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REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

BAGONG PILIPINAS

SEP 03 2025

REVENUE MEMORANDUM CIRCULAR NO. 081-2025

SUBJECT : Reiterating the Criteria and Guidelines on the Deductibility of Ordinary and Necessary Expenses Under Section 34(A)(1)(a) of the National Internal Revenue Code of 1997, as Amended.

TO : All Internal Revenue Officers and Others Concerned

I. BACKGROUND

Section 34(A)(1)(a) of the National Internal Revenue Code of 1997, as amended (Tax Code), provides that ordinary and necessary expenses paid or incurred during the taxable year which are directly attributable to the development, management, operation and/or conduct of trade, business or exercise of profession shall be allowed as deduction from gross income, to *wit*:

> *"Section 34. Deductions from Gross Income. – xxx*
>
> *(A) Expenses. –*
>
> *(1) Ordinary and Necessary Trade, Business or Professional Expenses. —*
>
> *(a) In General. — There shall be allowed as deduction from gross income all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on or which are directly attributable to, the development, management, operation and/or conduct of the trade, business or exercise of a profession... xxx"*

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Under the above provision and Section 65 of Revenue Regulations No. 2-40, for an expense to be deductible from a taxpayer's gross income, it must be both "ordinary" and "necessary" in the operation of the trade, business, or exercise of a profession.

This Circular is issued to reiterate the criteria and guidelines under which business expenses can be considered deductible for tax purposes, emphasizing the requirement that such expenses must be "ordinary" and "necessary" in accordance with Section 34(A)(1)(a) of the Tax Code. The cited rulings and principles provide a comprehensive framework for determining the deductibility of business expenses, essential for accurately reflecting the taxable income of the organizations, trades or businesses.

II. PERSONS ENTITLED TO DEDUCTION UNDER SECTION 34 OF THE TAX CODE

Section 34 of the Tax Code on deductions from Gross Income, clearly provides that in computing taxable income subject to income tax, deductions are permitted only for the following:

1. Individuals who are citizens or resident aliens under Section 24(A) of the Tax Code;
2. Non-resident aliens engaged in trade or business in the Philippines under Section 25(A) of the Tax Code;
3. Members of general professional partnerships under Section 26 of the Tax Code;
4. Domestic corporations under Section 27(A) of the Tax Code;
5. Proprietary educational institutions and hospitals under Section 27(B) of the Tax Code;
6. Government-owned and controlled corporations (GOCCs) under Section 27(C) of the Tax Code; and
7. Resident foreign corporations under Section 28(A)(1) of the Tax Code.

III. CRITERIA FOR DEDUCTIBILITY

In order for a business expense may be allowed as deductions from gross income, the following conditions must be met:[1]

1. the expense must be ordinary and necessary;
2. the expense must be paid or incurred within the taxable year;
3. the expense must have been paid or incurred in carrying on or which are directly attributable to, the development, management, operation and/or conduct of the trade, business or exercise of a profession; and
4. the expense must be supported by invoices, records or other pertinent papers.[2]

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A. The expenses must be ordinary and necessary

Taxpayers are allowed to deduct business expenses that are both "ordinary" (common and accepted in the trade or business) and "necessary" (appropriate and helpful for the business) from their gross income to determine their taxable income. For this purpose, ordinary and necessary expenses are defined as follows:

Ordinary Expenses – An "ordinary expense" is one that is normal, usual and customary in the type of business conducted by the taxpayer. It does not need to be habitual or recurring but should be common in the context of the business. The term "ordinary" denotes that the expense must be typical and usual in relation to the business activities.

Necessary Expenses – A "necessary expense" is one that is appropriate and helpful for the development of the taxpayer's business. This implies that the expense should be

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[1] Pilmico-Mauri Foods Corp. v. Commissioner of Internal Revenue (CIR), G.R. No. 175651 (Resolution), 14 September 2016; Atlas Consolidated Mining and Development Corporation v. CIR, 102 SCRA 246; CIR v. Isabela Cultural Corp., G.R. No. 172231, 12 February 2007.

