

Illustration A:

PFRS is a ride-hailing company and has recently expanded its operations to Mindanao. Thus, on April 1, 2022, PFRS purchased 15 vehicles valued at ₱800,000.00 each. PFRS funded this purchase from its 5-year loan acquired from TWIT Bank on January 1, 2021 amounting to ₱30,000,000.00 with an annual interest rate of ten percent (10%). The loan is considered a general borrowing. Of this loan, ₱14,000,000.00 has not yet been utilized and the rest was used to support its operations. The principal is payable in full at the end of the loan term. For the taxable year 2022, PFRS' revenue, cost of revenue, and operating expense (excluding interest and depreciation) amounted to ₱50,000,000.00, ₱30,000,000.00, and ₱13,000,000.00, respectively. Its total assets during the year amounted to ₱150,000,000.00, excluding land on which the particular business entity's office, plant, and equipment are situated. The expected useful life of the vehicles is 6 years. PFRS has elected to capitalize interest and uses the straight-line method of depreciation.

1. What amount of interest expense may be capitalized?

The amount of interest expense that may be capitalized is ₱4,500,000.00, as computed below:

$$\frac{\begin{array}{l} \text{₱12,000,000.00} \\ \text{(amount utilized to} \\ \text{purchase vehicles to} \\ \text{be used in business)} \\ \hline \text{₱30,000,000.00} \\ \text{(total amount of loan)} \end{array}}{\begin{array}{l} \text{₱15,000,000.00} \\ \text{(total interest from} \\ \text{loan)} \\ \hline \text{5 years} \\ \text{(loan term)} \end{array}} \times \begin{array}{l} \text{3.75 years} \\ \text{(period from the} \\ \text{purchase of vehicles} \\ \text{until the end of the} \\ \text{loan term)} \end{array} = \begin{array}{l} \text{₱4,500,000.00} \\ \text{(capitalizable} \\ \text{interest)} \end{array}$$

2. What is the total deductible expense for the taxable year 2022?

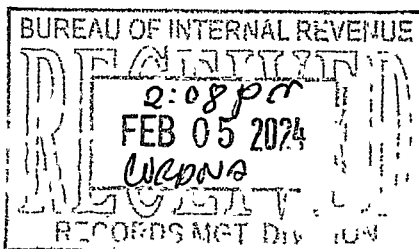
The total deductible expense for the year is ₱17,162,500.00, composed of the following:

- a. Operating expense (exclusive of depreciation and interest expense) – ₱13,000,000.00
- b. Depreciation – ₱2,062,500.00, computed as follows:

$$\frac{\begin{array}{l} \text{₱12,000,000.00} \\ \text{(total value of 15} \\ \text{vehicles)} \\ \hline \text{₱18,000,000.00} \\ \text{(total value of 15} \\ \text{vehicles plus} \\ \text{capitalizable} \\ \text{interest)} \\ \hline \text{6 years} \\ \text{(useful life of vehicle)} \end{array}}{\begin{array}{l} \text{₱4,500,000.00} \\ \text{(capitalizable} \\ \text{interest)} \\ \hline \text{9 mos. / 12 mos.} \\ \text{(depreciable period} \\ \text{for the year)} \end{array}} \times \begin{array}{l} \text{₱2,062,500.00} \\ \text{(depreciation for} \\ \text{the year)} \end{array}$$

- c. Interest expense – ₱2,100,000.00, computed as follows:

$$\frac{\begin{array}{l} \text{₱18,000,000.00} \\ \text{(part of the loan utilized} \\ \text{for other purposes)} \\ \hline \text{₱30,000,000.00} \\ \text{(total amount of loan)} \end{array}}{\begin{array}{l} \text{₱15,000,000.00} \\ \text{(total interest from loan)} \\ \hline \text{5 years} \\ \text{(loan term)} \end{array}} \times \begin{array}{l} \text{₱1,800,000.00} \end{array}$$



$$\begin{array}{r}
 \text{P}12,000,000.00 \\
 \text{(part of the loan utilized} \\
 \text{for purchase of} \\
 \text{vehicles)} \\
 \hline
 \text{P}30,000,000.00 \\
 \text{(total amount of loan)}
 \end{array}
 \times
 \begin{array}{r}
 \text{P}15,000,000.00 \\
 \text{(total interest from} \\
 \text{loan)} \\
 \hline
 \text{5 years} \\
 \text{(loan term)}
 \end{array}
 \times
 \begin{array}{l}
 \text{3 mos. / 12 mos.} \\
 \text{(period during the year} \\
 \text{within which the loan} \\
 \text{has not yet been} \\
 \text{utilized for purchase} \\
 \text{of vehicles)}
 \end{array}
 = \text{P}300,000.00$$

$$\text{Total interest expense} = \text{P}1,800,000.00 + \text{P}300,000.00 = \text{P}2,100,000.00$$

