Republic of the Philippines
DEPARTMENT OF FINANCE
Roxas Boulevard Corner Pablo Ocampo, Sr. Street
Manila 1004

DOF Opinion No. 002.2019

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SUBJECT: Request for Review of Bureau of Internal Revenue Ruling No. ITAD 094-2018

Dear **Atty. Biscocho**:

This refers to the subject letter dated 3 December 2018 ("Request for Review") which you filed with this Department on behalf of Aditya Birla Minacs Worldwide Ltd. ("Aditya India") to request the review of Bureau of Internal Revenue ("BIR") Ruling No. ITAD 094-2018 dated 22 October 2018, which ruled that:

> Accordingly, since the ratio of real property over total assets of Aditya Philippines as of March 31, 2014 is 73.48% which is more than 50%, Aditya Philippines' assets consist principally of real property under Section 2(b) of RR 4-86. Therefore, pursuant to paragraph 4, Article 14 of the Philippines-India tax treaty, capital gains derived by Aditya India from the transfer of its shares in Aditya Philippines to Maple UK are subject to capital gains tax imposed under Section 28(B)(5)(c) of the Tax Code.

It is your position, as stated in your Request for Review, that the immovable properties of Aditya Philippines do not comprise 50% of its total assets and, accordingly, the transfer of shares in Aditya Philippines to Maple UK is not subject to capital gains tax.

We agree with your position.

The significant difference between the computation of ratio between BIR and Aditya India is attributable to two line items, namely, **fully depreciated property and equipment still used in operations** and **deposits and advance rental**, which the BIR *both* included as part of the real properties of Aditya Philippines.

It is important to note that the figures used by the BIR for the fully depreciated property and equipment were lifted from Note 7 of the audited financial statements of Aditya Philippines for the period ended 2014 and 2013. The figures were the *gross value* of the fully depreciated property and equipment still used in operations.

However, the net book value of fully depreciated assets is zero. And in several cases,[1] the Court of Tax Appeals has consistently used the net book value of assets in computing the percentage of real property interest to determine whether the assets of a corporation, partnership, trust or estate consist principally of real property interest. Furthermore, under the relevant revenue regulations, it is the book value appearing in the financial statements that should be used as basis.[2]

The BIR, therefore, erred in including the *gross value* of the fully depreciated property and equipment still used in operations in its computation of the ratio of real property over total assets of Aditya Philippines. Based on the discussion above, it should be the net book value of zero instead of the gross value that should be used.

Moreover, deposits and advance rental should not be classified as real properties. Deposit accounts which arose from lease contracts and serve as collaterals for any unpaid rent due to the lessor are not classified as immovable properties,[3] henceforth, accounts of similar nature should not be included as part of Aditya Philippines' real properties. What are considered real property interest and/or real properties are limited under Section 3 of RR No. 04-86 and Article 415 of the New Civil Code of the Philippines. Additionally, current assets should not be classified as real properties.[4]

The nature of the **deposits and advance rental** accounts refers to lease commitments Aditya Philippines has entered into. The figures include security deposits which are reflected in both Aditya Philippines' current and non-current assets.[5] This being the case, deposits, both current and noncurrent, as well as advance rental should not be included in the computation of Aditya Philippines' real property interest. The BIR greatly erred when it considered the figures above as part of the real property interest of Aditya Philippines.

To reiterate, Section 3 of RR No. 04-86 and Article 415 of the New Civil Code of the Philippines provide an exclusive list of what should be considered real property

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[1] Futamura Chemical Co. Ltd. v. CIR, CTA Case No. 8906, 30 January 2017. *See also* Keppel Philippines Properties, Inc. v. CIR, CTA Case No. 8908, 19 July 2016 and Lawl Pte. Ltd. v. CIR, CTA Case No. 8307, 7 November 2013.

[2] Determination of whether the assets of a corporation consist principally of real property interest under the Philippine tax treaties, Revenue Regulations No. 04-86, Sections 4 and 5 (April 2, 1986).

