REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE
National Office Building
Quezon City

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REVENUE MEMORANDUM CIRCULAR NO. 089-2024

SUBJECT: Clarifying the Taxability of Income Derived by Local Government Units (LGUs) engaged in Proprietary Functions

TO: All Internal Revenue Officials, Employees and Others Concerned

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I. BACKGROUND

Section 2, Article X of the 1987 Philippine Constitution[1] ("**Constitution**") and Section 22 (d) of Republic Act ("**RA**") No. 7160[2] provides that Local Government Units ("**LGUs**"), being political subdivisions, shall enjoy local autonomy, including full autonomy in the exercise of their proprietary functions and in the management of their economic enterprises.

Section 5 of the Constitution and Section 18 of RA No. 7160 provide that LGUs shall have the power to: (1) create its own sources of revenues and to levy taxes, fees and charges subject to such guidelines and limitations as the Congress may provide, consistent with the basic policy of local autonomy. Such taxes, fees and charges shall accrue exclusively for their use and disposition and which shall be retained by them; and (2) acquire, develop, lease, encumber, alienate, or otherwise dispose of real or personal property held by them in their proprietary capacity and to apply their resources and assets for productive, developmental, or welfare purposes, in the exercise or furtherance of their governmental or proprietary powers and functions and thereby ensure their development into self-reliant communities and active participants in the attainment of national goals.

Section 27 (C) of the National Internal Revenue Code of 1997, as amended ("**Tax Code**"), expressly provides that LGUs (which are considered as a government agency[3]) are liable to pay tax imposed upon their taxable income, to *wit*:

"SEC. 27 Rates of income tax on domestic corporations. –

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[1] February 2, 1987.
[2] An Act Providing for a Local Government Code of 1991, October 10, 1991.
[3] Section 2 of Executive Order No. 292, otherwise known as the "Revised Administrative Code of 1987," July 25, 1987; Revenue Regulations No. 2-2023 dated March 29, 2023; Boy Scouts of the Philippines vs. National Labor Relations Commission, G.R. No. 80767, April 22, 1991, BIR Ruling No. OT-0659-2020, December 9, 2020; BIR Ruling No. 1353-18, November 15, 2018.

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(C) Government-owned or Controlled Corporations, Agencies or Instrumentalities. — The provisions of existing special or general laws to the contrary notwithstanding, all corporations, agencies, or instrumentalities owned or controlled by the Government, except the Government Service Insurance System (GSIS), the Social Security System (SSS), the Philippine Health Insurance Corporation (PHIC), the local water districts (LWD), shall pay such rate of tax upon their taxable income as are imposed by this Section upon corporations or associations engaged in a similar business, industry or activity."

However, Section 32 (B) (7) (b) of the Tax Code clarified that income derived from the exercise of essential government function accruing to LGUs are exempt from tax, to *wit*:

"SEC. 32. Gross Income. –

xxx xxx xxx

(B) Exclusions from gross income. – The following items shall not be included in gross income and shall be exempt from taxation under this Title:

xxx xxx xxx

(7) Miscellaneous Items.

xxx xxx xxx

(b) Income Derived by the Government or its Political Subdivisions. – Income derived from any public utility or from the exercise of essential governmental function accruing to the Government of the Philippines or to any political subdivision thereof."

Hence, it is clear that only the income derived by the LGUs from the performance of its proprietary functions shall be subject to Philippine taxes as are imposed upon corporations or associations engaged in similar business, industry or activity.

This Circular is, therefore, issued to provide clarification and guidance relating to the imposition of taxes on the proprietary activities of LGUs based on the current laws and recent jurisprudence.

II. FUNCTIONS OF LOCAL GOVERNMENT UNIT

Under Section 15 of RA No. 7160, LGUs' powers are two-fold in character: (i) governmental, legislative, public, or political; and (ii) proprietary, corporate or private.

