REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

RIZAL COMMERCIAL BANKING CORPORATION,
Petitioner,

- versus -

C.T.A. CASE NO. 4672

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated: FEB 12 1996

x - x

DECISION

This is an assessment case involving the amounts of P21,493,651.35 and P22,652,284.11 as petitioner's deficiency income tax and gross receipts tax, respectively, for the year 1987.

The following are the facts of the case as narrated by petitioner.

Rizal Commercial Banking Corporation (RCBC, for brevity) is a domestic registered corporation authorized to engage in the general banking business.

It owns 99% of the equity of RCBC International Finance Limited (RCBC IFL, for short), a Hongkong based finance company. As of December 31, 1986, its investment was reflected in its books at a cost of P96,418,186.00 with an allowance for market decline of P40,000,000.00.

When RCBC IFL had a quasi-reorganization in 1987, its share capital was reduced from a par value of HK$10. to HK$3.80, but there was no corresponding increase in the number of shares issued and outstanding.

The reduction of the share capital of RCBC IFL declined to P54,248,836.00 the carrying value of petitioner's investment. Thus, petitioner wrote off P42,169,350.00 and claimed the same as a deduction in its 1987 income tax return. It treated this deduction as bad debts arising from securities becoming worthless pursuant to Section 29(e) of the 1987 Tax Code.

Also for 1987, petitioner declared gross receipts of P649,527,303.78 for which it paid the amount of P35,450,847.33 as gross receipts tax based on the maturities of the instrument.

On January 24, 1990, petitioner received from respondent a demand letter dated January 15, 1990 together with assessment notices, urging petitioner to pay the amounts of P21,493,651.35 and P22,652,284.11, inclusive of interest and surcharge, as deficiency income tax and gross receipts tax, respectively, for 1987.

Petitioner protested the subject assessment in its letters of February 15, 1990, March 9, 1990 and August 6,

1991. It asserted the propriety of its bad debt deduction as under Section 29(e)(1) and (2) of the 1987 Tax Code, by way of exception, specifically in the case of a bank or trust company, securities becoming worthless are treated as bad debts expense for which an ordinary loss deduction from gross income is allowed. Moreover, petitioner argued that even if it is to be assumed that it erred in deducting as a bad debts expense the securities it has written off, its disallowance by respondent does not preclude the availment of the same as an ordinary loss deduction (**Connell Bros. Co. vs. Collector of Internal Revenue,** CTA Case No. 411 and 610, April 30, 1966). Furthermore, an item disallowed as a deduction under one provision of the law may be allowed as deduction under another provision of the law as long as the requisite for deductibility under the latter are satisfied (**Talisay-Silay Milling Co., Inc. vs. Commissioner of Internal Revenue,** CTA Cases Nos. 1399 and 1406, December 29, 1965).

As regards the gross receipts tax, petitioner alleged that it had duly paid the said tax when it used as tax base the trading gain or profit it realized from all its sale transactions net of trading loss.

In a letter dated August 26, 1991, which was received by petitioner on October 30, 1991, respondent denied petitioner's protest. Hence, the instant appeal filed with this Court on November 21, 1991.

Respondent filed his answer on March 23, 1992, alleging, among others, as special and affirmative defenses, the following:

> 1. Petitioner sustained no loss and had no asset outflows by reason of RCBC IFL's quasi-reorganization;
>
> 2. The claimed deduction of P42,169,350.00 by petitioner is in effect, its proportionate share on prior year's operating losses of the investor;
>
> 3. Mere shrinkage in the value of securities is not a deductible loss until the securities are disposed of and must be worthless;
>
> 4. As held in the case of **Fernandez Hermanos, Inc. vs. Commissioner of Internal Revenue,** 29 SCRA 532, there can be no partial writing off of a loss or bad debt. It has to be deductible in full or not at all, in the absence of any express provision in the Tax Code authorizing partial deductions;
>
> 5. Deductions being a matter of legislative grace shall be allowed only where there is a clear provision in the statute authorizing the deduction claimed (**Tan Guan vs. Collector,** CTA Case No. 451, December 27, 1985);
>
> 6. Assuming there was a loss sustained by petitioner, such loss would have been a capital loss deductible to the extent of capital gain under Section 29(d)(4)(B) of the Tax Code. Petitioner, however, realized no capital gain in 1987 from which the capital loss could be deducted;
>
> 7. Gross receipts means the whole amount received without deduction; and

