CORPORATE READJUSTMENT AND NONRECOGNITION OF GAIN OR LOSS

(A Taxpayer's View of Rep. Act No. 1921)

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On June 22, 1957, Rep. Act No. 1921 introduced an exception to the general rule found in Sec. 35(c), Tax Code, that the entire gain or loss upon the sale or exchange of property shall be recognized for income tax purposes. Since then, opinions of three well-placed technical men in the tax research and collection agencies of the Government had been published.[1] They concluded that Rep. Act No. 1921 in effect cannot apply here because, while it provides for nonrecognition of gain or loss in certain exchanges pursuant to merger or consolidation as defined, neither the Corporation Law nor any other statute authorizes these transactions, and if done, are *ultra vires*. This view, according to them, applies even more strongly to all expiring corporations, on the fact alone of such expiration, and without more. They recommended therefore that tax consequences befall these corporations and/or their shareholders and the survivor be subjected to dissolution proceedings, judicially or by legislation.

These views, coming as they do from high officials of the tax agencies of the Government might be taken as indicating the drift of official thinking on the matter. It is hoped that the policy-makers will reject their recommendations in time before they generate harmful effects to the economy of the nation. They are productive of much uncertainty and confusion in the business community. They tend to shake the belief that by the enactment of Rep. Act No. 1921, Congress and the President had at last recognized and removed a tax block—the taxation of paper profits or deduction of paper losses on exchanges pursuant to corporate readjustments—and had given the go-signal for tax-free recasting of corporate business. They

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[1] "Memorandum to the Commissioner of Internal Revenue" dated July 5, 1960 by Atty. Elias E. Vega, formerly Chief, Revenue Operations Executive (Assessment); "Tax-free Mergers or Consolidations" by Atty. Isidro Evangelista, Chief, Direct Taxes Branch, Joint Legislative Tax Commission, printed in VII Economic Research Journal, March 1961, p. 197; and "Merger and Consolidation of Expiring Corporations" by Atty. Troadio Quiazon, Jr., Chief, Legal Staff and Legal Counsel, Joint Legislative-Executive Tax Commission, printed in XXXVI Philippine Law Journal, Sept. 1961. The last writer submitted that Rep. Act No. 1921 applies only to public service corporations and railroads.

tend to alarm business which hoped that with Rep. Act No. 1921, the days of the Ogan rule [2] were over.

Business has long insisted that at the present stage of our economy, the jump-off from the agricultural to the industrial and commercial, requires corporate readjustments to cope effectively with sudden demands and sudden situations caused by fluid government policies and unforeseen opportunities. While business desires forms of readjustments not limited to the combinations enumerated in Rep. Act No. 1921, but more, including the divisive types, it welcomed the Act as a big forward step. It feels that Rep. Act No. 1921, in a limited way, removes an economic strait-jacket that hampers bold business expansions.

The views expressed in the articles mentioned in footnote (1), if adopted by the Government, might seriously interfere with those business readjustments so peculiarly necessary under existing conditions. Litigations will certainly arise. Business will be forced to stand idle while waiting for the slow wheels of the courts to grind out a final decision in a test case. Expiring corporations might decide to permanently retire. In the meantime, capital might be reluctant to team up with others even if doing so is the only practicable way to exploit a passing business opportunity.

By this article, the author tries to disabuse the reader of unwarranted impression about nonrecognition in merger or consolidation under Rep. Act No. 1921. While sincerely respecting them, he strongly disagrees with the contrary views expressed. By this paper, he will show that Rep. Act No. 1921, whose validity is not disputed, applies to mergers and consolidations as these terms are defined there. This conclusion rests on these premises discussed fully below:

1. Rep. Act No. 1921, a tax statute, for purposes of the income tax provides for nonrecognition of gain or loss in three exchanges made pursuant to a plan of merger or consolidation (Sec. 35(c) (2), Tax Code);

2. Rep. Act No. 1921 therefore defines merger or consolidation as meaning three types of transactions;

3. These three types of transactions can each be done under the Corporation Law. (The fact that the terms "merger" or "consolidation" are not expressly mentioned in the Corporation Law is irrelevant for purposes of applying the nonrecognition section of Rep. Act

[2] Ogan v. Meer, G.R. No. 49102, May 30, 1949 held:
"When the stockholders of one corporation become stockholders" of another by exchanging their stock in the former for stock of the latter, "they earn positive benefits and advantages . . . and in the present case, they profited by the difference of share values.
Congress considered the Ogan rule as an obstacle to necessary business readjustments. To remove in the law what it considered to be economically unsound technical construction of gains, Congress enacted Rep. Act No. 1921 to amend Sec. 35(c), Tax Code.

No. 1921 so long as the definition therein of "merger" or "consolidation" is satisfied. Neither is reliance on nontax authorities helpful.)[3]

4. The expiration alone of the term of a corporation, assuming that all the requirements of the definition section are satisfied does not prevent the operation of the nonrecognition section of Rep. Act No. 1921;

5. Tax loss, in terms of revenue excused for the moment by Rep. Act No. 1921, is not a valid objection to thwart the application of Rep. Act No. 1921 because that is the very purpose and intention of the sovereign in enacting the nonrecognition statute which, admittedly, is valid.

BACKGROUND—CORPORATE REORGANIZATION IN THE U.S.

Legislative history of nonrecognition. An adequate appreciation of R. A. 1921 requires at least an acquaintance with the history and purpose of the statutes governing reorganization of corporation in the U.S. for it is not disputed that it is a copy of similar statutes there. It is almost a legal truism that an imported statute carries its interpretation and meaning abroad if not contrary to local laws, policies and mores.

Before 1918, the general rule (that the entire gain or loss upon the sale or exchange of property) applied in the U.S. to exchanges of corporate stock incident to corporate readjustments if there was a change in form or extent of shareholder's investment, even if the whole investment still remained in solution. (*Marr v. U.S.*, 268 U.S. 536; *U.S. v. Phellis*, 257 U.S. 156; *Rockefeller v. U.S.*, 257 U.S. 176; *Cullinan v. Walker*, 262 U.S. 134). In the Revenue Act of 1918, U.S. Congress for the first time, provided for nonrecognition of gain or loss in corporate reorganization, merger or consolidation, as follows:

> "Sec. 202(b). When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities shall be treated as taking the place of the stock, securities, or property exchanged."

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[3] The contrary views relied primarily on corporation law treatises, cases and doctrines. Also cited is case of U.S. v. E. I. du Pont Nemours & Co., 353 U.S. 589, which is neither a reorganization nor even a tax case but an anti-trust case. Again, citation of Prof. Hellerstein's article, Mergers, Taxes & Realism, 71 Harvard Law Review 257 has no relation whatever with the proposition that under Rep. Act No. 1921 merger or consolidation is not authorized by our Corporation Law. Prof. Hellerstein's view is that there are certain kinds of mergers not now taxed which should be taxed because in reality there were changes in the form and extent of the interests of shareholders

In inserting the foregoing, the Senate Finance Committee stated:

> ".....provision....inserted (was) designed to establish the rule for determining taxable gains in the case of exchanges of property and to negative the assertion of tax in the case of certain *purely paper transactions.*"[4]

In the Revenue Act of 1921, the above rule was more comprehensively developed and the term "reorganization" was defined for the first time. Sec. 202(c) of said Act provided that no gain or loss shall be recognized —

> "(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization", as used in this paragraph, includes a merger or consolidation (*including the acquisition by one corporation* of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of another corporation, *or of substantially all the properties* of another corporation), recapitalization, or mere change in identity, form or place of organization of a corporation, (however effected);" (Emphasis supplied).

