ARTICLES

INCOME TAX TREATMENT OF CORPORATE MERGER AND CONSOLIDATION REVISITED

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Background of the Problem

Our tax authorities, so news reports say, have embarked on a determined campaign to collect more taxes. There is hardly any serious issue about that. In fact it is necessary because the huge government budget [1] has to be met. Money must be raised for the treasury so that the wheels of government will continue uninterruptedly to generate and provide the services so essential to the stability and growth of a well-ordered society.

Among the prime targets for potential sources of revenue are the expiring corporations. Available information indicates that there are thirty-seven local corporations whose charters will end within the next decade or so.[2] Added to these are those that have already spent their corporate terms [3] but which somehow managed to transfer their properties, assets and businesses to corporations created for that purpose. In terms of assets these corporations represent a substantial and significant segment of invested capital now immersed and employed in the economic stream of the nation. Some of them are well known in the business world. Their products and services are intertwined with the daily lives of our people. Their economic activities are as varied as one may imagine. Their overall annual payrolls run to a couple of a hundred million pesos, or even more.

The reason for this rising problem may be found in our contemporary legal history. More than fifty years ago our corporation law [4] was incorporated into our legal system.[4a] Corporations created in this country are limited under that law to a term of not more than fifty years.[5] They cannot extend this term.[6] When the

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[1] The government budget for the current fiscal year is ₱1,400,000,000. This is expected to increase by ₱200,000,000 in the next fiscal period.

[2] This is according to SEC records.

[3] Per SEC records there are today 26 expired corporations.

[4] Act No. 1459, as amended.

[4a] Our corporation law was enacted on March 1, 1906, but it became effective only on April 1, 1906.

[5] Section 6(4) of Act No. 1459, as amended, reproduced in 5 Philippine Annotated Laws, p. 283.

[6] See Section 18 of Act No. 1459, as amended, *loc. cit.*, p. 317.

designated time arrives these corporations must either liquidate and retire completely from business, or find a suitable way within the present framework of our laws to continue the business they had built over the years. These are the only two choices available to them.

If they elect to liquidate and withdraw from business completely, their stockholders most likely will have to pay income tax. Other unwholesome consequences will also set in: Their services which have attained a no mean degree of efficiency born out of years of experience and to which the public has become accustomed will have to end; their products most likely will be withdrawn temporarily or completely from the market, thus causing scarcity to the prejudice of the consumers; their employees will surely be dismissed and thrown out of their jobs, and forced to join the swelling rank of our unemployed; their stockholders, fearing the uncertainties of the future, will probably pull out entirely their investments and thereby augment our capital deficiency; and finally, it is reasonable to expect that the long-term revenue of the government will suffer in a very substantial way.

To a layman, it must be a source of wonder why we allow our corporations to pass out into oblivion. He will perhaps recall having heard it somewhere that corporations created in other countries and doing business in our shores can go on doing their business in our country for as long as they and their stockkholders wish, and then ask why our own creations cannot do likewise. Perhaps he will also ask why no significant and successful effort has been exerted to save our corporations from inevitable legal annihilation. Are these corporations not useful anymore nor important enough in the scheme of our national life to merit the attention of our leaders and to be the object of some equitable treatment? To him the thought must be confusing, indeed, why our leaders spend their time and energy in convincing the people to join in a concerted national effort to build, develop and maintain new industries, and yet paying no attention to our established corporate enterprises with solid industries at their command, allowing them to end and die, so to speak.[7] And then finally in utter frustration he will probably ask: Is this antinomy in our national policy a product of deliberate design or is it the offspring of ignorance and indifference?

[7] According to a recently published book: "The survival of human institutions depends not upon heaven but upon man. Yet there appears to be something in the nature of man that takes what he has constructed not merely for granted but as guaranteed for all eternity. The greatest hazard to institutions is not the problem of survival through the earliest years of their inception but survival after they have become established." (Richard Ellis, *The Meaning of Modern Business*, Columbia University Press, 1960, p. 1).

We are not here to answer these questions nor to offer an explanation. Suffice it to say at this time that other legal system [8] have already discarded the notion of a fixed inextendible term for

