1

HOTEL FILIPINAS, INC.,
Petitioner,

versus CTA CASE NO. 1912

COMMISSIONER OF INTERNAL
REVENUE,
Respondent.

x - - - - - - - - - - - x

Nov. 24 /71

D E C I S I O N

Petitioner is a duly organized corporation engaged in the operation and management of hotels, inns and other allied business.

Pursuant to its Articles of Incorporation, it is organized with an authorized capital of ₱1,000,000.00 divided into 900 common stocks and 100 preferred stocks with a par value of ₱1,000.00 each share. With particular reference to its preferred stock, petitioner's articles of incorporation provides as follows:

> SEVENTH: - That the authorized capital stock of said corporation (as amended February 27, 1957) shall be ONE MILLION PESOS (₱1,000,000.00) Philippine Currency, divided into NINE HUNDRED (900) shares of Common Stock and ONE HUNDRED (100) shares of Preferred Stock, both of the par value of ONE THOUSAND PESOS (₱1,000.00) each share.
>
> Except in those cases where the law provides otherwise, only Common Stock shall be entitled to voting rights and only holders of said shares may be elected directors of the Corporation.

The Preferred Stock shall be non-voting and shall be issued subject to the following conditions:

A. The holders of Preferred Stock shall be entitled to receive dividends at the rate of ten percent (10%) per annum, payable semi-annually or annually as the Board of Directors may from time to time determine. Said dividends shall be preferential and cumulative, whether or not in any period the amount hereof is covered by earnings or profits of the corporation; all dividends on the preferred stock shall be paid in chronological order with reference to the due dates for each semi-annual or annual installment and shall accrue and be cumulative from the date of the issuance thereof. In case any installment of said dividend is not paid on the dividend payment date of such installment, then the amount of such installment shall subsequently be paid before any dividends shall thereafter be paid to the holders of the Common Stock. Subject only to the foregoing limitation, dividends in cash or in stock, or otherwise, may be paid from time to time to the holders of the Common Stock from the surplus profits of the Corporation in such amounts and when and as declared and the holder of the Preferred Stock shall not be entitled to participate in any such dividends paid to the holders of the Common Stock. Accumulations of dividends on the Preferred Stock shall not bear interest. The holders of Preferred Stock shall be entitled to no other dividends than as above stated.

B. In the event of liquidation, dissolution, receivership, bankruptcy, or winding up of the affairs of the Corporation, voluntarily or involuntarily, except in connection with a merger or consolidation, the holders of the Preferred Stock shall be entitled to be paid in full, or ratably, in so far as the assets of the Corporation will permit; ONE THOUSAND PESOS (₱1,000.00) in Philippine Currency for each share of preferred stock held, together with the accrued and unpaid dividends thereon, in Philippine Currency, to date of distribution, before any distribution shall be made to the holders of the Common Stock, and shall be entitled to no other distribution.

C. The Preferred Stock shall not be convertible into any other shares or securities of the Corporation.

D. The Corporation may redeem the whole or any part of the Preferred Stock then outstanding upon paying in cash to the holder of such Preferred Stock redeemed ONE THOUSAND PESOS (₱1,000.00) a share, together with all accrued and unpaid dividends thereon, in Philippine Currency. The Corporation, however, shall in no case retire any Preferred Stock within ten years from the date of its issue.

x x x x x

The above conditions shall be printed in the stock certificates to be issued by the corporation.

In accordance with the provision of the article aforequoted, Sections A, B, C and a portion of Section D thereof were printed at the back of the certificates of preferred stock issued by petitioner.

The face of the certificates of preferred stock issued by petitioner states as follows:

THIS CERTIFIES THAT ________ is the owner of ________ Preferred Shares of the Capital Stock of

HOTEL FILIPINAS, INC.

transferable only on the books of the Corporation by the holder hereof in person or by Attorney, upon surrender of this Certificate properly endorsed.

IN WITNESS WHEREOF, the said corporation has caused this Certificate to be signed by its duly

authorized officers and to be sealed
with the Seal of the Corporation
this _____ day of _______ A.D., 19__.

