – P25k/depended NOT EXCEEDING 4
 - a. Such additional exemption for dependents shall be claimed only by one of spouses.
 - b. If legally separated spouses, the additional exemption may be claimed only by the spouse having custody of child. PROVIDED the total amount of additional exemption that may be claimed by both shall not exceed the maximum additional exemptions
 - c. Dependent means LC, IC, or legally adopted child <21years, unmarried and not gainfully employed, or regardless of age, those incapable of self-support because of mental/physical defect. It also includes foster child
 - i. Hence, if apart from being a minor (<21years), not gainfully employed, unmarried, and living with and dependent upon their parent for support
 - 1. If unable to self-support because of m/p defect, any age.
 - ii. Senior citizen does NOT fall within the meaning of the term “dependent”
- C. Change of Status – If taxpayer marries or should have additional dependents, taxpayer may claim the additional exemption IN FULL for such year.
 - a. If taxpayer dies during the year, his estate may still claim personal/additional exemptions for himself/dependents.
 - b. If spouse/dependents dies/marries/becomes +21years during the taxable year, the taxpayer may still claim the same exemptions

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- i. “status at the end of year rule” – whatever is the individual’s status EOY is used for determining his personal/additional exemption
 - D. Personal Exemption AVAILABLE to NONRESIDENT ALIEN – but only equal to the exemption allowed in the income tax law in the country where he belongs, but NOT to exceed the P50k amount fixed in this Section, PROVIDED that such nonresident alien shall file true and accurate return of total income.
 - a. Note that he is only allowed personal, NOT ADDITIONAL exemptions
 - b. If nonresident alien is not engaged in trade in PH, he will not be allowed to claim any personal exemption because his income tax is subject to FWT of 25% based on gross income
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NIRC – ALLOWABLE DEDUCTIONS (Notes)
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Sec. 36. Items NOT DEDUCTIBLE

A. General Rule – In computing net income, NO DEDUCTION ALLOWED in any case in respect to:

1. Personal, living, or family expenses

a. Note: Actual personal xxx expenses, being deemed covered by personal and additional exemptions, are not deductible.

2. Any amount paid for new buildings or for permanent improvements, betterments, made to increase value of property or estate (considered as capital expenditures)

a. This subsection does NOT APPLY to intangible drilling, and development costs incurred in petroleum operations which are deductible under Sec. 34G1.

3. Any amount expended in restoring property (considered as major repairs)

4. Premiums paid on any life insurance policy covering the life of officer/employee/person financially interested in trade carried on by taxpayer, when the taxpayer is directly/indirectly the beneficiary of the policy.

B. Losses from Sales or Exchanges of Property – In computing net income, NO DEDUCTION ALLOWED in respect of losses from sales/exchanges of property directly or indirectly

a. Also, interest expense and bad debts from sales of property between related parties are NOT deductible.

b. Rationale: Avoid sham or pretended sales/exchanges designed to create losses. The provision applies regardless of good faith. While losses in transactions between related taxpayers are NOT deductible, gains therefrom are deductible.

c. Rationale for prohibition from deductibility of capital losses from ordinary gains: To forestall shifting of deductions from an area subject to lower taxes (capital gains) to an area subject to higher taxes (ordinary gains)

1. Between members of family (includes only brothers/sisters whether full or half-blood, spouse, ancestors, and lineal descendants)

2. Between individual and corporation >50% in value of outstanding stock of which is owned directly/indirectly by or for such individual, EXCEPT in case of distributions in liquidation

3. EXCEPT in case of distributions in liquidation, between 2 corporation >50% in value of outstanding stock of each of which is owned directly/indirectly by or for same individual, if either one of such corporation was a personal holding company or a foreign personal holding company

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a. Personal holding company is a company used as “corporate pocketbook” to shelter a high bracket individual shareholder’s passive investment income from stocks, bonds, or other investment income. It can also apply where company receives amounts for personal services performed by shareholder. The individual transfers these assets to his “personal” corporate pocketbook which merely “holds” the assets, collects the dividends, interest, etc, and does not distribute the income until it liquidates, with the owner paying only a CGT at that time. To bar this device, the tax law imposes a special penalty called the personal holding company tax (also called improperly accumulated earnings tax), which is imposed in addition to regular corporate income tax.