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[8] *Alabama:* Duration is perpetual if not limited in charter (Ala. Code 1940, Title 10, Sec. 70). If limited, extension is permitted (*Ibid.* Sec. 18). *Alaska:* Duration is perpetual unless limited (Alaska Bus. Corp. Act, 1957, Sec. 48) and may be extended by amendment (*Ibid.* Sec. 53). *Arizona:* Duration is 25-year periods but subject to renewals (Ariz. Rev. St., 1956, Secs. 10-151). *Arkansas:* Duration may be perpetual or limited and if limited may be extended (Ark. St. 1947, Secs. 64-110). *California:* Duration is perpetual if not limited (Calif. Corp. Code, Sec. 308). *Colorado:* Perpetual or limited and if limited, extendible (Colo. Rev. Stats. 1953, Secs. 31-110). *Connecticut:* Perpetual or limited in charter (Conn. Gen. Stats. 1949, Sec. 5152). *Delaware:* Perpetual, or limited with extensions (Del. Code 1953, Secs. 102[a][6] and 312). *District of Columbia:* Perpetual, or limited with extensions (Dist. of Col. Bus. Corp. Act, Secs. 4 and 52). *Florida:* Perpetual, or limited (Fla. Stats. 1951, Sec. 608.03 amend. 1957). *Georgia:* Limited to 35 years but renewable for like period each time (Ga. Corp. Act 1938, Secs. 1 and 9[i]). *Hawaii:* Perpetual, or limited with extensions (Rev. Laws Hawaii, 1955, Secs. 172-14 and 172-19). *Idaho:* Perpetual, or limited with extensions ((Idaho Code 1949, Sec. 30-160). *Illinois:* Perpetual, or limited with extensions (Ill. Bus. Corp. Act 1933, Secs. 47 and 52). *Indiana:* Perpetual, or limited with extensions (Ind. Gen. Corp. Act 1929, Secs. 17, 22 and 26). *Iowa:* Duration of most corporations is 20 years, however, the articles may provide for less than 20 years, or perpetual existence. Banks and life insurance companies, companies for construction and operation of steam, inter-urban and street railways, may be formed for a period of 50 years (Code of Iowa 1954, Sec. 491:24). *Kansas:* Duration is limited to 100 years but may be extended (Kansas Gen. Sta. 1949, Sec. 17-2805). *Kentucky:* Perpetual, or limited with extensions (Ky. Rev. Stats. 1958, Secs. 271.035 and 271.125). *Louisiana:* Perpetual duration is prohibited. Articles must state limited duration but extendible (La. Const. Art. XIII, Sec. 17; Rev. Stats. 1950, Secs. 12:3 and 12:42). *Maine:* Duration is perpetual unless charter is forfeited or voluntarily surrendered (Maine Rev. Stats. 1954, c.53, Sec. 103). *Maryland:* Perpetual, or limited with extensions (Flack's Code of Md. 1951, Secs. 122 and 13 B and C). *Massachusetts:* Perpetual unless charter is forfeited or corporation is dissolved (Mass. Gen. Laws 1932 [Ter. Edd.] c. 156, Sec. 12, amend. 1932). *Michigan:* Limited to 30 years extendible by legislature while term is running, but each extension is only for 30 years (Mich. Const. Art. XII, Sec. 3; Mich. Gen. Corp. Act, Sec. 12). Perpetual existence allowed to municipal, railroad, insurance, canal companies, cemetery associations, and non-profit corporations (Idem.). *Minnesota:* Perpetual, or limited with extensions (Minn. Rev. Stats. 1593, Secs. 301.04 and 301.60). *Mississippi:* Maximum duration to be specified in articles is 99 years subject to extension (Miss. Code 1942, Secss. 5310 and 5823). *Missouri:* Perpetual or limited with extensions (Mo. Rev. Stats. 1949, Secs. 351.055 and 351.541). *Montana:* Maximum period to be stated in articles is 40 years but extendible. (Mont. Rev. Code 1947, Secs. 15-108 and 15-215). *Nebraska:* Perpetual or limited with extensions (Nebr. Reiss. Rev. Stats. 1943, Secs. 21-105 and 21-1,126). *Nevada:* Perpetual, or limited with extensions (Nev. Rev. Stats., Secs. 78.035 and 78.730). *New Hampshire:* No limitation on duration (N.H. Rev. Stats. 1955, Stc. 294.4). *New Jersey:* Perpetual, or limited with extensions (N.J. Rev. Stats. 1937, Secs. 14:3-1 and 14:11-1). *New Mexico:* Duration is 100 years maximum, or may be limited to a lesser period by the articles. Period is subject to extensions (N. Mex. Stats. 1953, Secs. 51-2-8, 51-2-2, and 51-2-22). *New York:* Perpetual, or limited with extensions (N.Y. Stock Corp. L., Secs. 5 and 45). *North Carolina:* Perpetual, or limited with extensions (N. Car. Bus. Corp. Act 1957, Secs. 55-7, 55-17 and 55-99). *North Dakota:* Perpetual or limited with extensions (N. Dak. Bus. Corp. Act 1957, Secs. 4, 49, and 102). *Ohio:* Perpetual unless limited in charter (Ohio Rev. Code 1953, Sec. 1701.04). *Oklahoma:* Maximum period is 50 years subject to extension for like period each time (Okla. Stats. 1951, Secs. 1.14 and 1.172). *Oregon:* Perpetual, or limited with extensions (Ore. Rev. Stats. 1953, Secs. 57.311, 57.030 and 57.355). *Pennsylvania:* Per-

corporations, but ours has tenaciously maintained this outmoded and backward idea.[9]