[2] H. Tambunting Pawnshop, Inc. v. CIR, G.R. No. 173373, 29 July 2013, 702 Phil 397-417, 715 SCRA 386-404.

directly connected and proximately resulting from carrying on the business and must contribute to the generation of income or profit or minimizing a loss.[3]

The mere allegation of the taxpayer that an item of expense is ordinary and necessary does not justify its deduction as business expense.[4] The taxpayer must substantially prove by evidence or records (i.e., invoices) that the deductions claimed are allowed under the existing laws, rules and regulations, otherwise, the same will be disallowed.[5]

1. Rules on Ordinary Expenses

As settled in various court cases, not all expenses, even if deemed necessary, qualify as ordinary. An expense that is inordinately large cannot be considered as an ordinary expense even if it is necessary. If an expense nearly equaled half of the total claimed expenses, it may be considered as inordinately large and, thus, could not be considered "ordinary," even if it might be "necessary" for the business's marketing strategy.[6] Hence, in determining whether a particular expense is ordinary, the size and relative proportion of expenses must be considered. Concomitantly, for an expense to be considered ordinary, they must be ordinary and necessary expenses paid or incurred in carrying on any trade or business, and should meet the further test of reasonableness in amount.[7]

Further, extraordinary and unusual amounts paid to persons (natural or juridical) as compensation for their supposed services, but without any relation to the measure of their actual services, cannot be regarded as ordinary and necessary expenses within the meaning of the law.[8] This posture is in line with the doctrine in the law of taxation that a taxpayer must show that its claimed deduction clearly come within the language of the law since allowances, like exemptions, are matters of legislative grace.[9] As such, they must be strictly construed against the taxpayer.

2. Rules on Necessary Expenses

Expenditures not directly related to the earnings of the business within the Philippines, such as costs incurred for the remittance of funds to an overseas head office, are not deductible.[10] It is important that the expense is necessary or integral to the income-generating activities of the business. Claims for deductions are a matter of legislative grace and do not turn on mere equitable considerations. The taxpayer in every instance has the burden of justifying the allowance of any deduction claimed.[11]

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[3] General Foods (Philippines), Inc. v. CIR, CTA Case No. 4386, February 8, 1994.
[4] Atlas Consolidated Mining and Development Corporation v. CIR, 102 SCRA 246.
[5] Id.
[6] CIR v. General Foods (Phils.), Inc., G.R. No. 143672, April 24, 2003.
[7] Zamora v. CIR, G.R. No. L-15290, L-15280, L-15289, L-15281, May 31, 1963.
[8] Aguinaldo Industries Corp. v. CIR, G.R. No. L-29790, February 25, 1982.
[9] Aguinaldo Industries Corp. v. CIR, G.R. No. L-29790, February 25, 1982.
[10] Esso Standard Eastern, Inc. v. CIR, G.R. Nos. L-28508-9, July 7, 1989.
[11] Merten's, Law of Federal Income Taxation, Section 25.03.

B. The expenses must be paid or incurred within the taxable year

Section 45 of the Tax Code states that "the deductions provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred', dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income, the deductions should be taken as of a different period."

Therefore, the deductible business expenses claimed must be for expenses that are paid or incurred within the taxable year when the corresponding revenue is earned. The term "taxable year" is defined under Sections 22(P) and 52(B) of the Tax Code as either the calendar year or the fiscal year, upon the basis of which the net income is computed. This criterion guarantees that the expense is directly linked to the particular period during which income is generated, which is consistent with the matching principle under the Generally Accepted Accounting Principles.

C. The expenses must be directly attributable to trade, business, or profession

The expense must be paid or incurred in connection with the development, management, operation, and/or conduct of the trade, business, or profession. This means that there should be a direct link between the expense being deducted and the taxpayer's business activities.

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The phrases "engage in business," "carrying on business" or "doing business" do not have different meanings, but separately or connectedly convey the idea of progression, continuity, or sustained activity. "Engaged in business" means occupied or employed in business; "carrying on business" does not mean the performance of a single disconnected act, but means conducting, prosecuting, and continuing business by performing progressively all the acts normally incident thereto; while "doing business" conveys the idea of business being done, not from time to time, but all the time.[12]

"Directly attributable" means the expenses must have a clear and direct connection to the development, management, operation, and/or conduct of the trade, business, or profession, ensuring they are essential for maintaining and generating business income.[13] This provision is intended to ensure that only expenditures that are directly tied to the development, management, operation and the ongoing activities of the business are deductible, thereby providing a fair and accurate representation of the taxable profit of the business.