Purpose of nonrecognition. The purpose of the foregoing changes was to eliminate economically unsound technical constructions and to allow business to undertake needed readjustments. The Senate Committee Report stated:

> "REPORT—SENATE FINANCE COMMITTEE (67th Cong., 1st Sess., S. Rept. 275).—Section 202 (subdivision c) provides new rules for those exchanges or "trades" in which, although a technical "gain" may be realized under the present law, the taxpayer *actually realizes no cash profit.*
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> "Under existing law 'when property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any x x x.' Probably no part of the present income tax law has been productive of so much uncertainty or *has more seriously interfered with necessary business readjustments.* The existing law makes a presumption in favor of taxation. The proposed act modifies that presumption x x x and specifies in addition certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value. These classes comprise the cases x x x where in any corporate reorganization or readjustment stock or securities are exchanged for stock or securities of a corporation which is a party to or results from such reorganization x x x.
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> "The preceding amendments, if adopted, will, by removing a *source of grave uncertainty* and by eliminating many *technical constructions which are economically unsound,* not only permit business to go forward with the readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges." (pp. 11-12) (Emphasis supplied.)

[4] S. Rept. No. 617, 65th Cong., 3d Sess. 5 (1918). Reproduced in Hellerstein, *op. cit.*, p. 258.

The foregoing definition of reorganization, insofar as relevant to Rep. Act No. 1921, merger or consolidation was carried over to the Rev. Act of 1924 as Sec. 204(h) (1) (A) and 1926, 1928 and 1932 as Sec. 112(i) (A).

In the Rev. Act of 1934 the definition of reorganization was amended as follows:

> Sec. 112. (g) (1). *The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock:* of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; *or of substantially all the properties of* another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a reorganization, however effected. (Emphasis indicates portion relevant here.)

That part of the above definition concerning statutory merger or consolidation and the acquisition of assets solely-for-stock remained in all subsequent Revenue Acts, including the 1939 and 1954 Codes.

The purpose of nonrecognition in exchanges accompanying corporate reorganization as above defined has been given by the U.S. Congress in the quotation reproduced above. That Congressional policy has been echoed in varying languages by the U.S. courts, the Internal Revenue Service and various tax authorities. Thus Income Tax Regulations Nos. 86, 94, 101, 103, 111 and 118, implementing the reorganization sections of the U.S. Revenue Acts of 1934, 1936, 1938 and the 1939 Tax Code until its repeal in 1954, provided:

> "Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. *The purpose of the reorganization provision of the* Internal Revenue Code is *to exempt from the general rule* certain specifically described changes *incident to such readjustments* of corporate structures, made in one of the particular ways specified in the Code, as are required by *business exigencies,* and which affect only a *readjustment of continuing interests in property under modified corporate forms.*" (Emphasis supplied).

Judge L. Hand of the 2d Circuit, Court of Appeals, stated the thought briefly and elegantly:

> "The purpose of the section is plain enough, men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract, from their holdings. Such transactions were not to be considered as 'realizing' any profit, because the collective interests still remained in solution." (Helvering v. Gregory, 694 F. 2d 809. See also Cortland Specialty Co. v. Comm., 60 F. 2d 937, 11 AFTR 857.)

On this same theme, another Court said:

> "The reorganization provisions were enacted to free from the imposition of an income tax purely 'paper profits and losses' wherein there is no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form, the tax being postponed to a future date when a more tangible gain or loss is realized." (Gilmore's Estate, 130 F. 2d 791, cited in Roebing v. Comm., 143 F. 2d 810).

A notable treatise on taxation contains the following on this subject:

> "The justification for the exemption from taxation of gains realized in corporate reorganization is that the parties making the exchanges have simply changed the form of their corporate holdings and that what was formerly a corporate business carried on by a particular corporate form or forms is to be now carried on and continued by other and perhaps new corporation having new corporate form. "The exemption, of course, was never intended to apply, and obviously did not apply, where there had been an acquisition by one corporation of either all the stocks of another or all the assets of another simply for cash." (3 Mertens, Law of Federal Income Taxation [1942] pp. 183-184).

In giving the rationale behind the reorganization provision of the U.S. Tax Code a noted professor of taxation wrote:

> " 'These provisions are based upon the theory that the types of exchanges specified in Section 203 are merely changes in form and not in substance . . . .' They reflect the congressional policy of 'exempting from tax gain from exchanges made in connection with a reorganization, in order that ordinary business transactions will not be prevented on account of the provisions of the tax law.' [5]

Finally, two famous authorities in taxation wrote:

> ". . . . . In general these sections are designed to permit business transactions involving certain corporate readjustments to be consummated without a tax being incurred by the participating corporations or their shareholders at the time of the transaction. The Congressional policy is that while such readjustments may produce changes in the conduct of a business enterprise, these changes do not involve a change in the nature or character of the relation of the owners of the enterprise to that enterprise sufficient to warrant taxation . . . or allowances or loss." [6]

In not recognizing gain or loss in corporate reorganization, the U.S. Congress had seen the necessity of corporate readjustments in business and industry. As these involve changes merely in form and not in substance, and the interest of the shareholder continues to be subject to the hazards of business in the new corporate form, it was both realistic and sound economic policy to forego for the moment the taxes otherwise technically due. Rep. Act No. 1921 was enacted under similar motivations.

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[5] Hellerstein, *idem*

[6] Surrey and Warren, Federal Income Taxation (1955), p. 1267.

REP. ACT NO. 1921 APPLIES EX PROPIO VIGORE

Purpose and scheme of Act. Reference to the Explanatory Note of Rep. Act No. 1921 [7] reveals that its purposes hew closely to the above reproduced purposes of the organization Acts of the U.S. These purposes of Rep. Act No. 1921, as clarified by references to the applicable quotations above, must be paramount in the construction, interpretation and analysis of the Act despite the contrary belief that American concepts of merger or consolidation do not apply here.

It is helpful to describe at this point the structure or scheme of Rep. Act No. 1921. Like its U.S. models, particularly the Revenue

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[7] Explanatory Note of H.B. 7235 that became Rep. Act No. 1921.

EXPLANATORY NOTE

Under the present provisions of the Philippine Income Tax Law, the exchange of one piece of property for another is a taxable event, the rule being that the property received is considered as the equivalent of money in a sum equal to its fair market value at the time the exchange was made. There is no limitation to this rule except that which is found in the income tax regulations to the effect that the property received in order to be deemed as the equivalent to money must be essentially different from the property transferred. This essential difference must refer to the substance and not merely to the form of the properties exchanged. As to what is the determinative factor to indicate such a substantial difference, the law does not specify. However, it is certain that if a taxpayer transfers his stock in one corporation for the stock of another corporation, gain or loss shall be deemed realized in such a case to the extent of the difference of the par value or other basis of the stock transferred and the market value of the stock received. This rule was established in Ogan v. Meer, the only case which dealt directly on the exchange of stock for stock. As the court in that case held, when the stockholders of one corporation become the stockholders of the other, as a result of the transaction or exchange, they earned positive benefits and advantages and, therefore, the gain or loss should be included in the computation of the taxable income of the taxpayer.

When the above rules are applied to exchanges incident to corporate combinations, their application will result in the imposition of tax or allowance of loss both on the corporate level as well as in the stockholders' level. Consider for instance this situation: Corporation X acquires all the assets of Corporation Y in return for the stocks of Corporation X, the assets transferred by Corporation Y having a basis of, say, ₱500,000.00 and a fair market value of ₱750,000.00. Under our present law the exchange is definitely a taxable transaction, the property received and the property given being essentially different. If after receipt of the stock, Corporation Y, preparatory to its dissolution, distributes the stocks to its stockholders in exchange for its own outstanding shares, such a distribution will likewise be taxable under the rule established in the Ogan case.

This method of Philippine income tax law in dealing with the problem of recognition of gain or loss from exchange of property in connection with corporate combinations is a deterrent factor in the economic development of the country. It discourages corporations from pooling their resources, thereby blocking one of the most important means thru which large concentrations of capital needed to finance the expansion of Philippine industries can be obtained. In other words, the present tax treatment of exchange of property under our law is a disincentive to business to combine and expand. Actually its net effect is to place corporations in what may be termed "a tax strait jacket" from which they could escape only at prohibitive cost.