____________________	____________________
Secretary	President

Petitioner carried these preferred stocks as part of its capital structure in its records or particularly in its Balance Sheet for the year ending December 31, 1958, in which it was stated, under the sub-heading "Stockholders Equity", that:

Capital Stock:	
Preferred - 10% Cumulative Preference Authorized, 100 shares at ₱1,000.00 par value per share; Issued and Outstanding, 100 shares	₱100,000.00
Common - Authorized, 900 shares at ₱1,000.00 par value per share; Fully paid	899,950.00
Total Paid-in Capital	₱999,950.00

In 1958, petitioner paid dividend on its preferred stock in the amount of ₱10,000.00. This amount was then claimed by it in its 1958 income tax return it filed on March 24, 1959 as deductible interest expense.

On September 16, 1963, respondent assessed petitioner in the sum of ₱2,360.00, as deficiency income tax, inclusive of interest thereon on the theory that the dividends in question are not interests under Section 78 of Revenue Regulations No. 2 implementing Section 30(b)(1) of the National Internal Revenue Code and, is therefore not deductible expense. Petitioner paid said amount and then filed a claim for refund.

Thereafter, without waiting for the decision of respondent, petitioner filed the present petition for review, seeking the refund of said amount.

The only issue posed before the Court is, whether the payments made by petitioner on its preferred stocks in the sum of P10,000.00 in 1958 are dividends not deductible from gross income or, interests deductible under Section 30(b)(1) of the National Internal Revenue Code, as implemented by Section 78, Revenue Regulations No. 2 of the Department of Finance.

The pertinent portions of Section 30(b)(1) of the Revenue Code and the implementing Section 78 of Revenue Regulations No. 2 of the Department of Finance read as follows:

> SEC. 30. Deductions from gross income.—In computing net income there shall be allowed as deductions-ib
>
> x x x x x
>
> (b) Interest:
>
> (1) In general.—The amount of interest paid within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation as income under this Title.

SEC. 78. Interest. x, x x

> . . . So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. x x

No comprehensive rule may be laid down for distinguishing in all cases between an investment in a corporation and a loan to it (Helvering, Com'r. of Internal Revenue v. Richmond, F & P.R. Co., 90 F [2d] 971) Federal Reporter, 2d Series). In determining whether payments made on preferred stocks are interests on indebtedness, or dividends on investment, the real intention of the parties must be sought, and the intention must turn on the facts and circumstances surrounding each case (Philippine Trust Co. v. Comm. of Internal Revenue, CTA 367, Jan. 30, 1961; U.S. v. Title Guarantee & Trust Co., 133 F 2d 990, 993). The distinction between interest and dividend may be briefly stated as follows:

> Payments made by a corporation on its shares of stock are dividends (not deductible), but payments made on its evidence of indebtedness are interest (deductible). Proper classification of the instrument under which the payments are made is sometimes difficult. The intent of the parties as determined from all the facts and circumstances controls. The characteristics of an evidence of indebtedness are: a definite obligee (either by name or designation); a definite ascertainable obligation; a time of maturity, either definite or that will become definite. It may, of course, possess other features as well. (Par. 1902, PH Fed. Tax Handbook, 1955.)

The articles of incorporation readily show that there is no provision therein that fixes a date of redemption of the preferred shares with a right to force payment in the event of default. Article SEVEN, paragraph D thereof which is printed on the stock certificate of the preferred shares provides that:

> D. The Corporation may redeem the whole or any part of the Preferred Stock when outstanding upon paying in cash to the holder of such Preferred Stock redeemed, ONE THOUSAND PESOS (₱1,000.00) a share, together with all accrued and unpaid dividends thereon, in Philippine Currency.
>
> The Corporation, however, shall in no case retire any Preferred Stock within ten years from the date of its issue. (Underscoring ours.)

Redemption is obviously optional on the corporation under this stipulation and creates no obligation to pay on any fixed date (Elko Lamoille Power Co. v. Commissioner of Internal Revenue, 50 F [2d] 595). The most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, is the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default (United States v. South Georgia Ry. Co., 107 F [2d] 3, citing Jewel Tea Co. v. United States, 2 Cir., 90 F. 2d 451, 112 A.L.R. 182; Commissioner of Internal Revenue v. O.P.P. Holding Corporation, 2 Cir., 76 F. 2d 11;

Jefferson Banking Co. v. Trustees of Martin Institute, 146 Ga. 383, 91 S.E. 463; Commissioner of Internal Revenue v. Proctor Shop, Inc., 9 Cir., 82 F. 2d 791).