The Problem and Its Setting

Actually, our task is directed toward the current drive of our tax collecting agency to tax stockholders of expired corporations. The precise point of inquiry is whether these stockholders should be taxed now simply because the old corporation has found it expedient to transfer its properties, assets and business to a newly created corporation, and even though the stockholders received actually no concrete or tangible value sufficiently definite in character to warrant the conclusion that they have received or derived in a practical sense a gain from their investment.

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petual, or limited with extensions (Penn. Bus. Corp. L., 1933, Secs. 204 and 801). *Puerto Rico:* Perpetual, or limited with extensions (Puerto Rico, Gen. Corp. Law 1956, Secs. 105 and 102[a][6]). *Rhode Island:* Perpetual or limited with no extension (Gen. Laws R.I. 1938, Secs. 5 and 7). *South Carolina:* Perpetual, or limited with extensions (Code of S.C. 1952, Secs. 12-63 and 12-412). *South Dakota:* Perpetual, or limited with extensions (S. Dak. Code 1939, 11.0202 and 11.0206). *Tennessee:* Perpetual, or limited with extensions (Tenn. Code 1956, 48-105[6], 48-119). *Texas:* Perpetual, or limited with extensions (Tex. Bus. Corp. Act 1955, Art. 2.02[1] and Arts. 401 and 402). *Utah:* Duration may be limited by articles, or perpetual, but minimum is three years (Utah Code 1953, Sec. 16-2-5). *Vermont:* Duration is perpetual unless articles limit it (Rev. Stats. of Vt. 1947, Sec. 5763). *Virginia:* Duration is perpetual unless limited by certificate of incorporation; if limited extension is allowed (Va. Code 1950, Secs. 13.1-49 and 13-1-56). *Washington:* Duration is perpetual unless limited by articles, and if limited is extendible (Rev. Code of Wash. 1951, Sec. 23.12.020 and 23.12.060). *West Virginia:* Duration is perpetual unless limited by articles, and if limited is extendible (W. Va. Code 1955, Secs. 3015 and 3023). *Wisconsin:* Perpetual, or limited with extensions (Wis. Bus. Corp. L. 1951, Secs. 180.45 and 180.50). *Wyoming:* Maximum period is 50 years subject to extensions (Wyo. Comp. Stats. 1945, Secs. 44-101 and 44-102).

Available information seems to indicate that perpetual existence is also allowed in Australia and its states, Austria, Bahamas, Bermuda, Belgium, Canada and its provinces, Denmark, England, Finland, France, Germany, Greece, Haiti, Honduras, India, Ireland (Eire), Israel, Italy, Japan, Lebanon, Leichtenstein, Mexico, Netherlands, New Zealand, Northern Ire.and, Norway, Pakistan, Portugal, Scotland, South Africa, Sweden and Switzerland. Duration must be stated in the articles although no maximum period required in Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Panama, Peru, Uruguay, and Venezuela. (*See IV Martindale Hubbell Law Directory*, 1962, pp. 2177, 3051).

[9] As Professor Henry Winthrop Ballantine, a noted scholar and writer on corporation law said: "It is difficult to perceive any wise policy or protection either to the public or to the shareholders in placing an arbitrary time limit such as twenty or thirty or fifty years upon the corporate life." (*Ballantine on Corporation*, 1946, p. 718). The shift in thinking in this area is confirmed by another author: "The formerly customary rule that a corporation's duration of existence could only be for twenty, thirty, forty, or fifty years now no longer is prevalent. The statutes now usually permit a certificate of incorporation (or amendment thereto) to state the duration as 'perpetual'; the duration is said to be deemed to be perpetual if no period is stated." (Howard L. Oleck, *Modern Corporation Law*, The Bobbs-Merrill Company, 1958, Vol. 1, p. 740).

So that we may fully grasp the real nature of the problem, let us illustrate the transaction which brings that problem to light. Let us suppose that X Corp. was organized on November 15, 1913, with an authorized capital stock of ₱1,000,000.00, divided into 100,000 shares with a par value of ₱10.00 each, all of which had been fully subscribed, paid and issued. In the course of time, this authorized capital stock was increased on several occasions to accommodate the declaration of stock dividends.[10] At the end of its fiscal period on October 31, 1962, X Corp., per its balance sheet as of that date, had a fully paid and issued authorized capital stock of ₱5,000,000.00 and an undistributed earned surplus of ₱4,000,000.00.[11] On paper X Corp. has a net worth of ₱9,000,000.00. This net worth is expected to increase by another ₱6,000,000.00 if the real assets and business of X Corp. are sold. Thus each share in X Corp. has a fair market value of ₱150.00.