A. Governmental Functions

An LGU is exercising its governmental powers when it is performing acts which administer the powers of the State and promoting public welfare which includes the legislative, judicial, public and political aspects. In its public capacity, a responsibility exists in the performance of acts for the public benefit, and in this respect, it is merely a part of the

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machinery of government of the sovereignty creating them, and the authority of the state is supreme.[4]

Government function is defined as functions of a municipal corporation or a local government unit which are conferred or imposed upon it as a local agency that are essential to its existence in the sense of serving the public and which has for its objective the promotion or advancement of the public health, safety, morals, general welfare, security, prosperity and contentment of the inhabitant or in the performance of a duty imposed by sovereign power.[5]

In order to establish as to whether an LGU performs a governmental function or not, it has the burden of proving that the objective of its economic endeavor is purely governmental. It must present through evidentiary documents, the purpose of its creation, the manner of its operation, intended recipients of its services or customers and the disposition of its revenues.[6]

B. Proprietary Functions

Proprietary function refers to those that are undertaken only by way of advancing the general interest of society, and merely optional on the government.[7] Proprietary powers are exercised for the special benefit and advantage of the community which include those: (1) that are ministerial, private, and corporate in nature, and not necessary to its existence; and (2) which inure to the advantage of its inhabitants.

Section 2 (5) of Revenue Regulations ("**RR**") No. 18-2012, qualified the acts that are considered performance of proprietary functions of the LGUs:

"SECTION 2. Definition of Terms. –

xxx xxx xxx

5. Government Proprietary Function – for purposes of these Regulations, when a public corporation or a local government unit acts in its proprietary character, it is regarded as having the rights and obligations of a private corporation. For government entities to be taxable, the following requisites must concur: (1) the government entity concerned must not be performing an essential governmental function; and (2) it must be engaged in similar business, industry, or activity as performed by other ordinary taxable corporations. All income realized from or received in the exercise of its proprietary functions shall be subject to income tax and business taxes in the same manner as other private corporations similarly situated."

Based on the foregoing, the following requisites must all be present in order for a specific act of LGU to be considered as proprietary in nature:

1. the LGU concerned must not be performing an essential governmental function; and

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[4] Angat River Irrigation System, et al. v. Angat River Workers' Union et al., G.R. Nos. L-10943 & L-10944, December 28, 1957.
[5] BIR Ruling No. 369-2011, October 5, 2011.
[6] Imposition of Income Tax and VAT by the BIR to Local Economic Enterprises, Bureau of Local Government Finance Opinion, April 20, 2017.
[7] BIR Ruling No. 471-2018, March 13, 2018.

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2. the LGU must be engaged in similar business, industry, or activity as performed by other ordinary taxable corporations.

There is no hard and fast rule for purposes of determining the true nature of an undertaking or function of an LGU. The surrounding circumstances of a particular case are to be considered and would be decisive. The basic element, no matter how beneficial to the public the undertaking may be, is that it is governmental in essence, otherwise the function becomes private or proprietary in character.[8]

III. TAX TREATMENT OF INCOME DERIVED FROM THE PERFORMANCE OF PROPRIETARY FUNCTIONS OF LGUs

To reiterate, any income derived by an LGU acting in its corporate capacity and for the purpose of economic gain and profit ("**Proprietary Income**") shall be subject to tax and treated just like an income of any other private or government corporation.

When LGUs act in its proprietary character, it is regarded as having the rights and obligations of a private corporation. Based on Section 30 of the Tax Code, the income of whatever kind and character of corporations from any of their properties, real or personal, or from any of their activities conducted for profit regardless of the disposition made of such income, shall be subject to tax imposed under the Tax Code.[9]

It bears stressing that the tax exemption privileges, including preferential tax treatment of all government units, including, for the avoidance of doubt, LGUs, were withdrawn by Presidential Decree No. 1931 (1984) and Executive Order No. 93 (1987).[10]

As such, the Proprietary Income derived by LGUs shall be subject to the following internal revenue taxes:

A. Income Tax

Section 27 (C) of the Tax Code provides that income derived by LGUs from the performance of proprietary activities are subject to income tax.

It must be noted that this includes income taxes imposed on passive income under Section 27(D) of the Tax Code such as, but not limited to, royalties, interests, dividends, sale of shares of stocks, income derived under the expanded foreign currency deposit system, and capital gain realized from sale, exchange, or other disposition of lands and/or buildings which are not actually used in the performance of such LGU's governmental functions.

