**June 25, 2018**

# BIR RULING NO. 1017-18

Sections 34 (F) and 43 of the NIRC of 1997, as amended; RR No. 2

*Gorriceta Africa Cauton & Saavedra*
15/F and 4/F Strata 2000, F. Ortigas Center, Pasig City

Attention: *AAA*

*BBB*

*CCC*

*DDD*

Gentlemen :

This refers to your letter dated October 3, 2017, requesting on behalf of your clients, **Manila Water Company, Inc. ("Manila Water" for brevity)** and its subsidiaries named herein below, permission to change the method of computing depreciation expense of their respective capital expenditure-related service concession assets from straight-line method to units of production method for financial accounting purposes while maintaining the straight-line method for income tax purposes.

## Background:

Manila Water is a domestic corporation engaged in the business of providing water, sewerage and sanitation, distribution services, pipe works and management services. Manila Water has subsidiaries, namely: (a) Boracay Island Water Company, Inc. ("Boracay Water" for brevity); (b) Clark Water Corporation ("Clark Water" for brevity); and Laguna AAA Water Corporation ("Laguna Water" for brevity), which are also engaged in the same line of business and are operating in specific areas in the Philippines. Manila Water together with its subsidiaries shall hereinafter be collectively referred to as "Group."

Each individual company forming part of the Group entered into separate concession agreements with various government corporations granting them specific rights over certain service concession assets for a specified period of time. [1] The Group records their concession arrangements under the Intangible Asset Model of International Financial Reporting Interpretations Committee 12, *Service Concession Arrangements*, in

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accordance with the applicable Philippine Financial Reporting Standards, proceeding from the grant of having the right to charge the users of public service. While the Group is granted specific rights over certain service concession assets, the legal title over these assets remain with the concerned government corporations.

Service concession assets pertain to the fair value of the service concession obligations at drawdown date, construction costs and cost overruns paid by the Group. These assets are currently amortized by the Group using the straight-line method over the expected life of the related concessions, both for financial accounting and taxation purposes.

Beginning May 1, 2017, each individual company forming part of the Group will adopt the units of production method in computing the depreciation of all its capital expenditure-related service concession assets (*i.e.*, water facilities and used-water facilities) for financial accounting purposes, *in order to reflect its income in a way that will better aid its management and its stakeholders in managing the business of and making decisions for the Group.* On the other hand, the Group wishes to maintain the straight-line method in computing depreciation expense for taxation purposes — a depreciation method which is more in keeping with the rules on taxation [2] of the government.

A shift to units of production method will spread the cost of water facilities and used-water facilities by the projected billed volume and used-water flow, respectively, until the end of the concession period. Unlike the straight-line method that uses time to determine how much value an asset has lost, the units of production method is based on actual usage. Hence, with the application of the units of production method, the amount that the Group will record as amortized expense will be directly tied to the actual usage of the capital expenditure-related service concession assets. This application of the units of production method will be more reasonable and provide due regard to the operating conditions of the Group thereby giving its management and the stakeholders a better overview of the financial standing of the Group for purposes of business management and decision making.

Nevertheless, while adopting the units of production method for financial accounting purposes will be useful to the management and the stakeholders of the Group in terms of business management and decision making, the Group opts to maintain the straight-line method in computing the depreciation of its capital expenditure-related service concession assets for taxation purposes *subject to reconciliation of discrepancies*, in order to protect the interests of the government.

The straight-line method is the simplest depreciation method to calculate the value that an asset has lost overtime. In the straight-line method, the depreciated value of the service concession assets can easily be determined because the cost or depreciation is merely spread evenly over its useful life. Therefore, the straight-line method provides a stable and uniform manner that is more reliable and verifiable in reducing an asset value

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for taxation purposes and as such, ensures consistency on annual income tax calculations of the Group.

To illustrate, below is a sample computation of depreciation of the capital expenditure-related service concession assets of Manila Water using the straight-line method vis-à-vis the units of production method for the year 2017, as well as the reconciliation of discrepancies resulting from the use of two (2) different methods.