When X Corp. was organized, its charter provided the usual fifty-year term which will expire on November 15, 1963. In anticipation for this inevitable date when X Corp. can no longer operate its business, its Board of Directors as early as 1961 outlined to the stockholders a proposal calling for the creation of a new corporation to take over the properties, assets and business and to assume all the liabilities of the outgoing corporation in exchange for shares of the corporation to be created equal to the number of outstanding shares of X Corp. This proposal was approved by the stockholders of X Corp. and as a consequence Y Corp.[12] was formed in the early part of 1962 with a nominal capitalization.[13] When the transaction is finally consummated each stockholder will surrender his shares in and to X Corp. In return he will receive an equal number of shares in Y Corp., with the same par value and rights as the X Corp. shares.

It thus becomes obvious that the economic position of the stockholder *before* and *after* the transaction will not be materially changed as a result thereof. After the transaction is accomplished, he will still own and hold shares each with a par value of ₱10.00 and with a fair market value of ₱150.00. That is, a stockholder

[10] Stock dividends which represent transfer of surplus to capital account are not subject to tax. See Section 83(b), National Internal Revenue Code.

[11] A surplus of this size which is rather large in relation to equity capital is suspect under Section 25 of the Internal Revenue Code.

[12] In practice, the new corporation usually bears a name almost identical with the name of the old corporation. Although name is not important, in many cases under Republic Act No. 1921, name of the new entity is important.

[13] The procedure followed in a number of instances is to have a nominal capital for the new corporation. This nominal capital will then be increased to an amount which will equal the issued and outstanding capital stock of the old corporation.

who is now the owner of one share, for instance, in X Corp. having a par value of ₱10.00 and a fair market value of ₱150.00 will likewise own, in lieu of his X Corp. share, a share in Y Corp. with an identical par and fair market value. This should be obvious since the properties, assets and business which now support the X Corp. shares will also constitute the basic support of the value of the Y Corp. shares. Under these circumstances, should the stockholders of X Corp. be taxed?

Deferment of Recognition of Gain or Loss in Certain Transactions Adopted in the Philippines

On June 22, 1957, Congress passed Republic Act No. 1921.[14] This law was patterned after similar laws in the United States.[15] Under Republic Act No. 1921, the gain or loss from a corporate merger or consolidation is not recognized as against the absorbed corporation or as against its stockholders and security-holders.

A law of that kind assumes the presence of transactions where the gain or loss, if any, should not be recognized for income tax purposes because they merely involve a modification of the *"form* of interest" of the taxpayer or because they affect nothing more than the *form* of the same business. These transactions are not sufficiently closed in a tax sense, and gain from them could be reached by income tax laws only through the application of the most artificial or formalistic concept of realization.[16] Such a law as Republic Act No. 1921, according to one author, is a matter of necessity "to free from the imposition of an income tax purely paper profits or losses wherein there is no realization of gain or loss in a business sense but merely a recasting of the same interests in a different form."[17] The same view was echoed by the Joint Philippine-American Finance Commission as early as 1947.[18]

[14] Republic Act No. 1921 is now Section 35(c) of the National Internal Revenue Code.

[15] The definition of "reorganization" under United States laws may be found in: Secs. 202 (b), 1918 Revenue Act; Sec. 202(c)(2), 1921 Revenue Act; Sec. 203(h)(i) of the 1924 and 1926 Revenue Acts; Sec. 112(i)(5) of the 1928 Revenue Act; Sec. 112(i) 1932 Revenue Act; Sec. 112(g)(1), 1936 and 1938 Revenue Acts; Sec. 112(9), 1939 Revenue Acts; and Sec. 368, 1954, Revenue Act. There are many provisions related to "reorganization" transaction under the United States Revenue Acts but limitation of time and space prevents us from giving them all here.

[16] See J. R. Hellerstein, "Mergers, Taxes, and Realism," *Harvard Law Review*, Vol. 71, No. 2 ((December, 1957), p. 254, at p. 276; Robert S. Holzman, *Corporate Reorganization* (New York: The Ronald Press Company, 1956), p. 12.1.

[17] Boris I. Bittker, *Federal Income Taxation* (New York: Prentice-Hall, Inc. 1954, p. 576.

[18] Report and Recommendations, Joint Philippine-American Finance Commission, 1947, p. 122. There the Commission said: "Two corporations may find that their business may be more efficiently operated as one corporation.