4. Between grantor and fiduciary of trust
 5. Between fiduciary of trust and fiduciary of another trust, if same person is a grantor with respect to each trust
 6. Between fiduciary of trust and beneficiary of trust
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Sec. 37. Special Provisions regarding Income and Deductions of Insurance Companies, Whether Domestic or Foreign

A. Special Deductions to Insurance Companies – net additions required by law to be made to reserve funds and the sums other than dividends paid within the year on policy and annuity contracts may be deducted

a. PROVIDED that the released reserve be treated as income for year of release

B. Mutual Insurance Companies – For companies requiring their members to make premium deposits to provide for losses and expenses, said companies shall NOT return as income any portion of premium deposits returned to their policy holders, but shall return as taxable income all income received by them from all other sources plus such portion of premium deposits as are retained by companies for purposes other than payment of losses and expenses and reinsurance reserves

C. Mutual Marine Insurance Companies – companies shall include in gross income the gross premiums less amounts paid for reinsurance, but shall include in deductions amounts repaid to policyholders on account of premiums previously paid by them and interest paid upon those amounts between the ascertainment and payment thereof

D. Assessment Insurance Companies – may deduct the actual deposit of sums with the officers of Government, as additions to guarantee or reserve funds

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Sec. 38. Losses from Wash Sales of Stock or Securities

A. In case of loss from sale/disposition of shares of stock where it appears that within a period of 30 days before sale to 30 days after sale, taxpayer has acquired (by purchase/exchange upon which the entire amount of gain or loss was recognized by law, or has entered into contract/option to acquire) substantially identical stock/securities, then NO DEDUCTION for loss, UNLESS the claim is made by a dealer in stock/securities and with respect to transaction made in ordinary course of business of dealer.

1. Notes: Wash sale of stock or securities is a sale or disposition of stock where the same or substantially identical securities are acquired or purchased within a 61-day period (30 days before sale and 30 days after sale) at a loss which loss is not deductible from gross income

a. Loss is NOT DEDUCTIBLE if taxpayer has, during 61-day period, entered into contract to acquire substantially the same stock as replacement stock

b. Also NOT DEDUCTIBLE: Sales “when issued” stock and to “short” sales made on the repurchase date, where delivery date is postponed beyond 31-day period of any loss claimed to have been sustained from any sale of stock, where it appears that within 30 days before sale and 30 days after sale, taxpayer has acquired substantially identical stock.

i. Except (DEDUCTIBLE) if: claim is made by dealer in stock; AND with respect to transaction in ordinary course of business of such dealer.

2. Rationale: prevent taxpayers from selling stock to establish a loss deduction and immediately repurchase the same.

B. If the amount of stock acquired is < amount of stock sold, then the particular shares of stock, the loss from the sale of which is NOT deductible, shall be determined by Sec. of Finance.

C. If amount of stock acquired is NOT < amount of stock sold, then the particular share, the acquisition of which resulted in NONDEDUCTIBILITY of loss, shall be determined by Sec. of Finance

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NIRC – ALLOWABLE DEDUCTIONS (Notes)
TRAIN LAW not yet implemented

Sec. 39. Capital Gains and Losses

A. Definitions:

1. Capital Assets – property held by taxpayer (connected or not connected with trade), but does NOT include
 - a. stock in trade of taxpayer or other property of a kind which would properly be included in the inventory of taxpayer if on hand at close of year,
 - b. or property held by taxpayer primarily for sale to customers in ordinary course of trade,
 - c. or property used in trade or business, of a character which is subject to allowance for depreciation under Sec. 34F
 - d. NOTES

- i. Generally refers to all properties of taxpayer other than ordinary asset. Ordinary assets, on the otherhand, are used primarily or for sale in the ordinary course of trade or business.
- ii. a, b, and c above are all ordinary assets.

2. Net Capital Gain – Gains from sales/exchanges of capital assets LESS losses from such sale/exchanges

3. Net Capital Loss – Excess of losses from sales/exchanges of capital assets LESS gains from such sale/exchange

B. Percentage taken into account – For any taxpayer EXCEPT corporation, only the following % of gain/loss recognized upon sale/exchange of capital asset shall be taken into account in computing net capital gain, net capital loss and net income:

1. 100% if capital asset has been held for < 12 months
2. 50% if capital asset has been held for >12 months.