Figure 1: *Sample computation of depreciation using the straight-line method vis-à-vis units of production method for the year 2017 and reconciliation of discrepancies.*

| **Service Concession Assets Depreciation (in PhP billions)** | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Figures for 2017 in PhP millions | | | | | | |
| **Straight line Method** | Straight-line depreciation expense per month | = | Carrying value of service concession assets as of April 30, 2017 / Remaining concession period (in mos.) | = | PhP_____ / 243 mos. | = | PhP____ |
| **Units of Production Method** | Units of production depreciation expense per month | = | Carrying value of service concession assets as of April 30, 2017 x Actual billed volume for the month / Project billed volume over remaining concession period (in mcm) | = | Php_____ x 40 mcm / 10,000 mcm | = | PhP____ |
| **Reconciliation (for taxation purposes)** | ITR reconciling item:<br>Difference of the depreciation expense = PhP____ | | | | | | |

Furthermore, below is a comparative schedule of estimated depreciation of capital expenditure-related service concession assets of Manila Water for the years 2017 to 2037 using the straight-line method vis-à-vis units of production method. As seen therefrom, the use of straight-line method and the units of production method will result in different taxable earnings per year due to various factors being considered for each method. Nonetheless, both depreciation methods will result in the same aggregate taxable earnings amounting to Php_____ million by the end of the concession agreement or zero difference. This means that the government will be able to collect the entire tax due from Manila Water under the straight-line method and thus will not incur revenue loss.

Figure 2: *Comparative schedule of depreciation of capital expenditure-related service concession assets of Manila Water for the years 2017 to 2037 using the straight-line method vis-à-vis units of production method.*

| End of Concession Period is on 31 July 2037 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Total** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** |
| UOP expense | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| SL expense | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Difference | (0) | _____ | _____ | _____ | _____ | _____ | _____ |
| Deferred tax impact | 0 | (__) | (___) | (___) | (___) | (___) | (___) |

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| | | | | | | | |
|---|---|---|---|---|---|---|---|
| UOP net income | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| SL net income | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Difference | 0 | (___) | (___) | (___) | (____) | (____) | (____) |
| Check | (0) | - | - | - | - | - | - |

| End of Concession Period is on 31 July 2037 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **2023** | **2024** | **2025** | **2026** | **2027** | **2028** | **2029** |
| UOP expense | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| SL expense | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Difference | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Deferred tax impact | (___) | (___) | (___) | (___) | (___) | (___) | (___) |
| UOP net income | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| SL net income | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Difference | (___) | (___) | (___) | (___) | (___) | (___) | (___) |
| Check | - | - | - | - | - | - | - |

| End of Concession Period is on 31 July 2037 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | **2030** | **2031** | **2032** | **2033** | **2034** | **2035** | **2036** | **2037** |
| UOP expense | _____ | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| SL expense | _____ | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Difference | _____ | (___) | (___) | (___) | (___) | (___) | (___) | (___) |
| Deferred tax impact | (___) | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| UOP net income | _____ | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| SL net income | _____ | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Difference | (___) | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Check | 0 | - | - | - | - | - | - | (0) |

With the use of two (2) different depreciation methods, Manila Water's tax records will differ from its accounting records per year but the same book value of the capital-related service concession assets will be derived at the end of the concession period. To address this issue, we propose that a reconciliation of the differences arising from the use of straight-line and unit of production methods, as demonstrated in Figure 1, be included as an attachment to the income tax return of Manila Water during those taxable years wherein the use of units of production method will result in higher taxable earnings (hereinafter referred to as "Reconciliation"). In case of Reconciliation, the revenue collection of the government will not be prejudiced since Manila Water will pay the appropriate tax resulting therefrom. Any overpayment made in Manila Water will be considered as its deferred tax assets.

The projections for Boracay Water, Clark Water and Laguna Water will show the same results as in Manila Water (*i.e.*, similar aggregate taxable earnings regardless of the depreciation method used). Boracay Water, Laguna Water and Clark Water will also implement Reconciliation so as not to prejudice the revenue collection of the government.

