

**REVENUE MEMORANDUM CIRCULAR NO. 89-2024** issued on August 13, 2024 clarifies the taxability of income derived by Local Government Units (LGUs) engaged in proprietary functions.

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.

The following requisites must all be present in order for a specific act of LGU to be considered as proprietary in nature:

- a. The LGU concerned must not be performing an essential governmental function; and
- b. The LGU must be engaged similar business, industry, or activity as performed by other ordinary taxable corporations.

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.

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including preferential tax treatment of all government units, including, for the avoidance of doubt, LGUs, were withdrawn by Presidential Decree No. 1931 (1984) and Executive Order No. 93 (1987).

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

Under Section 2.57.5(A) of Revenue Regulations (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 government functions.

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.

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

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.

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 Documentary Stamp Tax (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 Republic Act (RA) No. 11976 (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.

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 Capital Gains Tax (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 it 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 government function shall be excluded from its gross income.

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.

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

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 Section 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 government function shall be excluded from its gross income pursuant to Sec. 32 (B) (7) (b) of the Tax Code.

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.

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.

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.

In the case of 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.

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.

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.