C. Limitation on Capital Losses – Losses from sales/exchanges of capital assets shall be allowed only to extent of gains from such sale/exchanges. If a bank/trust company (a substantial part of whose business is receipt of deposit), sells any bond/debenture/note/certificate of indebtedness, issued by any corporation, with interest coupon or in registered form, any loss from such sale shall NOT be subject from the foregoing limitation and shall NOT be included in determining the applicability of limitation to other losses.

1. General Rule: Capital losses from sales of capital assets are allowed only to the extent of GAINS from such sale. If the dealings of the taxpayer in capital assets during the year result in a net capital loss, such LOSS CANNOT be deducted from ordinary income, in as much as capital losses are allowable only to the extent of capital gains

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- a. See p. 433 for the computation. Basically, you consider 50%/100% first, then deduct losses from gains, and the difference will be added to ordinary net income to get taxable net income (if capital gains), or nothing gets deducted from ordinary net income at all if you have net capital losses.
 - b. EXCEPTION: If a bank or trust company incorporated in PH, a substantial part of whose business is receipt of deposits, selling bond/debenture/note/certificate of indebtedness issued by any corporation (including one issued by government), with interest coupons or in registered form, ANY LOSS resulting from such sale shall NOT be subject to the limitation in Sec. 39(C), and shall NOT BE INCLUDED in determining the applicability of such limitation to other losses.
2. Rationale for the rule prohibiting the deduction of capital losses from ordinary gains: to ensure that only costs/expenses incurred in earning the income shall be deductible for income tax purposes (since only necessary expenses are allowed as deductions from gross income).

D. Net Capital Loss Carry-Over – If taxpayer, other than corporation, sustains a net capital loss, such loss shall be treated in the succeeding year as loss from sale/exchange of capital asset held <12 months.

1. Net capital loss carry over vs Net operating loss carry over

NCLCO	NOLCO
Can be availed of only by individual taxpayer	Available to both individuals and corporate taxpayers
Covers only 1 year	May be deducted from gross income for the next 3 consecutive taxable years
Capital asset transaction	Ordinary asset transaction
Directly governed by Tax Code only	Directly governed by Tax Code and by Investment Incentives Act

E. Retirement of Bonds, Etc – amounts received by holder upon retirement of bond/debenture/note/certificate of indebtedness, issued by any corporation with interest coupons or in registered form, shall be considered as amounts received in exchange therefor

F. Gains and Losses from Short Sales, Etc –

1. Gains or losses from short sales of property shall be considered as gains/losses from sales/exchanges of capital assets.
2. Gains or losses attributable to failure to exercise privileges to buy/sell property shall be considered as capital gains or losses.

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- a. Short sale refers to any sale of security which the seller does not own or any sale which is consummated by delivery of security borrowed by, or for the account of sellers.
 - i. See p.438 on when a person is deemed to own a security.
 - ii. Short sale is consummated when the property to cover the short sale is delivered.

Guidelines in determining whether REAL property is capital or ordinary asset:

A. If taxpayer is engaged in real estate business:

- 1. Real estate dealer – ordinary assets: all real properties acquired by him.
- 2. Real estate developer – ordinary assets: all real properties acquired (whether developed or undeveloped), all real properties held primarily for sale or for lease in the ordinary course of his trade or which would properly be included in the inventory of taxpayer if on hand at close of taxable year, and all real properties used in trade, whether in the form of land/building/other improvements.
- 3. Real estate lessor – ordinary assets: all real properties, whether land/improvement/ which are for lease/rent or being offered for lease/rent, or otherwise being used in trade.
- 4. Taxpayers habitually engaged in real estate business – ordinary assets: all real properties acquired in the course of trade by taxpayer habitually engaged in sale of real estate.
 - a. He may be considered as habitually engaged in sale of real estate when he registers with HLURB or HUDCC as real estate dealer/developer, or through substantial relevant evidence.

B. Taxpayers not engaged in real estate business – ordinary assets: real properties (whether land/building/other improvements, which are used in trade)

C. Taxpayers changing business from real estate business to non-real estate business – the change of business or amendment of the primary purpose of business shall not result in re-classification of real property held by it from ordinary asset to capital asset.