But Republic Act No. 1921 was never intended, and, in fact, should not be understood, as a tax-exempting statute. It merely postpones [19] the tax incidence of the transaction. It only means that the collection of the tax will be postponed for as long as the interests of the shareholder remains in the business and until such time as the gain is, in a practical sense, actually realized by him or by the new corporation through the sale of the new shares he received or of the property the new corporation acquired. In postponing the tax incidence of a corporate merger or consolidation, there is no loss of revenue to the government because the cost to the old corporation, of the assets it transferred is carried over to the new corporation, and also because the cost of the shares or securities of the old corporation is used as cost to the stockholder or security-holder of the new shares or securities he received.

Requirements for Tax Deferment

So that the income tax incidence of the transaction may be postponed, certain requirements must be met: First, there must be a merger or consolidation as defined in Republic Act No. 1921. Second, the merger or consolidation must be for a *bona fide* business purpose. Third, the interest of the stockholders in the old corporation must be continued in the new corporation. Fourth, all or substantially all of the assets, properties and business of the old corporation must be transferred to the new corporation solely for shares in the capital stock of the latter. Fifth, the shares of the stockholders in the old corporation must be exchanged solely for shares issued by the new corporation. Sixth, the securities of the security-holders in the old corporation must be exchanged solely for either shares or securities issued by the new corporation. Seventh, the cost to the old corporation of the assets transferred must be maintained and carried over to the new corporation. Lastly, the cost of the new shares or securities to the stockholders or security-holders must be the cost to them of their shares or securities in the old corporation.

Absence of any of these conditions will negate the postponement of the tax. These requirements are mandatory and are intended to safeguard the revenue of the Government. Republic Act No. 1921 concedes the deferment of the tax on gains from transaction covered by it, but one must not suppose that the statute opens the

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."

[19] Boris I. Bittker, *op. cit.*, p. 576.

gate to those who may have an ulterior purpose to filch the revenue of the Government through devices framed in the form of allowed transactions which in reality are not.

Merger or Consolidation under Republic Act No. 1921

Two types of transactions are classified as merger or consolidation in Republic Act No. 1921.[20] The first refers to "ordinary merger or consolidation." The second refers to the acquisition by a corporation of all or substantially all of the properties, assets and business of another corporation solely for shares.

Consolidation as ordinarily understood is the uniting or amalgamation of two or more corporations to form a new one.[21] The united concern resulting from the union of the constituent entities is called the consolidated corporation.[22] Merger is commonly understood to mean a situation where one corporation absorbs another and remains in existence; the absorbed corporation dissolves.[23] Invariably, in a consolidation the constituent entities are also dissolved.

However, in both merger and consolidation the dissolution of the old entities is not an indispensable requirement for income tax purposes.[24] Merger and consolidation are terms loosely used in tax statutes to cover a variety of transactions which, although not strictly so, have the peculiarities of these corporate devices.[25] It is in this loose sense that the terms are used in Republic Act No. 1921.

Ordinarily, when a local corporation is nearing its end, its directors form a new entity with identical purposes and powers. Even the new corporation's capital structure usually matches the capital structure of the old corporation. In practice, this new entity is

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[20] Section 35(c)(5)(b) of the National Internal Revenue Code provides that—"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 stocks."

[21] Metropolitan Edison Company v. Commissioner, 98 F.2d 807.

[22] *Ballantine on Corporation*, 1946, p. 681.

[23] Pinellas Ice & Cold Storage Co. v. Commissioner, 57 F.2d 188. The distinction between sale of corporate business as a method of combination, on the one hand, and "merger and consolidation," on the other, is fully explained in *Ballantine on Corporation*, 1946, pp. 664-665.

[24] In Minnesota Tea Company v. Commissioner, 296 U.S. 378, the court observed that—"Dissolution is not prescribed and we are unable to see that such action is essential to the end in view."

[25] Robert S. Holzman, *Corporate Reorganization* (New York: The Ronald Press Company, 1956), p. 2.17; Baar and Morris, *Hidden Taxes in Corporate Reorganization*, p. 78. Baar and Morris take the position that although the acquisition of substantially all the properties of another corporation may not be technically a merger or consolidation, it is so close in its effect to what takes place in a merger or consolidation that its results ought to be treated in the same way as far as tax consequences are concerned.

formed way ahead of time to give those who are to carry out the transaction sufficient time to prepare and to provide for all the necessary details. Although in the example given a few pages back the transaction appears relatively simple, this is far from the truth. There is a myriad of details to attend and a host of questions to resolve. Patent rights, trademarks, government licenses and permits, creditors' consent, licensing and royalty agreements, preparation of new books of accounts for the created entity and of financial statements for the old company, collective bargaining agreements, title to immovables, and many other matters must be attended. After all necessary documents had been prepared with such meticulousness and care as one expects in so important and delicate a transaction, the entire assets, properties and business of the outgoing entity are then transferred to its successor. The latter issues its required number of shares to the old corporation which in turn calls for its outstanding shares and delivers the shares of the new entity to the stockholders. The old company then steps out of business and suffers a natural death, so to speak, and the new entity takes over and runs and manages the same business, assets and properties.