3. What is the taxable income/(loss) and income tax due for the taxable year 2022?

The taxable income and income tax due for the year are P3,837,500.00 and P959,375.00, respectively, as computed below:

Sales revenue	P 50,000,000.00
Less: Cost of revenue	30,000,000.00
Net sales	P 20,000,000.00
Less: Operating expense	17,162,500.00
Taxable income	P 2,837,500.00
Income tax rate	25%
Income tax due	P 709,375.00

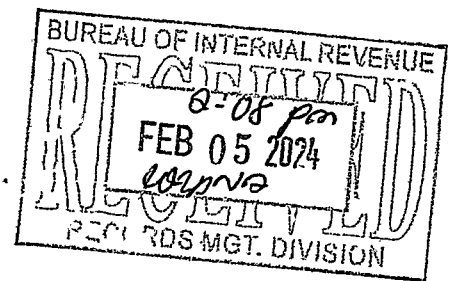


Illustration B:

In January 2022, NIRC Company purchased Machine A, Machine B and Machine C to be used in its manufacturing process valued at P500,000.00, P1,000,000.00, and P2,000,000.00, respectively, by acquiring a 4-year loan and a 5-year loan from TRAIN Bank in the amounts of P500,000.00 and P3,000,000.00, respectively, with an annual interest rate of ten percent (10%). The principal is payable in full at the end of the loan term. The company's yearly net income (before deducting interest expense and depreciation) is P10,000,000.00 and with total assets during the year of P150,000,000.00, excluding land on which the particular business entity's office, plant, and equipment are situated. In addition, the company earns P100,000.00 interest income on a yearly basis that is subject to final tax. The useful lives of Machine A, Machine B and Machine C are 3 years, 5 years and 6 years, respectively. Machine B, however, will take 2 years for it to be prepared for its intended use. The company has elected to capitalize its interest expense on Machines B and C.

Assuming that the company uses the straight-line method of depreciation, the following shall be the accounting treatment and tax treatment for Machines A, B, and C:

Machine A

Accounting Treatment

Year	Value of Machine A	Interest Expense	Depreciation	Balance
1	P 500,000.00	P 50,000.00	P 166,666.67	P 333,333.33
2	333,333.33	50,000.00	166,666.67	166,666.67
3	166,666.67	50,000.00	166,666.67	-
4	-	50,000.00	-	-

Tax Treatment

Year	Value of Machine A	Depreciation	Balance	Interest Paid	Limitation *	Allowable Interest Expense
1	₱ 500,000.00	₱ 166,666.67	₱ 333,333.33	₱ 50,000.00	₱ 20,000.00	₱ 30,000.00
2	333,333.33	166,666.67	166,666.67	50,000.00	20,000.00	30,000.00
3	166,666.67	166,666.67	-	50,000.00	20,000.00	30,000.00
4	-	-	-	50,000.00	20,000.00	30,000.00

* Computation of limitation: ₱100,000 (interest income) x 20% = ₱20,000

The differences are as follows:

Year	Interest Expense			Depreciation			Net Difference
	Accounting	Tax	Difference	Accounting	Tax	Difference	
1	₱ 50,000.00	₱ 30,000.00	₱ 20,000.00	₱166,666.67	₱166,666.67	₱ -	₱ 20,000.00
2	50,000.00	30,000.00	20,000.00	166,666.67	166,666.67	-	20,000.00
3	50,000.00	30,000.00	20,000.00	166,666.67	166,666.67	-	20,000.00
4	50,000.00	30,000.00	20,000.00	-	-	-	20,000.00
							₱ 80,000.00

The yearly net difference of ₱20,000.00 is a permanent difference that is not deductible from gross income for income tax purposes.

The following are the journal entries to record interest incurred and depreciation:

Accounting

Tax

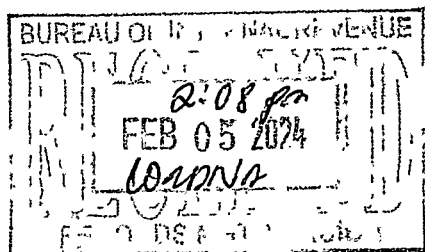
Years 1 – 4

Dr. Interest Expense	₱ 50,000.00	Dr. Interest Expense	₱ 30,000.00
Cr. Interest Liability	50,000.00	Cr. Interest Liability	30,000.00
Dr. Depreciation	₱ 166,666.67	Dr. Depreciation	₱ 166,666.67
Cr. Accumulated Depreciation	166,666.67	Cr. Accumulated Depreciation	166,666.67