D. Taxpayers originally registered to be engaged in real estate business but failed to subsequently operate – ordinary assets: all properties originally acquired by it

E. Treatment of abandoned and idle real properties – shall continue to be treated as ordinary assets; will not result into conversion into capital asset

- 1. PROVIDED that ordinary assets being used in business by a taxpayer engaged in business other than real estate business are AUTOMATICALLY CONVERTED into capital asset upon showing proof that it has not been used in business for more than 2 years.

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F. Treatment of real properties that have been transferred to buyer/transferee, whether transfer is through sale/barter/exchange/inheritance/donation/declaration of property dividends:

1. Transfer through succession/donation to heir/donee who is not engaged in real estate business and does not subsequently use it in trade = capital asset in the hands of heir/donee
2. Real property received as dividend by stockholders not engaged in real estate business and who does not subsequently use it in trade = capital asset in the hands of recipients, even if corporation which declared the real property dividend is engaged in real estate business
3. Real property received in a tax-free exchange by taxpayer not engaged in real estate business to a taxpayer who is engaged in real estate business/ taxpayer who is not engaged in real estate business but will use it in the business = ordinary asset in the hands of transferee

G. Treatment of real property subject of involuntary transfer – (including expropriation/foreclosure) – no effect on classification of real property in the hands of involuntary seller

Differences between CG and OG.

Capital Gains	Ordinary Gains
Sources of capital gains are sales or exchanges of capital assets	Sources of ordinary gains are sales or exchanges of ordinary assets
Capital gains are generally profits from sales of assets NOT stock in trade	Ordinary gains generally come from assets constituting stock in trade
Basis of capital gains tax is on the presumed gain Presumed gain = capital gain presumed to have been realized from sale xxx of real property classified as capital asset, including pacto de retro and other conditional sales xxx the basis of which is the zonal value or gross selling price, whichever is higher	Basis of ordinary tax is on the actual gain Actual gain = gain actually/constructively derived from sale of assets/properties treated as ordinary assets in excess of cost to taxpayer
Excess of gains from sales or exchanges of capital assets (i.e. other than capital gains from sales or exchanges of shares of stocks and real properties which are considered as capital assets) over the capital losses from such sales or exchanges should be included in gross income	All sales or exchanges of ordinary assets should be included in gross income

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Sec. 40. Determination of Amount and Recognition of Gain or Loss

A. Computation of Gain or Loss – Gain from sale xxx shall be excess of amount realized therefrom over the basis or adjusted basis for determining gain; loss shall be excess of the basis/adjusted basis for determining loss over amount realized; amount realized from sale xxx shall be sum of money received plus fair market value of property (other than money) received.

1. The amount of income derived or loss sustained from an exchange of property is the difference between the market value at the time of exchange of property received in exchange of, and the original cost or other basis of property exchanged.

B. Basis for Determining Gain or Loss from Sale or Disposition of Property – Basis of property shall be:

1. Its cost, if property was acquired by purchasing on or after 03/01/1913

2. Its fair market price or value as of date of acquisition, if property was acquired by inheritance

3. Its cost in the hands of donor/last preceding owner who did not acquire it by donation, if property was acquired by gift

a. Except that if such basis is greater than fair market value of property at the time of gift, then, for purpose of determining loss, the basis shall be fair market value.

4. Amount paid by transferee for the property, if property was acquired for less than an adequate consideration in money/money's worth

5. Basis as defined in Sec. 40C5, if property was acquired in transaction where gain or loss is not recognized under Sec.40C2.

a. If property was acquired thru a previous tax-free exchange,

i. The basis of stock or securities received by transferor is same as basis of property/stock/securities exchanged/transferred, increased by amount treated as dividends of shareholder and amount of gain recognized on exchange, decrease by money received and FMV of other property received, liability assumed by transferee. However, the property received as "boot" refers to money/property received in excess of stock/securities received by transferor on a tax-free exchange. If transferee of property assumes, as part of consideration to the transferor, a liability of transferor or acquires from the latter property subject to a liability, such assumption/acquisition (in the amount of liability) shall, for purposes of computing substituted basis, be treated as money received by the transferor on the exchange. Finally, if transferor

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receives several kinds of stock, Commissioner is authorized to allocate the basis among several classes of stocks.

b. Basis of property transferred in the hands of transferee – same as it would be in the hands of transferor, increased by amount of gain recognized to transferor on transfer.