Thus we see that in practical result the transaction described above may be said to be a merger in a loose sense. It may even be treated a merger as commonly understood. It has all the essential ingredients of a technical merger.

It is unfortunate that an irrelevant argument has been drawn into this area. Some [26] argue that as there is no express authority in our law for corporations to merge or to consolidate the transactions contemplated in Republic Act No. 1921 are not at all possible. On the surface this argument appears meritorious. However, when exposed to the searching light of legal analysis, the argument loses its solidity.

As we said before, the terms merger and consolidation are used in a loose, non-technical sense in Republic Act No. 1921. They are used as generic terms to describe two transactions, namely: (1) acquisition by a corporation of the assets and business of another; and (2) "ordinary merger or consolidation" as generally known in the field of corporation law. The first is expressly authorized

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[26] See for instance: Isidro Evangelista, "Tax Free Mergers or Consolidations," *Economic Research Journal*, Vol. VII, No. 4 (March, 1961), p. 197; Troadio Quiazon, 'Merger and Consolidation of Erpiring Corporations," *Philippine Law Journal*, Vol. XXXVI, No. 4 (September, 1961), p. 426. *Contra:* Demosthenes B. Gadioma, "Corporate Readjustment and Nonrecognition of Gain or Loss," *Philippine Tax Journal*, Vol. 7, No. 1 (January, 1962), p. 1.

in our corporation law.[27] Even our Supreme Court admits this fact in its decision in *Reyes v. Blouse.*[28] The second is also possible under our laws.[29] Besides, in their ultimate result there is very little difference between the two.[30] Republic Act No. 1921, moreover, says that "when used in this section" the terms merger and consolidation include the two classes of transactions. It is, therefore, irrelevant whether these transactions are mergers or consolidations under our corporation law. Congress has declared them to be so for income tax purposes, and that is good enough for us.

Requirement of Business Purpose

In form and substance we have seen that the transaction between the expiring corporation and its successor is in effect a merger. But this is not enough. Other conditions must be satisfied. One of these is the required business purpose.

The Gregory Case

The business purpose doctrine developed from the case of "*Gregory v. Helvering.*"[31] Its rise in the history of income taxation

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[27] "A corporation may, by action taken at any meeting of its board of directors, sell, exchange, lease or otherwise dispose of all or substantially all of its property and assets, incuding its goodwill, upon such terms and conditions and for such considerations, which may be money, stocks, bonds, or other instruments for the payment of money or other property or considerations, as its board of directors deem expedient, when and as authorized by the affirmative vote of shareholders holding shares in the corporation entitling them to exercise at least two-thirds of the voting power on such a proposal at a shareholders' meeting called for that purpose." (See Section 28½, Act No. 1459, as amended).

[28] Reyes v. Blouse, G.R. No. L-4420, prom. May 19, 1952.

[29] *See Section 1, Act No. 2772* which authorized the merger or consolidation of railway companies. See also *Section 20(g) of Commonwealth Act No. 146* which authorized the merger or consolidation of public utility companies with the approval of the Public Service Commission. See finally *Section 6(e) of The Securities Act* exempting from its provisions "the transfer or exchange by one corporation to another corporation of their own securities in connection with a consolidation or merger of such corporations."

[30] Randolph Paul, *Studies in Federal Taxation* (3rd Series, Cambridge: Harvard University Press, 1940), p. 70, where he made the observation that "the acquisition by one corporation resembles a merger in that business and properties of the transferor corporation become merged with the business and properties of the transferee corporation which continues as the owner of the business and properties of both corporation." *Lattin on Corporations* (Brooklyn: The Foundation Press, 1959), p. 536, also made the observation that—"Statutes today generally permit the sale of corporate assets for securities of the buying corporation and these are conveyed to the selling corporation for the transfer of its assets, the selling corporation frequently going out of business by formal dissolution with a sale of the shares received and a distribution *pro rata* in cash or a distribution of the shares themselves either directly or indirectly to the selling corporation's stockholders upon surrender of their own shares. The creditors, of course, must first be paid before the shareholders are entitled to share in the return of capital. The simplicity of this transaction has encouraged its use in many cases where the actual practical result was a merger of two or more corporations."