8. All presumptions are in favor of the correctness of tax assessment (**Interprovincial Autobus Co., Inc. vs. Commissioner of Internal Revenue,** 98 SCRA 290).

Issues having been joined, petitioner presented documentary as well as testimonial evidence to buttress its case. However, it failed to file its formal offer of evidence and so, on November 12, 1992 the Court ordered respondent to present his evidence in the next scheduled hearing (p. 70, CTA records).

On January 15, 1993, respondent presented his lone witness, Mr. Jose Sunga, Jr., the examiner who investigated the instant case. He identified and explained the contents of the documents presented as respondent's exhibits or evidence.

After respondent's counsel rested his case, petitioner presented its rebuttal evidence and thereafter, made a formal offer of the same including the documents previously marked but which were not formally offered.

Adjudication of the case at bar requires profound discussion of the issues raised, namely:

1. Is the bad debt/loss in the amount of P42,169,350.00 allowable as a deduction in petitioner's 1987 income tax return?

2. Is the proper base of gross receipts tax, the trading gain or profit realized from sale transactions net of trading loss?

The Court is swayed to declare negative answers for both questions.

Relative to the first issue, the primary law applicable is Section 30 of the 1987 Tax Code, specifically subsection (e) thereof, which reads:

> "**Section 30.** ***Deductions from gross income.*** xxx
>
> (e) *Bad Debts* - (1) In general - Debts due to the taxpayer actually ascertained to be worthless and charged off within the taxable year except those not connected with profession, trade or business and those sustained in a transaction entered into between parties mentioned under Section 31(b) of this Code.
>
> xxx"

Evidently, there are three (3) requisites for deductibility of bad debts, to wit:

> 1. There must be a valid and subsisting debt;
>
> 2. The debt must be actually ascertained to be worthless; and
>
> 3. The debt must be charged off within the taxable year.
>
> (Reviewer in Taxation, Roman Umali, 1980 edition, p. 154).

Ostensibly, petitioner interpreted the aforequoted law as to require only two (2) requirements which, as enumerated above, are only the last two requirements, numbers 2 and 3. Petitioner failed to consider the number 1 requirement, i.e., that there must be a valid and subsisting debt. Its protest letter of March 9, 1990, page 7, paragraph 3 thereof, contained the following statements:

> "Thus, it is clear that the amount corresponding to the write-off was not only 'actually ascertained to be worthless', it was likewise 'charged off within the taxable year.' Therefore, our client had legal basis for claiming a bad debts expense deduction under Section 29 (e)(1)." (p. 39, CTA records)

To the Court's mind, petitioner misconstrued the law. It omitted the first and foremost requirement for deductibility of bad debt. Without the first, the last two requirements will not be in existence or cannot be complied with. Obviously, what is there to be ascertained as "worthless" if there is no existing valid debt? Similarly, without a subsisting debt, what is there to be "charged off" and to be claimed later as bad debt deduction?

For emphasis of this vital point, the Court borrows the words of Jose Arañas, former Commissioner of Internal Revenue which run as follows:

> "29 **(103)** ***Bad debts deduction.*** - Generally, deductions are a matter of legislative grace and one of the concessions which Congress has made under this broad doctrine is an allowance for the uncollectible debt. Because of the frequency of its occurrence and the fact that it is available to all taxpayers, regardless of whether they are engaged in trade or business, this subject has had widespread application and has occasioned considerable litigation. In considering when

> debts are deductible, the first problem is to determine whether the taxpayer owed a debt. xxx"
>
> "Bad debts must be shown to have existed in fact and in law. This is an important requirement. A taxpayer cannot, for example, claim a bad debt if there were no legal liability that could be enforced in a court of law." (Updated National Internal Revenue Code, J. Arañas, 1988 edition, pp. 250-251; Underscoring supplied).

