

CHINA BANKING CORPORATION, PETITIONER, VS. COURT OF APPEALS, COMMISSIONER OF INTERNAL REVENUE AND COURT OF TAX APPEALS, RESPONDENTS.

G.R. No. 125508. July 19, 2000

Ponente: VITUG, J.

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VITUG, J.:

The Commissioner of Internal Revenue denied the deduction from gross income of "securities becoming worthless" claimed by China Banking Corporation ("CBC"). The Commissioner's disallowance was sustained by the Court of Tax Appeals ("CTA"). When the ruling was appealed to the Court of Appeals ("CA"), the appellate court upheld the CTA. The case is now before us on a Petition for Review on Certiorari.

Sometime in 1980, petitioner China Banking Corporation made a 53% equity investment in the First CBC Capital (Asia) Ltd., a Hongkong subsidiary engaged in financing and investment with "deposit-taking" function. The investment amounted to P16,227,851.80, consisting of 106,000 shares with a par Value of P100 per share.

In the course of the regular examination of the financial books and investment portfolios of petitioner conducted by Bangko Sentral in 1986, it was shown that First CBC Capital (Asia), Ltd., has become insolvent. With the approval of Bangko Sentral, petitioner wrote-off as being worthless its investment in First CBC Capital (Asia), Ltd., in its 1987 Income Tax Return and treated it as a bad debt or as an ordinary loss deductible from its gross income.

Respondent Commissioner of internal Revenue disallowed the deduction and assessed petitioner for income tax deficiency in the amount of P8,533,328.04, inclusive of surcharge, interest and compromise penalty. The disallowance of the deduction was made on the ground that the investment should not be classified as being "worthless" and that, although the Hongkong Banking Commissioner had revoked the license of First CBC Capital as a "deposit-taping" company, the latter could still exercise, however, its financing and investment activities. Assuming that the securities had indeed become worthless, respondent Commissioner of Internal Revenue held the view that they should then be classified as "capital loss," and not as a bad debt expense there being no indebtedness to speak of between petitioner and its subsidiary.

Petitioner contested the ruling of respondent Commissioner before the CTA. The tax court sustained the Commissioner, holding that the securities had not indeed become worthless and ordered petitioner to pay its deficiency income tax for 1987 of P8,533,328.04 plus 20% interest per annum until fully paid. When the decision was appealed to the Court of Appeals, the latter upheld the CTA. In its instant petition for review on certiorari, petitioner bank assails the CA decision.

The petition must fail.

The claim of petitioner that the shares of stock in question have become worthless is based on a Profit and Loss Account for the Year-End 31 December 1987, and the recommendation of Bangko Sentral that the equity

investment be written-off due to the insolvency of the subsidiary. While the matter may not be indubitable (considering that certain classes of intangibles, like franchises and goodwill, are not always given corresponding values in financial statements[1], there may really be no need, however, to go of length into this issue since, even to assume the worthlessness of the shares, the deductibility thereof would still be nil in this particular case. At all events, the Court is not prepared to hold that both the tax court and the appellate court are utterly devoid of substantial basis for their own factual findings.

Subject to certain exceptions, such as the compensation income of individuals and passive income subject to final tax, as well as income of non-resident aliens and foreign corporations not engaged in trade or business in the Philippines, the tax on income is imposed on the net income allowing certain specified deductions from gross income to be claimed by the taxpayer. Among the deductible items allowed by the National Internal Revenue Code ("NIRC") are bad debts and losses.[2]

An equity investment is a capital, not ordinary, asset of the investor the sale or exchange of which results in either a capital gain or a capital loss. The gain or the loss is ordinary when the property sold or exchanged is not a capital asset.[3] A capital asset is defined negatively in Section 33(1) of the NIRC; viz:

(1) Capital assets. - The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property used in the trade or business, of a character which is subject to the allowance for depreciation provided in subsection (f) of section twenty-nine; or real property used in the trade or business of the taxpayer."

Thus, shares of stock; like the other securities defined in Section 20(t)[4] of the NIRC, would be ordinary assets only to a dealer in securities or a person engaged in the purchase and sale of, or an active trader (for his own account) in, securities. Section 20(u) of the NIRC defines a dealer in securities thus:

"(u) The term 'dealer in securities' means a merchant of stocks or securities, whether an individual, partnership or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."

In the hands, however, of another who holds the shares of stock by way of an investment, the shares to him would be capital assets. When the shares held by such investor become worthless, the loss is deemed to be a loss from the sale or exchange of capital assets. Section 29(d)(4)(B) of the NIRC states:

"(B) Securities becoming worthless. - If securities as defined in Section 20 become worthless during the tax" year and are capital assets, the loss resulting therefrom shall, for the purposes of his Title, be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets."