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[8] Torio vs. Fontanilla, 85 SCRA 602 (1978).
[9] Imposition of Income Tax and VAT by the BIR to Local Economic Enterprises, Bureau of Local Government Finance Opinion, April 20, 2017.
[10] BIR Ruling No. 055-1991, April 3, 1991; BIR Ruling No. 369-2011, October 5, 2011.

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B. Withholding tax

While it is true that under Section 2.57.5 (A) of RR No. 2-98, withholding of creditable withholding tax shall not apply to income payments made to the national government and its instrumentalities, including provincial, city or municipal governments, this rule only applies to income payments received by the LGU in the performance of its governmental functions.

As discussed above, Proprietary Income shall be taxed the same just like any other private or government corporation. Hence, income payments to LGUs by reason of performance of proprietary functions shall be subject to withholding tax pursuant to RR No. 2-98.

C. VAT

Section 105 of the Tax Code provides for the persons liable to VAT, to *wit:*

> *"SEC. 105. Persons Liable. — Any person who, in the course of trade or business, sells, barters, exchanges, leases goods or properties, renders services, and any person who imports goods shall be subject to the value-added tax (VAT) imposed in Sections 106 to 108 of this Code."*

Moreover, Section 108 of the Tax Code provides for the tax rate and tax base of VAT on sale of services:

> *"SEC. 108. Value-added Tax on Sale of Services and Use or Lease of Properties.*
>
> *(A) Rate and Base of Tax. — There shall be levied, assessed and collected, a value-added tax equivalent to twelve percent (12%) of the gross sales derived from the sale or exchange of services, including the use or lease of properties;*
>
> *xxx xxx xxx*
>
> *The phrase 'sale or exchange or services' means the performance of all kinds of services in the Philippines, for others for a fee, remuneration or consideration, x x x"*

When LGUs perform corporate or private function that is proprietary in nature, it shall be held liable to twelve percent (12%) VAT on the total gross sales it derived from such activity.[11]

D. Other Percentage Taxes

Income derived by LGUs from the performance of its proprietary function that falls under Title V of the Tax Code shall be subject to percentage tax based on the percentage tax rates provided therein.

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[11] BIR Ruling No. 471-2018, March 13, 2018.

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E. DST

LGUs entering into private contracts/agreements relating to its performance of corporate or private function that is proprietary in nature, similar with private corporations, shall be held liable for DST under the Tax Code.

For transactions subject to the above internal revenue taxes, LGUs shall issue the appropriate invoice/s complying with the requirements under Section 237 of the Tax Code, as amended by RA No. 11976, otherwise known as the "Ease of Paying Taxes Act," and as implemented by RR No. 7-2024 and other existing rules and regulations. Hence, they shall apply for Authority to Print in the printing of their principal and supplementary invoices following the procedure under RR No. 7-2024 and other relevant revenue issuances.

IV. APPLICATION OF TAXES

A. Sale of properties that are no longer intended for governmental use

Under Section 27 (D) (5) of the Tax Code, it is provided that in the case of sale, exchange, or other disposition of lands and/or buildings which are not actually used in business and are treated as capital assets by domestic corporations, a final tax of six percent (6%) based on the gross selling price or current fair market value as determined in accordance with Section 6 (E) of the Tax Code, whichever is higher, is imposed upon capital gains presumed to have been realized therefrom. It must be noted that the said CGT is an income tax, the burden of which rests upon the seller which, in this case, is the LGU.

It is noteworthy to mention that LGU is subject to the CGT of 6% imposed on its capital gains presumed to have been realized from the sale of properties despite of its being a government entity. This is in accordance with Section 32 (B) (7) (b) of the Tax Code which provides that only the income derived by the LGU from the exercise of its essential governmental function shall be excluded from its gross income.[12]

B. Leasing of properties

Leasing of property to a private person and/or entity for it to construct, develop and operate a commercial activity is primarily an economic activity with a view to obtaining profit. The LGU in this case acts in its proprietary or private character since no governmental or public policy of the state is involved.[13]

C. Exchange of properties

It has been the consistent stance of this Office that an exchange of properties between two (2) parties is subject to CGT and the corresponding DST based on the fair market value of their respective properties as determined in accordance with Section 6 (E) of the Tax Code. If the exchange of properties between the LGU and

[12] BIR Ruling No. DA-419-98 dated September 14, 1998; BIR Ruling No. 396-11, October 25, 2011.
[13] BIR Ruling No. 239-14, June 25, 2014.