Machine B

Accounting Treatment

Year	Value of Machine B	Capitalized Interest	Interest Expense	Depreciation	Balance
1	₱ 1,000,000.00	₱ 100,000.00	₱ -	₱ -	₱ 1,100,000.00
2	1,100,000.00	100,000.00	-	-	1,200,000.00
3	1,200,000.00	-	100,000.00	240,000.00	960,000.00
4	960,000.00	-	100,000.00	240,000.00	720,000.00
5	720,000.00	-	100,000.00	240,000.00	480,000.00
6	480,000.00	-	-	240,000.00	240,000.00
7	240,000.00	-	-	240,000.00	-



Tax Treatment

Year	Value of Machine B	Capitalized Interest	Adjusted Value of Machine B	Depreciation	Balance
1	₱ 1,000,000.00	₱ 500,000.00	₱ 1,500,000.00	₱ -	₱ 1,500,000.00
2	1,500,000.00	-	1,500,000.00	-	1,500,000.00
3	1,500,000.00	-	1,500,000.00	300,000.00	1,200,000.00
4	1,200,000.00	-	1,200,000.00	300,000.00	900,000.00
5	900,000.00	-	900,000.00	300,000.00	600,000.00
6	600,000.00	-	600,000.00	300,000.00	300,000.00
7	300,000.00	-	300,000.00	300,000.00	-

The differences are as follows:

Year	Interest Expense			Depreciation			Net
	Accounting	Tax	Difference	Accounting	Tax	Difference	Difference
1	₱ -	₱ -	₱ -	₱ -	₱ -	₱ -	₱ -
2	-	-	-	-	-	-	-
3	100,000.00	-	100,000.00	240,000.00	300,000.00	(60,000.00)	40,000.00
4	100,000.00	-	100,000.00	240,000.00	300,000.00	(60,000.00)	40,000.00
5	100,000.00	-	100,000.00	240,000.00	300,000.00	(60,000.00)	40,000.00
6	-	-	-	240,000.00	300,000.00	(60,000.00)	(60,000.00)
7	-	-	-	240,000.00	300,000.00	(60,000.00)	(60,000.00)
							₱ -

There is an automatic gap between the interest expense and depreciation expense accounts due to the loan term, period of preparation of the machine, and useful life of the machine which may be disclosed in the notes to financial statements. The yearly net difference of ₱40,000.00 through years 3 to 5 are temporary differences that are deductible from gross income for income tax purposes in subsequent periods.

The following are the journal entries to record interest incurred and depreciation:

Accounting

Years 1 and 2

Dr. PPE – Machine B ₱ 100,000.00
Cr. Interest Liability 100,000.00

Years 3, 4 and 5

Dr. Interest Expense ₱ 100,000.00
Cr. Interest Liability 100,000.00

Years 3 to 7

Dr. Depreciation ₱ 240,000.00
Cr. Accumulated Depreciation 240,000.00

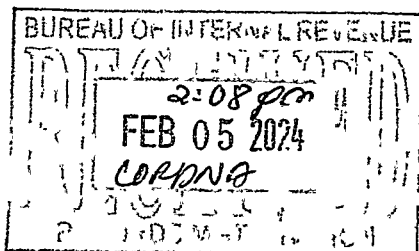
Tax

Year 1

Dr. PPE – Capitalized Interest
Expense ₱ 500,000.00
Cr. Interest Liability 500,000.00

Years 3 to 7

Dr. Depreciation ₱ 300,000.00
Cr. Accumulated Depreciation 300,000.00



Machine C

Accounting Treatment

Year	Value of Machine C	Capitalized Interest	Interest Expense	Depreciation	Balance
1	₱ 2,000,000.00	₱ -	₱ 200,000.00	₱ 333,333.33	₱ 1,666,666.67
2	1,666,666.67	-	200,000.00	333,333.33	1,333,333.33
3	1,333,333.33	-	200,000.00	333,333.33	1,000,000.00
4	1,000,000.00	-	200,000.00	333,333.33	666,666.67
5	666,666.67	-	200,000.00	333,333.33	333,333.33
6	333,333.33	-	-	333,333.33	-

Tax Treatment

Year	Value of Machine C	Capitalized Interest	Adjusted Value of Machine C	Depreciation	Balance
1	₱ 2,000,000.00	₱ 1,000,000.00	₱ 3,000,000.00	₱ 500,000.00	₱ 2,500,000.00
2	2,500,000.00	-	2,500,000.00	500,000.00	2,000,000.00
3	2,000,000.00	-	2,000,000.00	500,000.00	1,500,000.00
4	1,500,000.00	-	1,500,000.00	500,000.00	1,000,000.00
5	1,000,000.00	-	500,000.00	500,000.00	500,000.00
6	500,000.00	-	500,000.00	500,000.00	-

The differences are as follows:

Year	Interest Expense			Depreciation			Net Difference
	Accounting	Tax	Difference	Accounting	Tax	Difference	
1	₱ 200,000.00	₱ -	₱ 200,000.00	₱ 333,333.33	₱ 500,000.00	₱(166,666.67)	₱ 33,333.33
2	200,000.00	-	200,000.00	333,333.33	500,000.00	(166,666.67)	33,333.33
3	200,000.00	-	200,000.00	333,333.33	500,000.00	(166,666.67)	33,333.33
4	200,000.00	-	200,000.00	333,333.33	500,000.00	(166,666.67)	33,333.33
5	200,000.00	-	200,000.00	333,333.33	500,000.00	(166,666.67)	33,333.33
6	-	-	-	333,333.33	500,000.00	(166,666.67)	(166,666.67)
							₱ -

The yearly net difference of ₱33,333.33 through years 1 to 5 are temporary differences that are deductible from gross income for income tax purposes in the subsequent period.

The following are the journal entries to record interest incurred and depreciation:

Accounting

Tax

Years 1, 2, 3, 4 and 5

Dr. Interest Expense ₱ 200,000.00
Cr. Interest Liability 200,000.00

Year 1

Dr. PPE – Capitalized Interest Expense ₱ 1,000,000.00
Cr. Interest Liability 1,000,000.00

Dr. Depreciation ₱ 333,333.33
Cr. Accumulated Depreciation 333,333.33

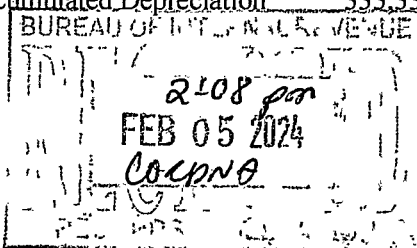
Dr. Depreciation ₱ 500,000.00
Cr. Accumulated Depreciation 500,000.00

Year 6

Dr. Depreciation ₱ 333,333.33
Cr. Accumulated Depreciation 333,333.33

Years 2, 3, 4 and 5

Dr. Depreciation ₱ 500,000.00
Cr. Accumulated Depreciation 500,000.00



Computation of Income Tax

Accounting

Year	Net Income before Interest and Depreciation (a)	Interest Expense (b)	Depreciation Expense (c)	Net Income (a - b - c) = (d)
1	₱ 10,000,000.00	₱ 250,000.00	₱ 500,000.00	₱ 9,250,000.00
2	10,000,000.00	250,000.00	500,000.00	9,250,000.00
3	10,000,000.00	350,000.00	740,000.00 ^m	8,910,000.00
4	10,000,000.00	350,000.00	573,333.33	9,076,666.67
5	10,000,000.00	300,000.00	573,333.33	9,126,666.67
6	10,000,000.00	-	573,333.33	9,426,666.67
7	10,000,000.00	-	240,000.00	9,760,000.00

Tax

Year	Net Income before Interest and Depreciation (a)	Allowable Interest Expense (b)	Depreciation Expense (c)	Net Taxable Income (a - b - c) = (d)	Income Tax (d) x 25%
1	₱ 10,000,000.00	₱ 30,000.00	₱ 666,666.67	₱ 9,303,333.33	₱ 2,325,833.33
2	10,000,000.00	30,000.00	666,666.67	9,303,333.33	2,325,833.33
3	10,000,000.00	30,000.00	966,666.67	9,003,333.33	2,250,833.33
4	10,000,000.00	30,000.00	800,000.00	9,170,000.00	2,292,500.00
5	10,000,000.00	-	800,000.00	9,200,000.00	2,300,000.00
6	10,000,000.00	-	800,000.00	9,200,000.00	2,300,000.00
7	10,000,000.00	-	300,000.00	9,700,000.00	2,425,000.00

Difference

Year	Accounting Net Income (a)	Taxable Net Income (b)	Difference (a - b)
1	₱ 9,250,000.00	₱ 9,303,333.33	₱ (53,333.33)
2	9,250,000.00	9,303,333.33	(53,333.33)
3	8,910,000.00	9,003,333.33	(93,333.33)
4	9,076,666.67	9,170,000.00	(93,333.33)
5	9,126,666.67	9,200,000.00	(73,333.33)
6	9,426,666.67	9,200,000.00	226,666.67
7	9,760,000.00	9,700,000.00	60,000.00
			₱ 80,000.00

The temporary differences reverse in subsequent periods. The remaining difference of ₱80,000.00 pertains to the limitation on interest expense which is not deductible from gross income for income tax purposes. In relation to the disclosures in the notes to financial statements, the taxpayer may note its election to capitalize interest expense for tax purposes. The differences must be included as reconciling items in the reconciliation of net income per books against taxable income in the income tax return.