[3] Keppel Philippines Properties, Inc. v. CIR, CTA Case No. 8908, 19 July 2016.

[4] Lawl Pte. Ltd. v. CIR, CTA Case No. 8307, 7 November 2013.

[5] Note 17 (Lease Commitments)
The Company has various lease agreements for its office space and condominium units with terms ranging from three months to five years. These leases are renewable on terms mutually agreed by the parties. Certain lease agreements require the Company to pay security deposits. These are included under "Prepaid expenses and other current assets" and "Other noncurrent assets" in the balance sheets. Accretion of interest on security deposits amounted to P0.40 million and P0.38 million in 2014 and 2013, respectively, and are included under "Other income" in the statements of comprehensive income.

interest and/or real properties. The list in RR No. 04-86 echoes the list provided by the Civil Code.

The Civil Code considers as immovable property, among others, anything attached to an immovable in a fixed manner, in such a way that it cannot be separated therefrom without breaking the material or deterioration of the object.[6] However, property which is movable in its nature only becomes immobilized when placed in a property by its owner, but not when so placed by a tenant, a usufructuary, or any person having only a temporary right, unless such person acted as the agent of the owner.[7]

In the case of Aditya Philippines, its properties are placed on *leased* office space and condominium units. A rundown of the financials of Aditya Philippines shows no presence of any tenement or land it directly owns giving this Office a reason to believe that any movable property placed by Aditya Philippines on these leased premises cannot be immobilized and, therefore, cannot be classified as real properties. The position of the BIR that the "Property and equipment" account wholly consists of real properties is appallingly bereft of legal basis.

Pertinent to note that under Section 32(B)(5), income exempt under a tax treaty which is binding upon the Government of the Philippines shall be exempt from taxation.[8] Under paragraph 4 Article 14 of the RP-India Tax Treaty, gains from transfer of shares of a company *may be taxed* in the Philippines if the property of such company consists principally of immovable property.

Under Philippine tax treaties, capital gains derived by residents of other Contracting States from the disposition of a share or of an interest in a Philippine corporation are taxable in the Philippines only if the assets of the corporation consist **principally** of real property interest located in the Philippines.[9] The term "principally" *means more than fifty percent of the entire assets in terms of value*.[10]

Based on the previous discussions, the BIR computation as to Aditya Philippines' real property interest for the period ended March 2014 fails to convince that the figure will reach beyond fifty percent as prescribed under RR No. 04-86. Henceforth, since Aditya Philippines' assets do not consist principally of real property interest located in the Philippines, the transfer of the shares of Aditya India in Aditya Philippines to Maple UK are not subject to capital gains tax imposed under Section 28(B)(5)(c) of the Tax Code in relation to paragraph 4 Article 14 of the RP-India Tax Treaty. Consequently, the BIR erred when it imposed capital gains tax on the said transfer.

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[6] Yap v. Tañada, GR No. L-32917, 18 July 1988

[7] Davao Saw Mill Co., Inc. v. Castillo, GR No. 40411, 7 August 1935.

[8] (B) Exclusions from Gross Income. — The following items shall not be included in gross income and shall be exempt from taxation under this Title:

xxx

(5) Income Exempt under Treaty. — Income of any kind, to the extent required by any treaty obligation binding upon the Government of the Philippines.

[9] Determination of whether the assets of a corporation consist principally of real property interest under the Philippine tax treaties, Revenue Regulations No. 04-86, Sections 4 and 5 (April 2, 1986).

[10] *Id.*

This ruling is being issued on the basis of the foregoing facts as represented. However, if upon investigation, it will be disclosed that the facts are different, then this ruling shall be considered as null and void.

Thank you.

Sincerely yours,

CARLOS G. DOMINGUEZ
Secretary of Finance
JAN 10 2019

CC **Commissioner Caesar R. Dulay**
Bureau of Internal Revenue

JAN 14 2019

DEPARTMENT OF FINANCE
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RECEIVED
JAN 14 2019
TERESITA SALAZAR