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the private person/entity relating to a commercial activity partakes the nature of voluntary exchange, it is subject to the aforesaid taxes.[14]

Accordingly, the private person/entity may opt to report the gain realized in the exchange in the manner provided for under Section 24 (A) (1) of the Tax Code. Under Section 24 (D) (1) of the Tax Code, an individual taxpayer has the option to report his tax liabilities, if any, on gains realized on dispositions of real property to the government or any of its political subdivisions or agencies either as a transaction subject to CGT of 6% under Section 24 (D) (1) of the Tax Code, or under Sec. 24 (A) (1) thereof and the corresponding DST prescribed in Section 196 of the same Code.

On the other hand, the LGU shall be subject to the CGT of 6% imposed under Section 27 (D) (5) of the Tax Code on the capital gains presumed to have been realized from the said exchange transaction of real property considered as capital assets. This is because only the income derived by the LGU from the exercise of its essential governmental function shall be excluded from its gross income pursuant to Sec. 32 (B) (7) (b) of the Tax Code.[15]

D. Interest from deposits and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements and royalties

The obligation of LGU to maintain depository accounts for its funds may not be construed as part of its essential governmental functions since this is not exercised in "administering the powers of the state and promoting the public welfare" nor is it included among the "legislative, judicial, public or political" powers of the LGU. It is in the nature of a function "for the special benefit and advantage of the city or municipality" and, hence, proprietary in character.[16]

With regard to investments, it appears that an LGU engages primarily in an economic activity with a view to obtaining profit when it maintains investments. The City acts in its proprietary or private character since no governmental or public policy of the state is involved.[17]

The LGU is subject to the twenty percent (20%) final tax on its interest income derived from its deposit accounts and yield and other monetary benefit from its investments in government securities, commercial papers and similar arrangements under Section 27(D)(1) of the Tax Code.

E. The forfeiture of or purchase by the LGU in the public auction of properties due to delinquency in real property taxes

The transaction shall be subject to CGT based on the bid price in the auction sale or the zonal value of the foreclosed property, whichever is higher.

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[14] BIR Ruling No. DA-(I-047) 571-08 dated December 23, 2008.
[15] BIR Ruling No. 009-10 dated June 3, 2010; BIR Ruling No. 436-11, November 9, 2011.
[16] City of Manila vs. Intermediate Appellate Court, 179 SCRA 428, 434-435 (1989); BIR Ruling No. 013-04, September 13, 2004.
[17] BIR Ruling No. 013-04, September 13, 2004.

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The Declaration of Forfeiture is subject to DST under Section 196 of the Tax Code, since upon registration of this document with the Office of the Registry of Deeds, the Registrar of Deeds is duty bound to transfer the title of the forfeited property to the LGU pursuant to Section 263 of RA No. 7160.[18]

The statutory seller in this particular situation is the concerned LGU. Under the Tax Code, the CGT is required to be paid upon consolidation of title over the property by the highest bidder which shall be made after the lapse of one (1)-year redemption period. If redeemed, there is no CGT due. But, if the owner fails to redeem the property, the highest bidder who, in most cases is the statutory seller (LGU), pays the CGT and DST, in order that a property may be registered under its name upon the registration of the certificate of sale. There is no exemption from taxes in case of foreclosure sale. The Tax Code requires payment of CGT/DST even on conditional sales of real property.[19]

V. REPEALING CLAUSE

All other Circulars and/or portions thereof that are inconsistent herewith are hereby repealed, modified or amended accordingly.

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

This Circular shall take effect immediately.

ROMEO D. LUMAGUI, JR.
Commissioner of Internal Revenue

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[18] BIR Ruling No. 224-11, July 12, 2011.
[19] BIR Ruling No. 009-10, June 3, 2010.