In addition to its discouraging effect, the present income tax rule on exchanges of property is also detrimental to the revenue needs of the Government because, whereas it tends to discourage successful corporations to combine, it tends to encourage such transactions in these cases where the possibility of deductible loss is apparent.

Another objectionable feature of the Philippine method is its being unrealistic. More often than not, exchanges involved in corporate combinations do not result in a substantial alteration in the interests of those who own the business affected by the transaction before it was reformed. Usually in such cases there was no change except as to the form of the muniment representing the interests of the owners. When, therefore, the Government imposes a tax on the supposed gain or when it allows the deduction of the supposed loss, what the government actually does is to tax what are often referred to as "paper profits" and to allow the deduction of "paper losses."

As early as 1947, the joint Philippine-American Finance Commission suggested that the Philippine income tax rule on exchanges of property be changed. The reason of the Commission in suggesting the change was this:

> "Two corporations may find that their business may be more efficiently operated as one corporation. If the interest of the individual remains in the business, the tax law can aid these business adjustments by regarding the new as the old, so that the tax will be payable, not at the time of the readjustment, but at the time of the disposition of the property or interest in ordinary course. Such aid would appear to be needed in the rehabilitation of Philippine industries."

In order to eliminate the obstacles to necessary business readjustments, and in order to prevent taxpayers in taking imaginary losses, and to remove in our law what is considered to be economically unsound technical construction of gains, it is proposed that Section 35(c) of the National Internal Revenue Code be amended.

Acts from 1921 onward, it provides for nonrecognition (at the corporate and shareholder levels) of gain or loss in enumerated exchanges involved in corporate reorganization (Sec. 35(c) (2) Tax Code, is limited to and uses the terms "merger or consolidation") and then proceeds to define "merger or consolidation" (Sec. 35(c) (5) (b)).[8]

These are two separate provisions with their respective functions. The operative or nonrecognition provision (Sec. 35(c) (2)) applies only if the definition provision (Sec. 35(c) (5)) is satisfied. For purposes of determining, therefore, if Rep. Act No. 1921 applies at all, the inquiry should be directed as to whether or not the acts constituting "merger or consolidation" as defined in Sec. 35(c) (5) (b) can be validly done in the absence of a statute expressly using these terms. It is the thesis of this article that those acts can be validly done under our Corporation Law.[9]

Merger or consolidation under Rep. Act No. 1921—acts done Rep. Act No. 1921 defines these terms as follows:

> "Sec. 35(c) (5) (b) The term 'merger' or 'consolidation when used in this section, shall be understood to mean: (1) the *ordinary* merger or consolidation, or (2) the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock......"

Three transactions are included in the meaning of merger or consolidation, to wit: (a) ordinary merger, (b) ordinary consolidation and (c) acquisition of assets solely for stock.

Meaning of ordinary merger or consolidation. Before 1934, the language used in the U.S. Revenue Acts in the definition of reor-

[8] Sec. 35(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) *Exceptions*: No gain or loss shall be recognized if in pursuance of a plan or 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 of 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, party to the merger or consolidation."

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"(5) *Definitions*—(b) The term "merger" or "consolidation" when used in this section shall be understood to mean: (1) the ordinary merger or consolidation, or (2) the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock: Provided, That for a transaction to be regarded as a merger or consolidation within the purview of this section, it must be undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation: Provided, further, that in determining whether a bona fide business purpose exists, each and every step of the transaction shall be considered and the whole transaction or series of transactions shall be treated as a single unit; Provided, finally, that in determining whether the property transferred constitutes a substantial portion of the property of the transferor, the term "property" shall be taken to include the cash assets of the transferor."

[9] It has been suggested that the proposition that Rep. Act No. 1921 does not apply because the Corporation Law does not expressly mention and authorize corporate merger and consolidation should be brushed aside by a mere reminder that Rep. Act No. 1921, as part of the Tax Code, is intended for matters involving taxation. In these matters, therefore, resort should be made primarily to the Tax Code, and where such Code is applicable, the Corporation Law or any other law for that matter finds no application.

Although this may be a valid suggestion, the author of this article chose to meet head-on the issues raised in the aforecited articles in footnote (1) in order to give full satisfaction on the merits, and in the process, show up some fallacious conceptions, premises and conclusions.

ganization was "merger or consolidation," without modifiers. This was interpreted to mean the ordinary merger or consolidation, as follows:

> "It must be assumed that in adopting par. (h), [Sec. 203, 1926 Act] Congress intended to use the words 'merger and consolidation' in their ordinary and accepted meanings." (Pinellas Ice and Cold Storage Co. v. Comm., 57 F. 2d 188, 10 AFTR 1529, 1930). (Emphasis supplied).

What then do these words mean? The same court answered as follows:

> "In a merger one corporation absorbs the other and remains in existence while the other is dissolved. In a consolidation, a new corporation is created and the consolidating corporations are extinguished. In either event, the resulting corporation acquires all the property, rights and franchises of the dissolved corporations, and their stockholders become its stockholders. (Royal Palm Soap Co. v. Seabord Air Line Ry. Co., 296 F. 448; Bouvier's Law Dict. (3d Ed.) p. 2202, verbo 'merger'." Pinellas case, *supra*).

The same answer was expressed in the case of *Cortland Specialty Co. v. Comm.*, 60 F. 2d 937, 11 AFTR 857.

> "A merger *ordinarily* is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist and the merging corporation alone survives. A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. In each case interests of the stock holders and creditors of any company which disappear remain and are retained against the surviving or newly created company. Atlantic & G. Railroad Co. v. Georgia, 98 U.S. at page 362, 25 L. Ed. 185; Matter of Bergdorf, 906 N.Y. 309, 99 N.E. 7140; Pinellas Ice & Cold Storage Co. v. Comm. (C.C.A.) 57 F. 2d 188; Royal Palm Soap Co. v. Seabord Air Line Ry. Co. (C.C.A.) 296 F. 448; Lee v. Atlantic Coast Line (C.C.) 150 F. 775." (Emphasis supplied.)

Standard authorities on the matter agree with the foregoing elements of ordinary merger or consolidation.

Let us now examine the acts involved in ordinary merger and ordinary consolidation to see if they can be done under our Corporation Law.

a. *Ordinary merger* as when corporation A merges with corporation B.

1. B acquires all assets of A.
2. B gives to A, in exchange, B stocks. (These may be the existing old

stocks or may be new issues depending on whether the acquisition increases the authorized capital stock.)

3. B asks its shareholders to exchange their B shares for new B shares if the asset acquisition alters the authorized capital stock.
4. A dissolves by requiring its shareholders to exchange their A shares for the B shares it receives.

Result: B corporation is now owned by two sets of shareholders, those of A and the original B shareholders.

(The acts are numbered for identification only and not necessarily in chronological order.)

Act No. 1, as to A, is authorized by Sec. 28 1/2 under the power of a corporation to *exchange or otherwise dispose* of all (or substantially all) its property and assets for *stock.* (Sale for money or nonstock property is not covered by Rep. Act No. 1921.) As to B, the acquisition is authorized by Sec. 13(5) under its power to deal with property as the purposes of its creation may permit.

Act No. 2, as to B, is authorized by Sec. 13(10) under its power to dispose of its shares and may be broadly assumed from Sec. 5 under its power to divide its shares into classes with such rights, preferences, etc. as it may provide.

Act No. 3, if it involves alteration of the capital stock is authorized under Sec. 17.

Act No. 4, is authorized under the Rules of Court, amending the Corporation Law in this regard.

If to do these acts it becomes necessary to amend the articles, then Sec. 18 is sufficient authority.

b. *Ordinary consolidation* as when corporations A and B are consolidated into newly formed corporation C.

1. A and B transfer all their property to a new corporation C.
2. C issues its stocks to A and B
3. A and B dissolve by requiring their respective shareholders to exchange their A and B shares for C shares.

Result: Shareholders of A and B now own C.

Again, Act No. 1 is authorized by Sec. 28-1/2. Act No. 2 inheres in the formation of a new corporation and is governed by various provisions of the Corporation Law. Act No. 3 is authorized by the Rules of Court.

It cannot be denied, therefore, however much we attempt to do so, that the acts constituting ordinary merger or consolidation, although not expressly called by these names, can be done under our

Corporation Law. In fact, the Securities & Exchange Commission, the agency entrusted with the administration of the Corporation Law has approved numerous transactions that it considered as ordinary mergers or consolidations coming under said Act. The Bureau of Internal Revenue itself has met and ruled on the tax consequences of those heretofore approved mergers or consolidations. The Supreme Court itself, as will be shown below, has opined that merger or consolidation can be carried out under the Corporation Law. The denial of the legality of ordinary mergers and consolidations after they have been long approved as valid by the very agency charged with its administration and by the Supreme Court, is caused by and timed to the passage of Rep. Act No. 1921 allowing nonrecognition, for tax purposes, of gain or loss in corporate merger and consolidation. It is caused by a desire to protect the very revenue which Congress and the Executive, by a valid statute, have deemed wise to forego for the moment for overriding economic advantages to the country. Such a desire, though commendable, cannot subvert and negate a valid Act of Congress.

c. *Transfer of asset solely for stock.*—By definition of the statute, this transaction is also a merger or consolidation for purposes of applying the nonrecognition provision in Sec. 35(c) (2). The Act provides:

> "The term 'merger' or 'consolidation', when used in this section, shall be understood to mean......... (2) the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock. . . . (Sec. 35[c] [5] [b], as amended by Rep. Act No. 1921).

A review of the U.S. models of Rep. Act No. 1921 shows that the same pattern was adopted prior to the 1934 Revenue Act, i.e., the acquisition by one corporation of substantially all the assets of another solely for stock was, by definition, also a merger or consolidation.

Before inquiring whether or not the acts involved in this third kind of merger or consolidation come within the scope of the Corporation Law, it is apropos to discuss its nature.

It is usually the type used when a giant swallows up a small business or when a healthy corporation salvages a sick one or when two corporations decide that rather than fail separately, they can succeed together.

It is directed by statute that the acquisition of assets by the corporation must be solely for its stock. There is no requirement that the transferor of the assets possess finally any specific percentage or proportion of the shares of the transferee or acquiring corporation. What is required is that in return for those assets, the transferor becomes a shareholder in the transferee. Furthermore, the assets acquired must constitute all substantially all of the assets of the transferor. By definition of the circular[10] released by the Department of Finance, "substantially all" means at least 80%. It is presently allowable therefore, for the transferee to pay in cash or other stock or nonstock property, to the extent of 20%, the assets required. This is an exception to the "solely" for stock requirement.

The transferor corporation ends up holding the stock of the transferee and its (transferor) stockholders may keep it alive or dissolve and liquidate it.

Assumption of liability-effects. What happens if as part of the plan in this 3rd type of merger or consolidation, the transferee corporation, generally the bigger or healthier one, assumes the liability of the transferor? Is the "solely for stock" rule violated resulting in inapplicability of the nonrecognition provision? This author believes "yes," there is a violation insofar as the assumption exceeds 20% of all the assets of the transferor corporation. Unlike in the U.S. Tax Code, the definition section of Rep. Act No. 1921 does not make assumption of liability by the transferee corporation an exception to the "solely for stock" requirement. It should be mentioned, however, that Rep. Act No. 1921 expressly does not remove from the nonrecognition provision the assumption by a party to an exchange of the liability of the taxpayer, also a party to that exchange.[11] In other words, in the context of merger or consolidation as defined by Rep. Act 1921, assumption of liability applies only in the shareholders level and not in the corporate level. This is so because in the *ordinary* merger or consolidation, the corporation receiving stock (transferor of the assets) is usually dissolved. It cannot therefore be the "taxpayer" referred to in Sec. 35(c) (3) (c).[12] On the other hand, in this third type of merger or consolidation, the transferee and surviving corporation receives assets and therefore cannot be the "taxpayer" referred to in the section.

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[10] " 'Substantially all' as used under this amendment means the acquisition by one corporation of at least 80% of the assets, including cash, of another corporation, which has the element of permanence and not merely momentary holding." (General Circular No. V-253, July 16, 1957.)

[11] Sec. 35(c) (3)(c)—

"If the taxpayer, in connection with the exchanges described in the foregoing exceptions, receives stock or securities which would be permitted to be received without the recognition of gain if it were the sole consideration, and as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money and/or other property, and shall not prevent the exchange from being within the exceptions."

[12] Sec. 35(c) (3)(c) might seem to apply to the transferor corporation, that does not dissolve in the third type of merger or consolidation. This author believes, however, that before the nonrecognition provision could apply, the definition section must first be satisfied. As the assumption of liability is not included in the definition but in the nonrecognition section of Rep. Act No. 1921, such assumption violates the "solely for stock" rule and therefore the nonrecognition section cannot apply.

As seen from the reproduced U.S. Revenue Acts, this third type of merger or consolidation being discussed was included in parenthesis as part of the definition of these terms in the U.S. Revenue Acts before 1934. In interpreting the name, the U.S. Supreme Court rejected the view that reorganization takes place only when the acquisition of assets for stock is in *connection* with ordinary merger or consolidation (our 1st and 2d types) and stated:

> "The words within the parenthesis may not be disregarded. They *expand* the meaning of 'merger' or 'consolidation' so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation." (Pinellas Ice & Cold Storage Co. v. Comm., 287 U.S. 462, 470, quoted with approval in Melvering v. Minnessota Tea Co., 296 U.S. 378.) (Emphasis supplied.)

We have digressed far enough to justify going back to our principal inquiry whether or not the acts constituting this 3d type of merger or consolidation can be done under the Corporation Law. Here are the acts involved in this transaction:

1. B acquires all or substantially all the assets of A.
2. B gives to A, in exchange, B stocks.
3. B asks its shareholders to exchange their B shares for new B shares if the asset acquisition alters the authorized capital stock.
4. A may or may not dissolve.

Result: If A dissolves, its shareholders exchange their A shares for B shares received by A so that they end up being shareholders in B. If A does not dissolve, then its shareholders remain A shareholders, but the only assets of A are the B shares received in exchange.

It will be noticed that the above acts, including dissolution of A are identical to those involved in ordinary merger, which, as we have seen, are authorized under the Corporation Law. If A does not dissolve, the fact that there is no ordinary merger as defined in (1) does not change the proposition that the acts are valid under the Corporation Law.

It is therefore not correct to say, as shown in the foregoing discussion, that our Corporation Law does not authorize mergers and consolidations as defined in Rep. Act No. 1921. We have shown that all the acts necessary to effect these kinds of corporate readjustments, ordinary merger or ordinary consolidation or assets for stock acquisition, fall within the intendment of our Corporation Law. Rep. Act No. 1921 applied, ex propio vigore, of its own force, with full effect, since its enactment. It does not need enactment of a statute expressly providing for merger or consolidation.

Supreme Court agrees that merger possible under Corporation Law. The Supreme Court has already expressed an opinion on this matter, a dictum, to be sure, but nonetheless, an opinion by our highest court. In effect, that court said that our Corporation Law contains ample provisions to carry out mergers and consolidations, in the true sense of the word, or in the light of American authorities.

All the articles cited in footnote (1) discussed the case in which this dictum is found, *Cesar Reyes v. Max Blouse,* G.R. No. L-4420, May 20, 1952. None of them, however, noticed, if they did not deliberately ignore, the parallel between the Public Service Act involved in that case and Rep. Act No. 1921 now under discussion. While all of them conceded that the Public Service Act sufficiently authorizes merger or consolidation of public land carriers, they refuse to grant the same to corporations coming under Rep. Act No. 1921.

The Public Service Act (Com. Act No. 146) requires the approval of the Commission before a public service can do enumerated acts. Among these is merger or consolidation of property, franchises, privileges or rights.[13] The Supreme Court itself has stated, and the contrary articles accepted its correctness, that Sec. 20(g) allows "not only the merger or consolidation of the assets and properties of two public service corporations, but also of the two such corporations themselves".[14] Com. Act No. 146 does not outline the procedure nor define the term merger or consolidation. How then should the "merger or consolidation" that it allows be carried out? The Supreme Court said:

> "As to how the merger or consolidation shall be carried out, our Corporation Law contains ample provisions to this effect (Secs. 17½, 18 and 28½). This law does not require that there be an *express legislative authority* or unanimous consent of all stockholders to effect a merger or consolidation." (Cesar Reyes v. Max Blouse, *supra*). (Emphasis supplied).

To make sure about the meaning of the "merger or consolidation" it was talking about, the Supreme Court said that even if these terms referred to:

> "both of the assets and properties of the two (corporations) as well as of the two corporations themselves in the true sense of the word, or in the light of American authorities, still we believe that this can be carried out in this jurisdiction in the light of our Public Service Law." (Cesar Reyes v. Max Blouse, *supra*.)

We have shown previously what is meant, ordinarily, by the terms "merger" or "consolidation" as understood in the light of American authorities.

[13] Sec. 20(g), Com. Act No. 146.
[14] XXXVI Phil. Law Journal, *op. cit.*, p. 441.

Rep. Act No. 1921 starts by providing for nonrecognition of gain or loss in enumerated exchanges pursuant to merger or consolidation. Like Com. Act No. 146, it does not outline any procedures to be followed. Unlike Com. Act No. 146, however, Rep. Act No. 1921 defines "merger or consolidation." Not only does it define these terms, but it also provides tests and requirements that must be satisfied before the transaction is considered merger or consolidation for purposes of nonrecognition of gain or loss. Like Com. Act No. 146, Rep. Act No. 1921 does not require that there be an express legislative authority to effect merger or consolidation. By way of express authorization therefore (the element sought by the contrary opinion), Rep. Act No. 1921 is not different from Com. Act No. 146. Yet, the Supreme Court and the contrary opinions concede that Com. Act No. 146 sufficiently authorizes corporations treated therein (carriers) to merge or consolidate. Why cannot the same authorization be read into Rep. Act No. 1921? Why can not we equally say with the Supreme Court that merger or consolidation can be carried out in this jurisdiction in the light of Rep. Act No. 1921? Because of the tax loss? Other than this consideration, Rep. Act No. 1921 does not differ from Com. Act 146 for purposes of the proposition being discussed. This author therefore believes that the above quoted dictum, if dictum it is, of the Supreme Court in the Max Blouse case, is equally applicable as regards Rep. Act No. 1921. He therefore submits that like Com. Act No. 146, as to public service corporations, Rep. Act No. 1921 sufficiently authorizes corporations falling under it to merge or consolidate as these terms are ordinarily understood or to merge or consolidate merely their property or assets, and these can be carried out under our Corporation Law.

Rep. Act No. 1921 does not use "statutory" merger or consolidation. The major premise of the three articles cited in footnote (1) is the proposition that as no law and nothing in the Corporation Law expressly authorizes merger or consolidation, Rep. Act No. 1921 cannot apply.

We have shown the fallacy of this premise by demonstrating that the acts constituting the three transactions involved in a merger or consolidation in Rep. Act No. 1921 are authorized under the Corporation Law. The fundamental error of said premise is that it equates with the word "ordinary" used in the Rep. Act No. 1921—definition of "merger or consolidation" the modifier "statutory," the term used in the present U.S. Tax Code which defines reorganization as "(A) a statutory merger or consolidation" (Sec. 368(a)(1)). The cited articles assume that the use by Rep. Act No. 1921 of "ordinary" and not "statutory" is insignificant for purposes of their thesis. It is significant. Their failure to discern this greatly weakens their premises and accordingly vitiates their conclusions.

Dipping again for enlightenment into the history of the definition of reorganization in the U.S., we find that "statutory" before "merger or consolidation" was inserted for the first time in the U.S. Revenue Act of 1934.

Before that year, the definition used plain, unadorned "merger or consolidation" which we have shown above, was interpreted to mean the ordinary merger or consolidation.

The regulations implementing Rev. Act of 1934 and later Acts have defined "statutory merger or consolidation" as referring "to a merger or consolidation effected in pursuance of the corporation laws of the U.S. or a State or Territory or District of Columbia." [15]

It is apparent that the articles cited transplanted this U.S. regulation in their analysis of Rep. Act No. 1921. They would therefore require a statute expressly mentioning and authorizing "merger" or "consolidation" and without such statute they concluded that no merger or consolidation is possible here and the nonrecognition provision does not apply.

This is not correct. Before 1934, as previously discussed, the U.S. Revenue Acts defined "reorganization" to include merger or consolidation identical to our Rep. Act No. 1921. Yet nonrecognition of gain or loss in exchanges resulting from such mergers or consolidations was extended to corporations in States not having statutes providing for merger or consolidation. Nonrecognition was also extended to corporations in different states, even if, under their respective State statutes, such merger or consolidation could not be possible. It was only upon the passage of the Revenue Act of 1934, when the definition inserted the term "statutory", that these corporations were cut off from the benefits of nonrecognition via merger or consolidation. Against this background, nonrecognition under Rep. Act No. 1921 should apply to ordinary mergers or consolidations even if there is nothing in the Corporation Law or any other Law expressly authorizing "merger" or "consolidation".

The possible denial to these corporations of the benefits of nonrecognition, however, caused the U.S. Senate to restore as part of the definition of "reorganization" in Sec. 112(g) (1) Rev. Act of 1934, the following, which (formed part of the definition of merger or consolidation) was deleted by the House:

[15] Art 112 (g-2), Regs. 94, Sec. 19.112(g)-2, Regs. 103; Sec. 29.112(g)-2 Reg. 111; Sec. 39.112 (g)-2, Regs. 118. Not found in 368(b), I.R.C. of 1954 as mentioned in VII Economic Research Journal, p. 199.

> "(B) the acquisition by one corporation in exchange solely for its voting stock: of at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation." [16]

It is submitted that inasmuch as Rep. Act No. 1921 does not require "statutory" merger or consolidation, the absence of any provision in the Corporation Law expressly using the terms and authorizing "merger" or consolidation" does not prevent the operation of the nonrecognition provision of Rep. Act No. 1921. Ordinary merger or consolidation, possible under the Corporation Law, is sufficient.[17]

In order, however, to fully satisfy the contrary thesis that ordinary merger or consolidation means "statutory merger or consolidation", we will grant *arguendo* such proposition. We will find nevertheless, that in the light of the legislative history indicated in footnote (16), the conclusion that nonrecognition would not be available will not be correct because the assets-for-stock acquisition will still be a merger or consolidation by definition in our law. For purposes of Rep. Act No. 1921, what is required is that there be merger or consolidation, either the ordinary (which we grant *arguendo* to be "statutory") or the acquisition of assets for stock type. Both types come within the meaning of "merger or consolidation" in applying the nonrecognition section.[18]

EXPIRING CORPORATIONS WITHIN SCOPE OF REP. ACT NO. 1921

Opinions had been advanced that expiring corporations, by such fact alone, are not covered by Rep. Act No. 1921. If they do merge

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[16] Report, Senate Finance Cte. (73d Cong., 2d Sess., S. Report No. 558):

". . . the House Bill eliminates from the definition of "reorganization" as it appears in the present law the parenthetical phrase appearing after the words 'merger or consolidation' . . .

x x x x x

"Your Committee is in complete agreement with the purposes of the House Bill. . . . . However, some modifications are recommended in order to bring about a more uniform application of the provisions in all 48 of the States. Not all of the States have adopted statutes providing for mergers or consolidations; and, moreover, a corporation of one state cannot ordinarily merge with a corporation of another state. The Committee believes that it is desirable to permit reorganizations in such cases. . . . Consequently, the committee recommends as follows: "(B)" reproduced above.