The above provision conveys that the loss sustained by the holder of the securities, which are capital assets (to him), is to be treated as a capital loss as if incurred from a sale or exchange transaction. A capital gain or a capital loss normally requires the concurrence of two conditions for it to result: (1) There is a sale or exchange; and (2) the thing sold or exchanged is a capital asset. When securities become worthless, there is strictly no sale or exchange but the law deems the loss anyway to be "a loss from the sale or exchange of capital assets." [5] A similar kind of treatment is given, by the NIRC on the retirement of certificates of indebtedness with interest coupons or in registered form, short sales and options to buy or sell property where no sale or exchange strictly exists.[6] In these cases, the NIRC dispenses, in effect, with the standard requirement of a sale or exchange for the

application of the capital gain and loss provisions of the code.

Capital losses are allowed to be deducted only to the extent of capital gains, i.e., gains derived from the sale or exchange of capital assets, and not from any other income of the taxpayer.

In the case at bar, First CBC Capital (Asia), Ltd., the investee corporation, is a subsidiary corporation of petitioner bank whose shares in said investee corporation are not intended for purchase or sale but as an investment. Unquestionably then, any loss therefrom would be a capital loss, not an ordinary loss, to the investor.

Section 29(d)(4)(A), of the NIRC expresses:

"(A) Limitations. - Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in Section 33."

The pertinent provisions of Section 33 of the NIRC referred to in the aforesaid Section 29(d)(4)(A), read:
"Section 33. Capital gains and losses. -

"x x x x x x x x.

"(c) Limitation on capital losses. - Losses from sales or exchange of capital assets shall be allowed only to the extent of the gains from such sales or exchanges. If a bank or trust company incorporated under the laws of the Philippines, a substantial part of whose business is the receipt of deposits, sells any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, any loss resulting from such sale shall not be subject to the foregoing limitation and shall not be included in determining the applicability of such limitation to other losses."

The exclusionary clause found in the foregoing text of the law does not include all forms of securities but specifically covers only bonds, debentures, notes, certificates or other evidence of indebtedness, with interest coupons or in registered form, which are the instruments of credit normally dealt with in the usual lending operations of a financial institution. Equity holdings cannot come close to being, within the purview of "evidence of indebtedness" under the second sentence of the aforequoted paragraph. Verily, it is for a like thesis that the loss of petitioner bank in its equity investment in the Hongkong subsidiary cannot also be deductible as a bad debt. The shares of stock in question do not constitute a loan extended by it to its subsidiary (First CBC Capital) or a debt subject to obligatory repayment by the latter, essential elements to constitute a bad debt, but a long term investment made by CBC.

One other item. Section 34(c)(1) of the NIRC, states that the entire amount of the gain or loss upon the sale or exchange of property, as the case may be, shall be recognized. The complete text reads:

"SECTION 34. Determination of amount of and recognition of gain or loss.-

"(a) Computation of gain or loss. - The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis or adjusted basis for determining gain and the loss shall be the excess of the basis or adjusted basis for determining loss over the amount realized. The amount realized from the sale or other disposition of property shall be the sum of money received plus the fair market value of the property (other than money) received. (As amended by E.O. No. 37)

"(b) Basis for determining gain or loss from sale or disposition of property. - The basis of property shall be -
(1) The cost thereof in cases of property acquired on or before March 1, 1913, if such property was acquired by purchase; or

"(2) The fair market price or value as of the date of acquisition if the same was acquired by inheritance; or

"(3) If the property was acquired by gift the basis shall be the same as if it would be in the hands of the donor

or the last preceding owner by whom it was not acquired by gift, except that if such basis is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value; or

"(4) If the property, other than capital asset referred to in Section 21 (e), was acquired for less than an adequate consideration in money or moneys worth, the basis of such property is (i) the amount paid by the transferee for the property or (ii) the transferor's adjusted basis at the time of the transfer whichever is greater.

"(5) The basis as defined in paragraph (c) (5) of this section if the property was acquired in a transaction where gain or loss is not recognized under paragraph (c) (2) of this section. (As amended by E.O. No. 37)

“(c) Exchange of property.

"(1) General rule.- Except as herein provided, upon the sale or exchange of property, the entire amount of the gain or loss, as the case may be, shall be recognized.

