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

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

D E C I S I O N

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."
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> 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 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