When a taxpayer incurs expenses related to both active and passive income, determining which expenses qualify as valid deductions under the "ordinary and necessary" provisions requires careful consideration of their direct connection to income-generating activities. Active income[14] typically arises from the direct involvement (active pursuit) in

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[12] Imperial v. Collector of Internal Revenue, G.R. No. L-7924, September 30, 1955.

[13] The term "directly" as defined in Black's Law Dictionary refers to something that is done without any intervening agency or step; it is immediate and straightforward. This definition is often used in legal contexts to describe actions or relationships that occur without any intermediary.

[14] Active income - income in the active pursuit and performance of its primary purpose - Iconic Beverages, Inc. v. CIR, CTA EB Case Nos. 1563 & 1564 CTA Case No. 8813, September 18, 2018.

trade, business, or professional activities, while passive income[15] comes from investments like dividends, interest, and royalties. Passive income is already subject to different rates and taxed finally at source, therefore, these incomes are no longer included in the computation of gross income, which determines taxable income.[16] Therefore, it is crucial to segregate the expenses that are directly attributable to active business operations from those related to passive income generation.

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In determining whether income is passive or active under Republic Act (RA) No. 12214 or the "Capital Markets Efficiency Promotion Act" and relevant jurisprudence, the *key consideration is the level of the taxpayer's involvement in earning the income*. Passive income arises from sources that do not require the taxpayer's continuous or direct participation, such as interest, royalties, dividends, and capital gains, and is not subject to Value-added Tax (VAT). This is affirmed in cases like *Commissioner of Internal Revenue v. Bank of Commerce*[17] and *Republic v. Spouses Bunsay*[18], where such income was taxed separately due to its passive nature. In contrast, in the case of *Iconic Beverages, Inc. vs. Commissioner of Internal Revenue*[19], it clarifies that active income results from the taxpayer's active pursuit of its primary business or trade. A passive income can become active if the taxpayer repeatedly and systematically engages in activities that produce such income, transforming it into a business venture. Likewise, income typically considered active may be treated as passive if it is earned occasionally or without any substantial or recurring effort. Ultimately, classification hinges on *whether the income results from habitual, business-driven actions or from merely holding assets and earning returns without substantial participation*. Thus, the *degree, frequency, and intent of participation* in the income-producing activity are the main considerations in classifying income as passive or active.

Expenses directly tied to the development, management, operation, or conduct of active trade or business can be deducted as they meet the criteria of being ordinary and necessary. However, expenses related to managing investments that generate passive income, such as fees for financial advice, interest from loan to finance investments, or brokerage services, and other related expenses may not qualify under the same provision, as they do not relate directly to the taxpayer's active business operations.

Moreover, each income stream, whether subject to regular tax, preferential rates, tax-exempt, or final tax, should have its expenses correctly identified. Furthermore, Section 43 of the Tax Code demands that income be computed annually using a method that clearly reflects the income. Non-compliance with these rules may lead to reclassification of expenses and potential disallowance if they are not directly tied to the development, management, operation and/or business activities, ensuring fairness and transparency in tax reporting.

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[15] Passive Income -The subject matter of the FWT is the passive income generated in the form of interest on deposits and yield on deposit substitutes- CIR v. Bank of Commerce, G.R. No. 149636, June 8, 2005, 498 PHIL 673-693; Capital Gains tax [CGT] is a tax on passive income- Republic v. Spouses Bunsay, G.R. No. 205473, December 10, 2019.

[16] CIR vs. Philippine Airlines, Inc., G.R. No. 160528, October 9, 2006.

[17] CIR vs. Bank of Commerce, G.R. No. 149636, June 8, 2005.

[18] Republic of The Philippines vs. Spouses Marcelino Bunsay and Nenita Bunsay, G.R. No. 205473, December 10, 2019.

[19] Iconic Beverages, Inc. vs. CIR, CTA Case No. 8607, August 14, 2015.