"(2) Exception. - No gain or loss shall be recognized if in pursuance of a plan of merger or consolidation (a) a corporation which is a party to a merger or consolidation exchanges property solely for stock in a corporation which is, a party to the merger or consolidation, (b) a shareholder exchanges stock in a corporation which is a party to the merger or consolidation solely for the stock in another corporation also a party to the merger or consolidation, or (c) a security holder of a corporation which is a party to the merger or consolidation exchanges his securities in such corporation solely for stock or securities in another corporation, a party to the merger or consolidation.

"No gain or loss shall also be recognized if property is transferred to a corporation by a person in exchange for stock in such corporation of which as a result of such exchange said person, alone or together with others, not exceeding four persons, gains control of said corporation: Provided, That stocks issued for services shall not be considered as issued in return of property."

The above law should be taken within context on the general subject of the determination, and recognition of gain or loss; it is not preclusive of, let alone renders completely inconsequential, the more specific provisions of the code. Thus, pursuant, to the same section of the law, no such recognition shall be made if the sale or exchange is made in pursuance of a plan of corporate merger or consolidation or, if as a result of an exchange of property for stocks, the exchanger, alone or together with others not exceeding four, gains control of the corporation.[7] Then, too, how the resulting gain might be taxed, or whether or not the loss would be deductible and how, are matters properly dealt with elsewhere in various other sections of the NIRC.[8] At all events, it may not be amiss to once again stress that the basic rule is still that any capital loss can be deducted only from capital gains under Section 33(c) of the NIRC.

In sum -

(a) The equity investment in shares of stock held by CBC of approximately 53% in its Hongkong subsidiary, the First CBC Capital (Asia), Ltd., is not an indebtedness, and it is a capital, not an ordinary, asset.[9]

(b) Assuming that the equity investment of CBC has indeed become "worthless," the loss sustained is a capital, not an ordinary, loss.[10]

(c) The capital loss sustained by CBC can only be deducted from capital gains if any derived by it during the same taxable year that the securities have become "worthless." [11]

WHEREFORE, the Petition is DENIED. The decision of the Court of Appeals disallowing the claimed deduction of P16,227,851.80 is AFFIRMED.

SO ORDERED.

Davide, Jr., C.J., Bellosillo, Melo, Puno, Kapunan, Mendoza, Panganiban, Quisumbing, Purisima, Pardo, Buena, Gonzaga-Reyes, Ynares-Santiago, and De Leon, Jr., JJ., concur.

[1] Let it be stressed that referred to here are the intangibles of first CBC Capital (Asia), Ltd., specifically its franchise and goodwill, and not of CBC or its investments nor to any outstanding shares of stock for that matter of either corporation which are correctly treated as equity capital of First CBC Capital or investment of CBC, as the case may be, and thus invariably reflected as such in financial statements.

[2] See Sections 29 and 30, NIRC.

[3] Section 20 (z) of the NIRC provides:

“(z) The term ‘ordinary income’ includes any gain from the sale or exchange of property which is not a capital asset or property described in section 34 (now 33) (a). Any gain from the sale or exchange of property which is treated or considered, under other provisions of this Title, as ‘ordinary income’ shall be treated as from the sale or exchange of property which is not a capital asset as defined in Section 34 (now 33) (a). The term ‘ordinary loss’ includes any loss from the sale or exchange of property which is not a capital asset. Any loss from the sale or exchange of property which is treated or considered, under other provisions of this Title, as ‘ordinary loss’ shall be treated as loss from the sale or exchange of property which is not a capital asset.”

[4]

“(t) The term ‘securities’ means shares of stock in a corporation and rights to subscribe for or to receive such shares. The term includes bonds, debentures, notes, or certificates, or other evidence of indebtedness, issued by any corporation, including those issued by a government or political subdivision thereof, with interest coupons or in registered form.”

[5] Sec. 29(4)(B) of the NIRC.

[6] Sec. 33(e) and (f), NIRC, provides:

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(e) Retirement of bonds, etc. – For the purposes of this Title, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof) with the interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

(f) Gains and losses from short sales, etc. – For the purpose of this Title –

(1) Gains or losses from short sales of property shall be considered as gains or losses from sales or exchanges of capital assets; and

(2) Gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as capital gains or losses.

[7] Sec. 34(c), NIRC.

[8] See Sections 29, 30, 32 and 33, NIRC.

[9] Sec. 33(1), NIRC.

[10] Sec. 29(D)(4)(B), NIRC.

[11] Sec. 33 (c), in relation to Sec. 29 (d)(4)(B), NIRC; evidently, no such capital gains have been derived by CBC during the taxable year in question.

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