In reply, please be informed that Section 109 of Revenue Regulations (RR) No. 2, otherwise known as the Income Tax Regulations, provides that:

*"SECTION 109. Method of computing depreciation allowance. — The*

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*capital sum to be replaced should be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deductions taken by him, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made. If it develops that the useful life of the property will be longer or shorter than the useful life as originally estimated under all the then known facts, the portion of the cost or other basis of the property not already provided for through depreciation allowances should be spread over the remaining useful life of the property as re-estimated in the light of the subsequent facts, and depreciation deductions taken accordingly."* (Underscoring supplied)

A taxpayer is allowed or granted the privilege to choose the accounting method as in its judgment best suited to its purpose. The afore-cited provision of RR No. 2 clearly allows taxpayers to use whatever method of computing depreciation allowance provided that it is reasonable and has due regard to operating conditions and clearly reflecting the income.

In relation thereto, Sections 167 and 168 of the same RR, provide that —

*"SECTION 167. Methods of accounting. — It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. Any approved standard method of accounting which reflects taxpayer's income may be adopted. x x x"*

*"SECTION 168. Changes in accounting methods. — The true income, computed under the law shall in all cases be entered in the return. If for any reason the basis of reporting income subject to tax is changed, the taxpayer shall attach to his return a separate statement setting forth for the taxable year and for the preceding year the classes of items differently treated under the two systems, specifying in particular all amounts duplicated or entirely omitted as the result of such change.*

*A taxpayer who changes the method of accounting employed in keeping his book shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner of Internal Revenue. For the purposes of this action, a change in the method of accounting employed in keeping books means any change in the accounting treatment of items of income or deductions, x x x."* (Underscoring supplied)

Also, Section 43 of the National Internal Revenue Code of 1997, as amended,

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states that:

> *"SEC. 43. General Rule. — The taxable income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer, but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner clearly reflects the income. If the taxpayer's annual accounting period is other than a fiscal year, as defined in Section 22 (Q), or if the taxpayer has no annual accounting period, or does not keep books, or if the taxpayer is an individual, the taxable income shall be computed on the basis of the calendar year."*

In case of change in accounting method, which includes change in depreciation method, Section 168 of RR No. 2 merely requires a taxpayer to attach to its return a separate statement setting forth the taxable year and for the preceding year the classes of items differently treated under the two (2) systems, specifying in particular all amount duplicated or entirely omitted as the result of such change.

Furthermore, as represented, while the Group will change the method of accounting employed in keeping its book (*i.e.*, from straight-line method to units of production method), it will not compute its income upon such new method for purposes of taxation. The Group will be using the units of production method in computing the depreciation of its capital expenditure-related service concession assets while maintaining the straight-line method for other fixed assets group such as property, plant and equipment and service concession asset-concession fees for financial accounting purpose, herein described, as follows:

| **Fixed Assets Group** | **Statutory and Management Reporting** | **Tax Reporting** |
|---|---|---|
| Property, plant and equipment | SL | SL |
| Service concession assets-CAPEX | UOP | SL |
| Service concession assets-concession fees | SL | SL |

In view of the foregoing provisions of RR 2 (Income Tax Regulations), as well as of Section 43 of the National Internal Revenue Code of 1997, as amended, this Office grants Manila Water's and the Group's request to change the method of computing depreciation expense of their respective capital expenditure-related service concession assets from straight-line method to units of production method for financial accounting purposes in order to reflect its income in a way that will better aid its management and its stakeholders in managing the business of and making decisions, while maintaining the straight-line method for income tax purposes effective May 1, 2017.

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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*

## Footnotes

1. The concession agreements separately entered into by Manila Water, Boracay Water, Clark Water and Laguna Water will end in 2037, 2034, 2040, and 2035, respectively.
2. Under Title II, Chapter VII, Section 34 (F) (1) of the National Internal Revenue Code ("Tax Code"), there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including reasonable allowance for obsolescence) of property used in the trade or business. In relation thereto, Title II, Chapter VII, Section 34 (F) (2) of the Tax Code provides that the term reasonable allowance shall include, but not limited to, an allowance computed in accordance with rules and regulations prescribed by the Secretary of Finance, upon recommendation of the Commissioner, under any of the following methods: i) straight-line method; ii) declining-balance method; iii) sum-of-the-years-digit method; and iv) any other method which may be prescribed by the Secretary of Finance upon recommendation of the Commissioner.

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