C. Exchange of Property –

1. General Rule – Upon sale/exchange of property, entire amount of gain/loss shall be recognized, except as herein provided.

2. Exception – (Tax-free exchange) No gain/loss shall be recognized if in pursuance of plan of merger/consolidation –

a. A corporation (party to M/C) exchanges property solely for stock in a corporation (also a party to M/C)

b. Shareholder exchanges stock in corporation (party to M/C), solely for stock of another corporation (party to M/C)

c. Security holder of corporation (party to M/C), exchanges securities in such corporation, solely for stock in another corporation (party to M/C)

d. Transfer is made by a person acting alone or together with others, not exceeding 4 persons;

e. As a result of exchange, the transferor, alone or together with others not exceeding 4, gains control of transferee;

PROVIDED that stocks issued for services shall NOT be considered as issued in return for property.

i. NOTES:

1. A qualified tax-free exchange of property for shares is not tax evasion, but rather tax avoidance.

2. To constitute tax evasion, there must be: a) end to be achieved; b) accompanying state of mind which is described as being evil, in bad faith, willful or deliberate and not merely accidental; and c) a course of action or failure of action which is unlawful.

3. Exchange not Solely in Kind

a. In connection with an exchange, if xxx receives not only stock/securities permitted to be received without recognition of gain/loss, but also money/property, the gain (NOT THE LOSS) shall be recognized but in an amount < sum of money/FMV of property received; PROVIDED, that as to shareholder, if the money/property received has the effect of distribution of taxable dividend, there shall be taxed as dividend an amount of gain recognized not in excess of his proportionate share of undistributed

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earnings and profits of the corporation; the remainder of the gain recognized shall be treated as capital gain.

- b. In connection with an exchange, if transferor corporation receives not only stock without recognition of gain/loss but also money/other property, THEN:
 - i. If receiver corporation distributes it in pursuance to plan of M/C, NO GAIN to corporation shall be recognized from the exchange; BUT
 - ii. If receiver corporation does not distribute it in pursuance to plan of M/C, the gain (not the loss) shall be recognized but in an amount not in excess of sum of such money and FMV of such other property so received which is not distributed.

4. Assumption of Liability -

- a. In connection with the exchanges, if taxpayer receives stocks which would be permitted to received without recognition of gain if it were the sole consideration, and another party to exchange assumes liability of taxpayer xxx as part of consideration, such assumption or acquisition shall not be treated as money/property and shall not prevent the exchange from being within the exceptions.
- b. If amount of liabilities assumed plus the amount of liabilities to which the property is subject exceed the total of adjusted basis of property transferred pursuant to such exchange, then such excess shall be considered as gain from sale/exchange of capital asset or property which is not a capital asset, as the case may be.

5. Basis

- a. Basis of stock received by transferor upon exchange shall be the same as basis of property xxx exchanged, decreased by:

- i. money received
- ii. FMV of other property received

and increased by

- i. amount treated as dividend of shareholder
- ii. amount of any gain that was recognized on the exchange

PROVIDED, that the property received as “boot” shall have as basis its FMV;

PROVIDED further, that if as part of consideration to the transferor, the transferee of property assumes a liability of transferor or acquires from the transferor property subject to liability, such

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assumption/acquisition (in the amount of liability) shall be treated as money received by transferor on the exchange

PROVIDED finally that if transferor receives several kinds of stock, the Commissioner is authorized to allocate the basis among the several classes of stocks.

b. The basis of property transferred in the hands of transferee shall be same as it would be in the hands of transferor increased by the amount of gain recognized to the transferor on the transfer.

6. Definitions

a. Securities – means bonds and debentures, but not notes of whatever class or duration

b. Merger or Consolidation – either

i. ordinary merger or consolidation, or

ii. acquisition by one corporation of all or substantially all properties of another corporation solely for stock

PROVIDED, that for a transaction to be regarded as merger/consolidation, it must be undertaken for a bona fide business purpose and not solely for purpose of escaping the burden of taxation;

PROVIDED further, that in determining whether a bona fide business purpose exists, each and every step of transaction shall be considered and the whole transaction or series of transactions shall be considered as single unit

PROVIDED finally that in determining whether the property transferred constitutes a substantial portion of property of transferor, the term property shall include cash assets of transferor

c. Control – ownership of stocks in corporation possessing at least 51% of total voting power of all classes of stocks entitled to vote.