Undeniably, in 1987 petitioner had no valid and subsisting bad debt. Hence, it was highly improbable for it to ascertain the worthlessness of its alleged "bad debt" as no such valid account then ever existed. In the same line of argument, "charging off" would not similarly be feasible as the amount of P42,169,350.00 was not a valid debt. This amount was in reality a mere shrinkage in value of shares of stocks which, as respondent claimed, did not result in any loss on the part of petitioner.

Thus, the testimony of respondent's witness, Mr. J. Sunga, Jr. which partially runs as follows:

> "xxx
>
> JUDGE ACOSTA
>
> Why did you disallow the bad debts? It was never explained. Bad debts are allowable per se under the Internal Revenue Code as allowable deduction. Why did you disallow?
>
> A. Because actually it was not a bad debt, sir. Because to have a bad

debt expense the number requirement is <u>there must be a debt</u>.

JUDGE ACOSTA

Yes, of course.

A. That was written off as ascertained to be worthless and written off during the deductible year. But in this case, sir, the P42 million, Your Honor, that was deducted, <u>this is not a bad debt</u>, sir, <u>this is an investment of a security of another corporation which underwent a quasi-reorganization</u>.

JUDGE ACOSTA

So, it's not really a bad debt.

xxx"

(<u>TSN</u> hearing of January 15, 1993, pp. 53-54; Underscoring supplied)

The Court concurs with respondent's theory. Petitioner had not incurred any loss. For it to suffer loss, there must be an actual sale or disposition of said shares at their shrunken price. There being no such sale, petitioner could not validly claim a deduction for ordinary loss from its 1987 gross income. In this connection, Jose C. Vitug has explained in his <u>Compendium of Tax Law and Jurisprudence</u>, 2nd revised edition, p. 103 thereof, that:

"<u>Losses on account of the shrinkage in value of securities or shares of stocks are not deductible until after the loss would have been actually sustained by the disposition of the said securities.</u> When, however, such securities become worthless during the taxable

> year and are capital assets, the loss therefrom shall be considered as a loss from the sale or exchange, on the last day of such taxable year, of capital assets. (Underscoring supplied)

To further elucidate, it is worth reproducing hereunder a 1974 Bar question and answer material to this point.

> "Question. Grand Philippines Corporation has a capital stock of 1,000 shares without par value. At the time of incorporation each no-par value share had a stated value of P5.00. After several years of successful operations with an earned surplus of P120,000.00, the corporation's board of directors increased the stated value of each share by P120.00 so that each share was then worth P125.00. The BIR, for income tax purposes, has assessed each stockholder for the P120.00 increase. Is this action of the BIR correct?
>
> "Answer. The action of the BIR is not correct. Each stockholder has not derived any income with the mere increase in value of their shares. This is similar to one where a parcel of land is acquired and after a few years the value of said land increased by mere lapse of time. No gain or income is derived by the owner of the land until and after actual sale or disposition thereof for an amount in excess of the original cost."
> (Reviewer in Taxation, R. Umali, 1985 Revised Edition, pp. 78-79)

The above-cited BAR question and answer provides the rationale or justification behind respondent's disallowance of loss deduction being claimed by herein petitioner. If respondent BIR cannot assess on an "expected income" of a stockholder relative to his shares, equity or fair play demands that a taxpayer/stockholder cannot also claim a loss deduction on his "expected loss." In both instances or situations, there must be an actual sale or disposition of shares, before a loss deduction may be allowed or before an income tax may be imposed. Simply stated, in the absence of actual sale, there is no income tax nor allowable loss deduction to speak of.