"The Committee believes that these transactions, when carried out, as prescribed in this amendment are in themselves sufficiently similar to mergers or consolidations as to be entitled to similar treatment." (Reproduced also in Roebling v. Comm., 143 F. 2d S10.) See also discussion by Cong. Harrison, Sen. Cong. Record Vol. 78 as follows: ". . . Your Committee has modified the provision of the House in order to provide a uniform rule for reorganizations in all the states which will permit legitimate business readjustments designed to strengthen the financial conditions of the participating corporation." p. 5847.

[17] Note, however, the argument in one of the articles mentioned in footnote (1) that the use of the term "statutory merger or consolidation" in the U.S. Tax Code, and the definition of this term as referring to State statutes supports the conclusion that Rep. Act No. 1921 does not apply. here. How this conclusion is supported by the premises indicated is not clear to the author of this paper

[18] Referring to the acquisition of substantially all the assets of a corporation for stock the Supreme Court of the U.S. said in the case of Pinellas Ice & Cold Storage, 287 U.S. 462, 470:

> "They expand the meaning of 'merger' or 'consolidation' so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation."

or consolidate, tax consequences should occur [19] and the existence of the surviving corporation should be attacked judicially or by legislation.[20]

This author believes that such opinions do not come to grips with the core of the problem. The accident of termination of the corporate charter, a corporation law question, has nothing to do with the tax question of nonrecognition of gain or loss in exchanges pursuant to merger or consolidation as defined for tax purposes. Rather, the question should be whether or not the expiring corporation, by its decision to merge or consolidate, satisfies the business purpose as well as the continuity of interest tests and all the other requirements set by Rep. Act No. 1921 in defining "merger or consolidation". If it does, then the nonrecognition section operates. Whether or not, however, the decision to continue in business, standing alone, satisfies the business purpose test, is outside the scope of this paper.[21]

It has been suggested that our Corporation Law limits corporate life to 50 years [22] and other than insurance companies, this term

[19] They recommended that (1) liquidating dividends be collected, (2) the profits (or losses) be recognized upon the transfer for stock of assets from the old corporation to the new corporation and (3) as alternative, the 25% penalty tax for unreasonable accumulation be imposed on the new corporation.

These recommendations seem to be bottomed on corporate disregard. However, they fail somehow to pursue their recommendations to the limit of their logic in order to test their validity and reasonableness.

No. (1), under Sec. 83, Tax Code, should be collected from the shareholders of the swallowed-up corporation. Tremendous administrative difficulties will arise where the corporation is widely-held. The tax collectible will depend not on the fair market value of the asset and the original cost to the corporation. It is determined by the excess of the liquidating distribution received by the shareholder over the cost or basis of his stock, as well as upon the tax rate applicable to each shareholder. Finally, inasmuch as no distribution is actually done, much haggling over valuation, deduction and allied problems will arise together with evils that go with the exercise of broad discretion by the tax collectors.

No. (2) might easily be applied if the assets are transferred for cash or nonstock property, in which case, the exchange would not be a Rep. Act No. 1921 merger or consolidation anyway. On the other hand, if solely stock is received for the assets, a true merger or consolidation as well as Sec. 16, Corporation Law, requires that the stock reflect the true value of the assets. In which case, Rep. Act No. 1921 would postpone taxation by preserving in the books of transferee the original basis of the assets in the hands of the transferor. Recommendation No. (2) would ignore this and collect the tax right away. Effect: the asset would be carried in the books of transferee at its stepped-up basis with a corresponding reduction of any future taxes. No. (2) then merely substitutes the judgment of its author for that of the Congress as to timing of collection of tax. Clearly, this substitution can never be sustained legally.

No. (3), aside from its novelty, has no redeeming factor, either in law or in logic. The tax on unreasonable accumulation attaches if, among other things, the accumulation serves no business purpose, i.e., not needed in the business. If a merger or consolidation qualifies under Rep. Act No. 1921, this purpose necessarily has been satisfied and the ground for imposing this penalty tax automatically evaporates. On the contrary, if the accumulation serves no business purpose, then the transaction does not qualify under Rep. Act No. 1921; gain or loss is recognized and imposition of the penalty tax becomes unnecessary. Neither can it be granted that the Government may choose which course to take between recognizing gain or loss and imposing the penalty tax. If recognition is proper, then the penalty tax is ruled out.

[20] See XXXVI Philippine Law Journal, *op. cit.*

[21] This author believes that standing alone, the decision of an expiring corporation to merge or consolidate in order to continue in business is valid and sufficiently meets the business purpose test. Especially is this so because in merging or consolidating, the expiring corporation merely exercises a privilege extended by law. This question should be judicially ventilated and examined.

[22] The Memorandum mentioned in footnote (1) concluded that U.S. concepts of reorganization and nonrecognition should not apply here because of basis differences in corporate life, i.e., here it is limited to fifty years; there, state laws provide no such limit.

This is not exactly correct. Generally, there, like here, state laws limit corporate life or require the term of corporate existence to be stated in the Articles. Perpetual corporate existence in its literal meaning, is the exception there. Thus, North Carolina limits corporate life to 60 years, Arizona to 25, Iowa and Mississippi to 90 and Oklahoma to 50 (N.C. Session Laws, ch. 1940; 4 Ariz. Code 1959, Secs. 53-304. Code Iowa 1954, Sec. 491.24. Miss. Code 1942, Sec. 53.10. Okla. Stats Annot 1951, Title 18, Sec. 1.14). See also footnote 16, *supra*, where Congressional intent cannot be legally extended. This paper does not quarrel with this corporation law proposition. It merely disagrees with the manner it is being used in the field of taxation. Rep. Act No. 1921 mergers or consolidations, the three types described previously, do not involve an agreement of the shareholders to extend the life of the expiring corporation. On the contrary, helpful tax planning requires that the expiring corporation should be dissolved without waiting for its termination and its business continued in a new corporate form. It cannot be denied that this can be legally done.

The old corporation, for purposes of the Corporation Law, dies after its dissolution. It is true that its assets, rights and shareholders continue, but they continue in a new corporate form under the provisions of the Corporation Law. But then it is contended by the aforecited articles that the new corporation is merely the "old" one masquerading under a new form; that the new one is a "dummy" of the old. This contention confesses utter lack of understanding of the essence of corporate reorganization and the reasons for not recognizing gain or loss. It is because of the fact that the changes involve merely paper changes, changes only of form, not substance, that nonrecognition is extended. This treatment is a policy question, no longer within construction or interpretation of statute. The Congress has spoken—impose no tax. That command should be given full force and effect even if we do not agree with its wisdom. This author, however, agrees with the explanatory note that Rep. Act No. 1921 is needed to give impetus to necessary corporate readjustments.

The contrary view, in a hazy sort of way, would want to apply the doctrine of corporate disregard to the surviving corporation. It suffices to answer here that corporate entity is not to be lightly disregarded. It is only when the corporation is used to defeat public convenience or to commit fraud or to perpetuate a wrong that the courts pierce the corporate veil. The facts of each case govern whether or not the corporation is used for the condemned objectives. These facts should also determine whether or not the expiring corporation that merges or consolidates satisfies the business purpose and other tests in Rep. Act No. 1921.

The opposite view proceeds along the theory that because the Corporation Law limits corporate existence to 50 years, it must liquidate when that term ends. Inasmuch as Sec. 83, Tax Code, recognized gain or loss (capital) upon liquidation, then it is illegal, according to said view, for an expiring corporation to escape this

to apply the reorganization rules uniformly among the several states having different state laws on mergers and consolidations was clearly expressed.

tax consequences by merging or consolidating under Rep. Act No. 1921. The error of this reasoning is obvious.