[31] See 27 B.T.A. 223; 69 F. 2d 809; and 293 U.S. 465 (1935).

had been accompanied with violent disagreements.[32] It was derisively called a "revolutionary doctrine," [33] a "Treasury shibboleth," [34] an "Alice-in-Wonderland," [35] a "doctrine of last resort." [36] On the other hand, it was defended by others [37] as a reasonable and necessary measure "to protect technical rules from distortion through tax-motivated transactions lacking a business purpose or other substantial economic reality." [37a]

The *Gregory* case established the rule that tax deferment is allowed in a corporate reorganization [38] only if it has a business purpose. In that case a reorganization that met the very letter of the law was not recognized because the transaction was "an operation having no business or corporate purpose." [39] What were the facts of the *Gregory* case? Simply these: Gregory owned all the shares of United Mortgage Corporation. This company in turn held among its assets 1,000 shares in Monitor Securities Corporation. Gregory wanted to sell these shares, but the taxes which would be due if the shares were given to her first as a dividend would be too large for her comfort. So she organized the Averill Corporation. Three days after, the Monitor shares were transferred by United Mortgage Corporation to Averill Corporation and in consideration of that transfer Averill Corporation issued all of its stock to Gregory. Then three days later Averill Corporation was dissolved and the Monitor shares were delivered to Gregory who afterwards sold them. Her obvious purpose was to allocate a part of her cost of the United Mortgage Corporation shares to her shares in Averill Corporation so that on the liquidation of the Averill Corporation this allocated cost would be deducted from the value of the Monitor shares which she received as liquidating dividend. Had United Mortgage Corporation sold the Monitor shares and paid a dividend

[32] Randolph Paul, *op cit.*, p. 125n.

[33] *Idem.*

[34] Montgomery, *Federal Income Tax Handbook*, 1935, p. 185.

[35] Roswell Magill, "Four Urgently Needed Changes in Income Taxation," *The Journal of Accountancy*, Vol. 88, No. 6 (December, 1949), p. 494.

[36] Ralph S. Rice, "Judicial Techniques in Combatting Tax Avoidance," *Michichigan Law Review*, Vol. 51, No. 7 (May, 1953), p. 1045.

[37] Stanley S. Surrey, "Definitional Problems in Capital Gains Taxation," *Harvard Law Review*, Vol. 69, No. 6 (April, 1956), p. 985. See also J. R. Hellerstein, "State Franchise Taxation of Interstate Business," *Tax Law Review*, Vol. 4, No. 1 (November, 1948), p. 95; Edwin S. Cohen, Stanley S. Surrey, Thomas N. Tarleau, and William C. Warren, "A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Stockholders," *Columbia Law Review*, Vol. 52, No. 1 (January, 1952), p. 53n.

[37a] Stanley S. Surrey, "Definitional Problems in Capital Gains Taxation," *Harvard Law Review*, Vol. 69, No. 6 (April, 1956) at p. 995.

[38] The term "reorganization" is used in the Federal Income Tax Law to describe a variety of corporate transaction.

[39] Robert S. Holzman, *op. .cit.*, p. 2.19.

[39] Robert S. Holzman, *op. cit.*, p. 2.19.

to Gregory, she would have been liable for a much higher income tax.

The U.S. Commissioner of Internal Revenue required Gregory to pay a tax as if the United Mortgage Corporation had paid her a dividend equal to the amount realized from the sale of the Monitor shares. She refused and claimed that the transfer of the Monitor shares by United Mortgage Corporation to Averill Corporation was a literal reorganization within Section 112(i)(I)(B) of the 1928 Act.[40] The U.S. Board of Tax Appeals[41] agreed with this *literal* approach and sustained the view of Gregory.[42] According to the Board "a statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration."[43] But the Second Circuit Court of Appeals, speaking through Judge Learned Hand, reversed the Board.[44] In the opinion of the Circuit Court—

> ". . . a *transaction*, otherwise within an exception of the tax law, *does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation.* Any one may so arrange his affairs that his taxes shall be as low as possible; *he is not bound to choose* that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; *but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.* 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. *But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand,* not as an ephemeral incident, egregious to its prosecution. . . ."[45]

The Supreme Court of the United States sustained the view of the Circuit Court[46] saying: "The reasoning of the court below in

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[40] The transaction in Gregory v. Helvering followed to the letter the provision of Section 112(i)(1)(B) of the 1928 U.S. Revenue Act which provided as follows: "The term 'reorganization' means . . . (B) 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."

[41] This name has since been changed to "The Tax Court."

[42] See 27 B.T.A. 223.

[43] *Idem* at p. 225.

[44] Gregory v. Helvering, 69 F. 2d 809.

[45] *Idem* at pp. 810-811.