While the designation of securities as preferred stock is not conclusive upon the status of the holder, yet what the parties in a given case have called the subject of the contract is of no little significance in determining their purpose, and where the purpose authorized and the purpose declared is the issue of stock and not the creation of debt, the intention to create a debt should be clear and convincing (United States v. Title Guarantee & Trust Co., 133 F. 2d 988). The articles of incorporation call the securities in question as preferred stocks; make it appear that the Preferred Stocks are part of the authorized capital stock of the corporation; and call the increment of the Preferred Stock dividend. These features also appear in the recitals of the printed matter of the preferred stocks. And the Balance Sheet for the year ending December 31, 1958 carries the Preferred Stocks as part of the Capital Stock under the sub-heading "Stockholders Equity." It is quite obvious from the nomenclature given by the Corporation to the stocks in question and their increment that the relationship between the holders of the Preferred Stocks and the Corporation is not that of creditor and debtor but corporation and stockholders. On the other hand, there are not enough features clearly indicating that the fair intendment of the parties as to the certificates of stock in question was otherwise.

That the holders of the preferred stocks in question have no voting right is of little significance. Broadly speaking, a preferred stock is a mode by which a corporation obtains funds for the enterprise without borrowing money or contracting a debt, the stockholder being preferred as to principal and interest but having no voice in management. It differs only from other stocks in that it is given preference and has no voting right but the stockholder is not a creditor of the company (Elko Lamoille Power Co. v. Commissioner of Internal Revenue, 50 F [2d] 595). Thus, that the holder of a stock has no voting right does not conflict with the existence of a corporation and stockholder relationship. Neither is the fact that the dividend is cumulative of such significance. Cumulative dividend is not an uncommon feature of preferred shares. Needless to say, the presence of such equivocal features in the case at bar is certainly not enough ground for considering the relationship between petitioner and its preferred stockholder as that of debtor and creditor especially in view of other convincing features showing the contrary. //

The nearest parallel to this case is that of Elko Lamoille Power Co. v. Commissioner of Int. Rev., 50 F. (2d) 595, the facts of which as stated by the Court are as follows:

> The petitioner is a Nevada corporation engaged in power and light business at Elko, Nev. In 1924 a bond issue of $100,000 was authorized; $90,000 was sold, of which $15,000 was thereafter retired. It later became necessary to secure further funds, and it was concluded to issue preferred stock instead of selling available bonds. In 1925 $80,000 preferred stock, bearing 7 per cent dividends, payable semiannually, preferred as to income and assets, callable after three years at 110, was authorized. The stock certificates contained the following provision: "The dividends on the preferred stock shall be cumulative and shall be payable before any dividends on the common stock shall be paid or set apart, so that if in any year dividends amounting to seven per cent. shall not have been paid thereon, the deficiency shall be payable before any dividends shall be paid upon or set apart for the common stock. * * * In the event of any liquidation or dissolution or winding up * * * of the corporation, the holders of the preferred stock shall be entitled to be paid in full, both the par value of their shares and the unpaid dividends accrued thereon, before any amount shall be paid to the holders of the common stock, and after the payment to the holders of the preferred stock of its par value and the unpaid accrued dividends thereon, the remaining assets and funds shall be divided and paid to the holders of the common stock according to their respective shares. * *** The preferred

stock shall be without voting power, said right being restricted to the common stock. Redeemable after 3 years at 110."

Upon the foregoing facts, the Court held that the relationship between preferred stockholders and a corporation is that of corporation and stockholders, not that of creditor and debtor, saying that there was no definite date for payment of the capital since redemption was at the option of the corporation.

WHEREFORE, the decision appealed from is hereby affirmed.

SO ORDERED.

Quezon City, November 26, 1971.

RAMON L. AVANCEÑA
Associate Judge

WE CONCUR:

ROMAN M. UMALI
Presiding Judge

ESTANISLAO R. ALVAREZ
Associate Judge