Firstly, it is legal for a corporation to dissolve and liquidate anytime before its term expires. Nothing in the Corporation Law compels a corporation to live out its complete term. No provision therein is therefore violated.

Secondly, recognition of gain or loss under Sec. 83, Tax Code, attaches to corporate liquidation, whether or not the corporate term has been completed. The expiration of the corporate term therefore, is significant, tax-wise, only for one event, the attendant liquidation and distribution of assets to shareholders. Other than this liquidation, the Tax Code is not interested in the completion of the full corporate term.

Thirdly, non-application of Sec. 83, Tax Code, derives from Rep. Act No. 1921 which expressly amends Sec. 35(c) (2) and in effect, amends in this respect Sec. 83. If it is conceded that Rep. Act No. 1921 amends Sec. 83 in cases where the corporation liquidates but has many more years ahead of it, it is difficult to see why Rep. Act No. 1921 does not have the same effect in the case of an expiring corporation unless the question is directed to the business purpose and other tests. To insist that Sec. 83, Tax Code, in disregard of Rep. Act No. 1921, must govern the liquidation of an expiring corporation which merges or consolidates under the latter, is to deny the power of Congress to amend its Acts. It is to deny the power of Congress to forego taxes or exempt or postpone their collection. Or, if this extreme position is not intended, the contrary view in effect says that though the Congress and the President, in enacting Rep. Act No. 1921, have the power, will and purpose to extend nonrecognition to gain or loss in corporate reorganization exchanges, they should not be believed. This is a cynical view to entertain. This author willingly grants this credibility and insists in this paper that the Congress and the President intended Rep. Act No. 1921 to apply with full force and effect to all kinds of corporate readjustments coming under it. The evident purpose and clear language of Rep. Act No. 1921 to lift the tax impact from the enumerated corporate readjustments because any changes taking place are merely paper changes not resulting in realization of gain or loss should not be lightly disregarded. If the fear is tax avoidance, and this fear seems to underlie the conclusion of the articles mentioned in footnote (1), then the right approach is to apply strictly the tests expressly included in Rep. Act No. 1921. Those tests, absent in U.S. Revenue Acts before 1954, but evolved by the U.S. courts since 1932, have been found to be effective in policing the tax-free corridor of reorganization. There is no reason why our Bureau of Internal Revenue and our Courts, in the light of U.S. administrative and judicial precedents, cannot similarly use them especially when they are parts of the statute. This author is confident that the Bureau of Internal Revenue and the courts can effectively sport tax-evasion schemes using the guise of merger or consolidation. The contrary view in effect recommends throwing away the baby of merger or consolidation with the dirty water of tax evasion. This can hardly be called a prudent recommendation.

Administrative enforcement impossible. There is a further defect in the view that expiring corporations, by such fact alone, do not come within the nonrecognition provision of Rep. Act No. 1921. Such view will impose an impossible load on the Bureau of Internal Revenue. What criteria should be followed in determining what are "expiring" corporations? One year before termination? Why one year and not two? Why two and not five? Why not ten? Or if the criteria is in days, would 365 days before termination suffice? Why not 360 days? Why not 300 days? Why not 200 or 100 or 50 days? Why not 10 days or even one day? To compel the Commissioner of Internal Revenue to adopt any of these cut-off periods without reference to business purpose, is to invite arbitrariness and its attendant evils. It would provoke litigations. It would force him even to tread a dangerous constitutional field mined with "due process" and "equal protection" clauses. On the other hand, this paper advocates that the tests of business purpose and continuity of interest should be adopted in determining whether or not expiring corporations come within Rep. Act No. 1921. Cases cited by the articles referred to in footnote (1) support this recommendation. In those cases the transactions were ignored and the corporate veils were pierced because of lack of business purpose and/or failure to meet the continuity of interest test; in some, the transactions were sham, done only for tax avoidance.

BUILT-IN SAFEGUARDS IN REP. ACT NO. 1921

Profiting probably from the experience of the United States in the administration of the models of Rep. Act No. 1921 as recorded in the numerous cases cited (and more not cited) by the articles mentioned in footnote (1) above, our Congress incorporated as part of the statute itself safeguards judicially evolved abroad. Principally, these are (1) business purpose test and (2) continuity of interest test. In determining existence of business purpose the several steps of a transaction are treated as a single unit.[23]

[23] Sec. 35(c) (5)(b):
. . . (b) "The term "merger" or "consolidation", when used in this section, shall be understood to mean: (1) the ordinary merger or consolidation, or (2) the acquisition by one cor-

One fundamental and elementary principle underlying corporate reorganization is that the nonrecognition of gain or loss in the accompanying exchanges never extends to sales transactions. This is so fundamental that though never expressed, it is always tacitly assumed by tax men in discussing corporate reorganization. The reason why sales are not covered is obvious from the purpose of nonrecognition—there is no realization of gain or loss because the changes involved are merely paper changes, changes in form not substance; the shareholder's investment continues to be in solution in new corporate form. (This last is also the basis of the continuity of interest rule.) Whereas, a sale (for cash) "is the clearest kind of a closed transaction with complete realization and recognition of gain or loss as could possibly be." [24] Where an alleged sale is not for cash, then it is proper to examine whether the transaction is closer to a sale or to a legitimate corporate readjustment. This reminder about sales transaction is necessary because there is haste to assume that what occurs in a merger or consolidation under Rep. Act No. 1921 is a sale. It is said, for example, that although Sec. 28½, Corporation Law authorizes the corporation to *sell* its assets, "said assets (must be) *sold* for a fair and adequate price; that the minority stockholder participate fairly in the *profit of the sale;*...." [25]

The assumption rules itself out of the operation of Rep. Act No. 1921 which never applies to a sale.

Continuity of interest. We will show further that the contrary articles mentioned rest on vague understanding of corporate reorganization.

In destroying the alleged "bogey-man" that merger or consolidation under Rep. Act No. 1921 is *ultra vires*, the contrary opinion cites two hypothetical merger agreements. Thus, an old company with net worth of ₱6 M merges into and transfers its assets to a newly formed corporation with zero assets in exchange for the latter's stock. Or an old corporation with net worth of ₱25 merges into and transfers its assets to another for the latter's stock valued at ₱12 M. These illustrations, it was concluded, demonstrate that the mergers are *ultra vires* for the surviving corporation issued stock worth less than the assets acquired.[26]

poration of all or substantially all the properties of another corporation solely for stock: Provided, That for a transaction to be regarded as a merger or consolidation within the purview of this section, it must be undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation: Provided, further, that in determining whether a bona fide business purpose exists, each and every step of the transaction shall be considered and the whole transaction or series of transactions shall be treated as a single unit: Provided, finally, That in determining whether the property transferred constitutes a substantial portion of the property of the transferor, the term "property" shall be taken to include the cash assets of the transferor.

[24] 3 Mertens, *op. cit.*, pp. 183-184.

[25] Articles mentioned in footnote (1).

[26] VII Economic Research Journal, *op. cit.*, p. 202.

Let us dissect these illustrations and test the validity of the conclusion.

In the first illustration, the old corporation in effect is a subscriber to the stock of the new. There is no difference between this situation and that of an individual who sets up a new business in a corporate form by transfering his ₱6 M for all the shares of his corporation. The ₱6 M forms the assets of the new corporation. The individual investor now holds paper certificates, if at all. Yet it is never suggested that the transaction is null and void for want of a consideration. It is accepted that the individual did not "buy" paper scraps for ₱6 M cash. It is accepted that the paper certificates show his ownership of the assets of the Corporation worth ₱6 M.

The situation is not altered legally just because the subscriber or shareholder is a corporation. Much less is the situation altered if instead of cash, property and other noncash assets are transferred in exchange for the shares of stock.