Based on all the foregoing, after finding the disallowance of bad debts as to be with legal basis, the Court upholds the validity of the 1987 deficiency income tax assessment in the amount of P21,493,651.35 issued by respondent against petitioner.

The issue on gross receipts tax is hinged on the definition or composition of the term itself, i.e. "gross receipts." Petitioner contends that the gross receipts tax (GRT for brevity) should be imposed on gross receipts of the bank net or exclusive of trading loss. Respondent believes otherwise. GRT should be based on gross receipts without any deduction for loss.

Again, this Court finds for the respondent. GRT is to be based on the gross receipts without any consideration for trading loss.

The provision of the law imposing tax on gross receipts is as follows:

SEC. 119. ***Tax on banks and non-bank financial intermediaries.***[1] - There shall be collected a tax on gross receipts derived from sources within the Philippines by all banks and non-bank financial intermediaries in accordance with the following schedule:

(a) On interest, commissions and discounts from lending activities as well as income from financial leasing, on the basis of remaining maturities of instruments from which such receipts are derived.

Short term maturity not
in excess of two (2) years 5%
Medium-term maturity - over
two (2) years but not
exceeding four (4) years 3%
Long-term maturity:
(i) Over four (4) years
but not exceeding
seven (7) years 1%
(ii) Over seven (7) years 0%

(b) On dividends 0%

(c) On royalties, rentals or property, real or personal, profits from exchange and all other items treated as gross income under Section 28 of this Code 5%

Provided, however, That in case the maturity period referred to in paragraph (a) is shortened thru pretermination, then the maturity period shall be reckoned to end as of the date of pretermination for purposes of classifying the transaction as short, medium or long term and the correct rate of tax shall be applied accordingly.

Nothing in this Code shall preclude the Commissioner from imposing the same tax herein provided on persons performing similar banking activities.

---

[1] As amended by P.D. No. 1739.

Gross receipts "means all the receipts arising from or growing out of the employment of the corporation's capital in its designated business or otherwise." (**State vs. Central Trust Co.**, 67 A. 267, 271, 106 Md. 268, cited in Words and Phrases 18, p. 769)

Gross receipts is synonymous with gross earnings "which mean entire receipts without deduction for any expenditure, or any cost of operation, or other expense or cost of service." (Acts 1933, pp. 204, 207, 2, 8. **Fort Smith Gas Co. vs. Wiseman,** 74 S.W. 2d 789, 792, 189 Ark. 675; Ibid.. Underscoring supplied)

Based on the first definition, GRT is a tax on gross receipts less capital. Its tax base allows no other deductions like cost of operation or service pursuant to the second definition.

Trading loss of herein petitioner is not capital and hence, not excludable from its gross receipts. It is a cost of operation or service which may be allowed as a deduction from gross income pursuant to Section 29 of the Tax Code. Respondent is therefore, correct in disallowing the claimed deduction of petitioner for trading loss.

WHEREFORE, the decision of Commissioner of Internal Revenue assessing petitioner for deficiency income tax in the amount of P21,493,651.31 and for deficiency gross receipts tax in the amount of P22,652,284.11, both for taxable year 1987, is **AFFIRMED.** Petitioner is hereby ordered to pay said amounts to respondent plus 25% surcharge or aforesaid amounts for late payment and 20% annual interest from December 3, 1991 until fully paid pursuant to Sections 282 and 283 of the 1986 Tax Code as amended by P.D. 1994 which took effect on January 1, 1986.

No pronouncement as to cost.

SO ORDERED.

MANUEL K. GRUBA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

RAMON O. DE VEYRA
Associate Judge

CERTIFICATION

I hereby certify that this decision was reached after due consultation among the members of the Court of Tax Appeals in accordance with Section 13 Article VIII of the Constitution.

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals