January 21, 2021

BIR RULING NO. OT-008-21

Sec. 34 (D), NIRC; RR No. 02; 000-00

Du-Baladad & Associates
20th Floor, Chatham House, Rufino Cor. Valero Sts.
Salcedo Village, 1227 Makati City

Attention: *AAA*

Gentlemen :

This refers to your letter dated January 31, 2020 requesting on behalf of your client, **DAVAO LIGHT AND POWER COMPANY, INC.** ("the Company") for confirmation of your opinion that for income tax purposes, the Company is allowed to write off and claim as deduction the remaining book value of a backup power plant which has become obsolete after it is demolished by the Company.

As represented, the Company, with Taxpayer Identification Number (TIN) 0000-000-000-000, is duly incorporated and registered under Philippine laws. It is engaged in the business of power distribution. Pursuant to such business, the Company had erected power plants used in generating power. One such back-up power plant is the integrated power facility, known as the Bajada power plant, located in J.P. Laurel St., Bajada, Davao City, and its substations. For a number of years, the said power plant and its substations had been used by the Company for power generation. However, the Company has determined that the power plant is no longer producing its desired output. The said facility and its associated substations are unfit for continued use in the generation and production of power. In other words, it has become obsolete. Unless rehabilitated, the plant will continue to operate at a loss. The cost to rehabilitate the power plant would entail a substantial capital outlay which would likely exceed any projected revenue from the plant's rehabilitation. Thus, the continued operation of the power plant is no longer economically viable. Accordingly, it was decided in a special board meeting held on October 29, 2018 that the commercial operation of the power plant shall be discontinued and abandoned permanently. The power plant and substations will eventually be dismantled and disposed or destroyed in

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accordance with the regulations of the BIR.

The Company expects a loss in the value of the facility arising from the eventual destruction of the same. The plant facility and its substations, consist of equipment, building, building improvements, land improvements and substation equipment with a total cost of P674,454,727.11. The loss would amount to the carrying value of the facility, consisting of this cost less the accumulated depreciation, as declared by the Company in its books. Any proceeds to be derived from the sale of the scrap materials generated from the demolition of the facility will be recognized by the Company as its income.

In reply, please be informed that the deductibility of losses is governed by the pertinent provisions of the Tax Code as well as its implementing regulations. Specifically, Section 34 (D) (1) of the National Internal Revenue Code of 1997, as amended (Tax Code), provides:

> *"**Section 34.** Deductions from Gross Income. — Except for taxpayers earning compensation income arising from personal services rendered under an employer-employee relationship where no deductions shall be allowed under this Section other than under Subsection (M) hereof, in computing taxable income subject to income tax under Subsections 24(A); 25(A); 26; 27(A), (B) and (C); and 28(A)(1), there shall be allowed the following deductions from gross income:*
>
> xxx xxx xxx
>
> *(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:*
>
> *(a) If incurred in trade, profession or business;*
>
> *(b) Of property connected with the trade, business or profession, if the loss arises from fires, storms, shipwreck, or other casualties, or from robbery, theft or embezzlement.*
>
> *The Secretary of Finance, upon recommendation of the Commissioner, is hereby authorized to promulgate rules and regulations prescribing, among other things, the time and manner by which the taxpayer shall submit a declaration of loss sustained from casualty or from robbery, theft or embezzlement during the taxable year: Provided, however, That the time limit to be so prescribed in the rules and regulations shall not be less than thirty (30) days nor more than ninety (90) days from the date of discovery of the casualty or robbery, theft or embezzlement giving rise to the loss.*

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(c) No loss shall be allowed as a deduction under this Subsection if at the time of the filing of the return, such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

xxx xxx xxx."

In relation thereto, Section 98 of Revenue Regulations ("RR") No. 02 provides:

"Section 98. Loss of Useful Value. — When through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use of such business, he may claim as deduction the actual loss sustained. In determining the amount of the loss, adjustment must be made, however, for improvements, depreciation and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any products makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off in the books and fully explained in returns of income."

Applying the above provisions of the law and its implementing revenue regulations, when assets are abandoned or discarded because the continued use is no longer beneficial to the business, the related loss may be claimed as deduction. Accordingly, pursuant to the provisions of Section 34 (D) (1) of the Tax Code, and Section 98 of RR No. 02, the remaining book value of the Bajada Power Plant and its substations which had become obsolete and which will eventually be dismantled shall be allowed as deduction for income tax purposes when the facility is demolished.

However, please note that Section 110 of RR No. 2 provides for the conditions under which obsolescence could become an item of deduction from gross income. Thus, we quote the said section in its entirety as follows:

"With respect to physical property the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that

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depreciation deductions alone are insufficient to return the cost (or other basis) at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts obtaining with respect to each item of property concerning with a claim for obsolescence is made. No deductions for obsolescence will be permitted merely because, in the opinion of a taxpayer, the property may become obsolete at some later date. This allowance will be confined to such portion of the property on which obsolescence is definitely shown to be sustained and cannot be held applicable to an entire property unless all portions thereof are affected by the conditions to which obsolescence is found to be due." (emphasis supplied)

Thus, while obsolescence is, by nature, allowed as a deduction, the determination of the factual case leading to the determination of whether or not there is obsolescence is a factual issue that is beyond the jurisdiction of a ruling to confirm.

Based on the foregoing, we therefore confirm that:

1. When assets are abandoned or discarded because the continued use is no longer beneficial to the business, the related loss may be claimed as deduction, pursuant to Section 34 (D) (1) of the Tax Code, in relation to Section 98 of RR No. 02; and

2. The remaining book value of the Bajada Power Plant and its substations which had become obsolete and which will eventually be dismantled shall be allowed as deduction for income tax purposes when the facility is demolished. This is, however, subject to compliance with the conditions set forth in Section 110 of RR No. 02 under which obsolescence could become an item of deduction from gross income.

This ruling is being issued on the basis of the foregoing facts as represented. However, if upon investigation, it will be disclosed that the facts are different, then this ruling shall be considered null and void.

Very truly yours,

(SGD.) CAESAR R. DULAY
Commissioner of Internal Revenue

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