The next question is whether or not the transfer of those assets for shares of stock is permissible under Sec. 28-½, Corporation Law. There is no question that it is permitted. It is not therefore *ultra vires.*

The second illustration is quite unusual in the world of reality where the survivor corporation, the transferee of the assets, is usually the bigger and financially healthier one. In the illustration, it is the ₱12 M corporation that swallows up the ₱25 M corporation or the biblical David vs. Goliath epic projected into business. This second illustration requires certain assumptions. Calling the ₱25 M corporation A and the ₱12 M corporation B, we assume that A and B are owned by different sets of stockholders; that only ₱12 M, not all the shares, of B have been issued; that the authorized capital stock of B is large enough to accommodate the acquisition; and that B is worth only ₱12 M in assets.

Here is what happens by the illustration given:

A transfers its assets (₱25 M) to B.
B issues from its authorized capital stock additional shares worth ₱12 M, so that the outstanding shares issued now total ₱24 M.
A receives the ₱12 M worth of B shares.
A requires its shareholders to surrender their A shares (worth ₱25 M) in exchange for B shares worth ₱12 M and then dissolves.
Result: A shareholders become 50% stockholders in B corporation which now has assets worth ₱37 M (₱12 M-₱25 M), or a reduction in equity from ₱25 M to ₱18.5 M. The original B stockholders (who had proprietary interest worth only ₱12 M) own the other 50% of B. As B is now worth ₱37 M these old B

shareholders increased their proprietary interest to ₱18.5 M, instead of only ₱12 M.

For emphasis, we repeat our observation above that the second illustration cannot be true to reality. This author has not come across any set of shareholders, sane or insane, who are willing to reduce their proprietary interest in property from 100% to 74% for nothing.

But even if the transaction illustrated does happen, and it is clearly *ultra vires,* the argument of its author is misplaced because that transaction would not be a merger under Rep. Act No. 1921. The *continuity of interest* rule will not be satisfied with respect to the shareholders of A for their interest in the transferred asset has been substantially reduced and altered. They have given up effectively their equity in 26% of the ₱25 M assets in favor of the old B shareholders; their proprietary interest, now evidenced by 50% of B shares, continues in only 74% of their old assets worth ₱25 M.

Now, let us alter the facts of the second illustration to bring it under Rep. Act No. 1921, and then test whether the transaction is *ultra vires* under Sec. 28-½, Corporation Law. Although it is odd for a small corporation to gobble up a big one, we will not disturb the illustration on this point.

A transfers its ₱25 M assets to B which is worth only ₱12 M, thus increasing the assets of B to ₱37 M. B issues B shares to A worth ₱25 M. so that the worth of outstanding B shares is correspondingly increased to ₱37 M.

Result: A requires its shareholders to surrender their A shares (worth ₱25 M) in exchange for B shares. A shareholders now own 71.35% (25/37) of B corporation which now owns assets worth ₱37 M. Old B shareholders (originally worth ₱12 M) now own the other 28.65% (12/37) of B corporation.

This is a clear merger under Rep. Act No. 1921. Assuming that the exchange has a business purpose, the other test, continuity of interest, is satisfied. A shareholders transferred ₱25 M assets to B and they continue to have proprietary interest of ₱25 M (71.35% of ₱37 M) in B. B shareholders originally had ₱12 M. After the exchange, as owners of 28.65% of B, they continue to own ₱12 M. We submit that the exchange here comes under Sec. 28-½, Corporation Law.

By the foregoing, we have not only refused a fallacy but also illustrated the test of continuity of interest even before describing it.

It will be recalled that before the U.S. Revenue Act of 1934, merger or consolidation meant also acquisition by one corporation of substantially all the assets of another. The U.S. law did not provide, as it did in the 1934 and subsequent Acts and in our Rep. Act No. 1921, that the acquisition must be solely for stock. There were exchanges, therefore, which claimed to be mergers or consolidations as defined in the reorganization section even if substantially all assets were acquired for nonstock property, like notes and bonds. In all those cases, the transactions were struck down as not being reorganization because of absence of continuity of interest of the transferor.

This rule had its crude beginnings in the case of *Pinellas Ice & Cold Storage v. Comm., supra,* where the Court said:

> " Certainly, we think that to be within the exemption the seller (transferor) must acquire an interest in the affairs of the purchasing (transferee) company more definite than that incident to ownership of its short term purchase-money notes."

It is to be observed that this case did not spell out the amount of interest required. This missing content was supplied by *Helvering v. Minnesota Tea Co.,* 296 U.S. 378, as follows:

> "And now we add that this interest must be definite and material; it must represent a *substantial part* of the value of the thing transferred." (Emphasis supplied.)

Even after the U.S. Revenue Act of 1934 adopted the "solely for stock" requirement in the acquisition of substantially all the assets of a corporation by another, the continuity of interest test continued to be applied and refined by the courts. The Supreme Court summarized it as follows:

> "As the court below properly stated, the section is not to be read literally, as denominating the transfer of all the assets of one company for what amounts to a cash consideration given by the other a reorganization. We have held that where the consideration consists of cash and short term notes the transfer does not amount to a reorganization within the true meaning of the statute, but is a sale upon which gain or loss must be reckoned. (Pinellas Ice & Cold Storage Co. v. Comm., 287 U.S. 462). We have said that the statute was not satisfied unless the transferor retained a substantial stake in the enterprise and such stake was thought to be retained where a large proportion of the consideration was in common stock of the transferee (Helvering v. Minnesota Tea Co., 296 U.S. 378), or where the transferor took cash and the entire issue of preferred stock of the transferee corporation. (John A. Nelson Co. v. Helvering, 296 U.S. 374). And, where the consideration is represented by a substantial proportion of stock, and the balance in bonds, the total consideration received is exempt from tax . . ." (LeTulle v. Scofield, 308 U.S. 415).

This author believes that against the background of U.S. jurisprudence, the continuity of interest test expressly found in Rep. Act No. 1921 is concrete enough to serve as accurate guide to the courts and to tax administrators and practitioners. The opposite thesis, that this test and the other American concepts of merger and consolidation are not applicable here will needlessly throw tax planning ashambles.

Business purpose test. This test originated with the much abused case of *Gregory v. Helvering,* 69 F 2d 809; 293 U.S. 465. The facts of that case are too well known to be again reproduced here. Suffice it to say that the taxpayer wanted to save on income taxes on the sale of appreciated assets of her solely owned corporation. She chose the reorganization route and literally and carefully followed the statute (which did not, like Rep. Act No. 1921, expressly contain the business purpose test). The Circuit Court of Appeals did not approve of the device used and in recognizing the gain, enunciated the now famous test of business purpose.

> "But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganization'." (J.L. Hand. 69 F. 2d 809).

This test dominated jurisprudence on corporate reorganization and was admittedly a landmark case. It was the source, too, of violent disagreement and confusion and was 'all things to all men'.[27] It did not remain confined to the field of corporate reorganization. It pervades the entire Tax Code and all tax avoidance schemes must be prepared to meet it. (*Kocin, Trustes v. U.S.,* 187 F 2d 707). Even outside taxation, it is applied to effect disregard of corporate entity and of transactions found to be sham, disguise, masquerade, make-believe, mask, artifice, ruse or other names. (Kocin case, *supra.*)

Again, it can be said as was said in connection with the continuity of interest test, that the requirement for a business purpose in Rep. Act No. 1921 is not a semantic formula. It has content that can be applied administratively and judicially in striking down tax avoidance schemes masquerading as R.A. 1921 merger or consolidation. With such weapons in the hands of the Bureau of Internal Revenue and the Courts, there is no justification for the pessimism and fear of tax avoidance haunting the articles cited in footnote (1), which fear fathers the radical recommendation of not applying Rep. Act No. 1921.

[27] Paul, Studies in Federal Taxation, 3rd series (1940) 125 and references cited.