D. Substantiation

The taxpayer must substantially prove by evidence or records the deductions claimed under the law, otherwise, the same will be disallowed. The mere allegation of the taxpayer that an item of expense is ordinary and necessary does not justify its deduction.[20] Pieces of evidence, such as official invoices and vouchers, must be presented to substantiate the business expenses.[21]

It is a governing principle in taxation that tax exemptions must be construed in *strictissimi juris* against the taxpayer and liberally in favor of the taxing authority; and one who claims an exemption must be able to justify the same by the clearest grant of organic or statute law. An exemption from the common burden cannot be permitted to exist upon vague implications. And since a deduction for income tax purposes partakes of the nature of a tax exemption, then it must also be strictly construed.[22]

IV. TAX TREATMENT OF EXPENSES PERTAINING TO TAX-EXEMPT INCOME

Expenses solely incurred in relation to tax-exempt income are not deductible for regular income tax purposes. Allowing deductions for expenses that produce tax-exempt income would effectively give the taxpayer a double benefit – the income is exempt from tax, and the expenses reduce taxable income from other sources. Business expenses related to tax-exempt income do not contribute to the generation of taxable income and therefore do not meet the criteria of being necessary for the conduct of the business in the pursuit of income.[23]

Accordingly, if a taxpayer incurs expenses solely to generate tax-exempt income, these expenses cannot be deducted from its regular taxable income.

V. TAX TREATMENT OF EXPENSES PERTAINING TO INCOME SUBJECT TO FINAL WITHHOLDING TAX

Income subject to final withholding tax is typically taxed at the source, and the tax withheld is considered the final tax liability on that income. Examples include interest from savings accounts or dividends from stocks, where the financial institution or the payor withholds a flat tax rate. The expenses solely related to generating this income are usually not deductible against other taxable income subject to regular income tax. Since this passive income has already been taxed at a final rate, allowing further deductions would distort the taxation principle that final withholding tax is comprehensive and conclusive. Thus, costs related to investment management do not qualify for deductions typically reserved for business operations.

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[20] Pilmico-Mauri Foods Corp., Petitioner, v. CIR, G.R. No. 175651, September 14, 2016.
[21] H. Tambunting Pawnshop, Inc. v. CIR, *supra;* First Lepanto Taisho Insurance Corporation v. CIR, G.R. No. 197117, April 10, 2013.
[22] CIR v. Isabela Cultural Corp., G.R. No. 172231, 12 February 2007.
[23] Citytrust Banking Corporation vs. CIR, CTA Case No. 5261, January 28, 1998.

VI. TAX TREATMENT OF EXPENSES PERTAINING TO INCOME SUBJECT TO PREFERENTIAL TAX RATE

When expenses are directly attributable to income subject to a preferential tax rate due to specific incentives or under special laws, these expenses must be carefully segregated from those subject income. The primary reason for this segregation is to ensure that the expenses directly tied to the preferentially taxed income are not deducted from the regular taxable income, thereby preventing any reduction to regular taxable in the tax base of the regular income. This segregation helps in maintaining the integrity of the tax system and ensures that the benefits of preferential tax rates are not improperly extended to regular income.

For business enterprises registered with Investment Promotion Agencies and whose availing of the five percent (5%) special corporate income tax (SCIT) incentive based on its gross income earned, in lieu of all national and local taxes, under Section 294(B) of the Tax Code, the "gross income earned" refers to gross sales/revenues net of sales discounts, returns, allowances, and direct costs related to production of goods/services. Indirect operating expenses like advertising, representation, entertainment, commissions, clinic and office supplies, as well as freight and handling costs unrelated to production, which did not qualify as direct costs are disallowed as deductions for this purpose.[24] Section 1(b), Rule 2 of the Implementing Rules and Regulations of RA No. 12066 provides for the list of direct costs for purposes of determining the gross income of businesses under the five percent (5%) SCIT incentive.

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

All concerned are hereby enjoined to be guided accordingly and to give this Circular as wide a publicity as possible.

This Circular takes effect immediately.

ROMEO D. LUMAGUI, JR
Commissioner of Internal Revenue

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[24] CS Garments, Inc. v. CIR, C.T.A. EB Case No. 287 (CTA Case No. 6520), January 14, 2008.