[46] 293 U.S. 465 (1935). The court said: "It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing sub-

justification of a negative answer leaves little to be said." The Supreme Court agreed that "a new and valid corporation was created. But that corporation was nothing more than a contrivance. . . . It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death."

Meaning of the Gregory Case

Many glosses have been placed upon the sense of *Gregory v. Helvering* by jurists and by writers. But there is no greater authority than Learned Hand himself whose doctrine of purpose was affirmed and adopted by the United States Supreme Court. In one case[47] this is what he said: "It is important to observe just what the Supreme Court held in that case. It was solicitous to reaffirm the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it. It is true that the court has at times shown itself indisposed to assist such efforts . . . but it has never so far as we can find, made that purpose the basis of liability; and it has often said that it could not be

division (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. x x x But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said."

"When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' x x x of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding x x x by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death."

"x x x The whole undertaking x x x was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its fact lies outside the plain intent of the statute."

[47] Chisholm v. Commissioner, 79 F. 2d 14 (2d. Cir. 1935).

such. The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, but the purpose which counts is the one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize. In *Gregory v. Helvering* the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world." [47a]

The Name of the Doctrine Changed
But Its Meaning Remained

After its initial appearance in *Gregory v. Helvering* the business purpose doctrine had been used under different labels to strike down transactions which had no other purpose but to escape legi-

[47a] *Idem* at p. 15; In National Investors Corp. v. Hoey, 144 F. 2d. 466 (2d Cir., 1944). Learned Hand stated that the Gregory case "merely declares that to be a separate jural person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term, 'corporation' will be interpreted to mean a corporation which does some 'business' in the ordinary meaning." In Fairfield Steamship Corp. v. Commissioner, 157 F. 2d 321 (2d Cir., 1946) he again referred to the Gregory case: "The question there was whether, when Congress used the word, 'corporation,' it meant to include corporations which had not been organized for ordinary business purposes, but only to escape taxes. That did not make relevant the taxpayer's motive to escape taxation; it merely held that the statute should be read in the light of its own purpoose." Further, in another case, he again explained the Gregory case: It is . . . abundantly settled in decisions of the Supreme Court that a taxpayer's motive is irrelevant in determining his liability . . . It has at time been said that Gregory v. Helvering . . . is at war with this doctrine, because it was only the purpose of the taxpayer to escape taxation that made futile the elaborate web of legal transactions which she wove in entire accord with the letter of the Act . . . Nevertheless, we hold that the Act is to be interpreted against its own background, and . . . it was proper to exclude those that had no other result than to evade taxation. The purpose of the Act was to exempt from tax only such legal transactions as arose out of an enterprise or venture that had some other authentic object of its own, and were neither alien and hostile to raising of revenue, not designed to effect no change in legal interest except to defeat a tax." Loewi *et al* v. Ryan *et al*, 229 F. 2d. 627 (2d. Cir., 1956).

timate tax liabilities. Thus, the doctrine was known and used under such names as "legitimate business purpose,"[48] "real business purpose,"[49] "genuine economic justification,"[50] "legitimate business object,"[51] "justifiable business reason,"[52] "sound business prudence,"[53] "honest business purpose,"[54] "justifiable corporate reason,"[55] "substantial business purpose,"[56] "bona fide business purpose,"[57] and others. But, although the name used might have been different, the principle meant remained the same.

Our Tax Administrators and the Gregory Case

Some of our tax administrators look upon the business purpose doctrine as a convenient platform to throw the full weight of our income tax law on the stockholders of expired corporations. They think of it as if it were a magic wand which by its mere touch could make the benefit of Republic Act No. 1921 vanish beyond the reach of the stockholders. They quote freely from the *Gregory* case all right, but that is all. Perhaps by doing that they feel they have already deadened the mental cords of their professional adversaries. But far be it from the truth.

Their usual argument runs something like this: "The transaction between the old corporation and the new entity has no bona fide business purpose. The stockholders must pay the tax because the essential motive behind the transaction is tax avoidance." Please, heed a friendly advice: Thou shalt not use the business purpose doctrine in vain.

Mergers Undertaken by Expiring Corporations Have a Business Purpose

If we analyze the transaction objectively, without being affected by passion, and without regard to the pesos and centavos involved, we cannot help but note a definite business purpose behind the transaction. To understand this, one has to remember that our corporation law requires a definite term for our corporations. Once that term ends, it cannot be extended. The back of the corporation

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[48] Keefe v. Cote, 213 F. 2d. 651 (1st Cir., 1954).
[49] Giles Bullock *et al.*, 26 T.C. 276.
[50] Home Furniture Co. v. Commissioner, 168 F. 2d. 312 (4th Cir., 1948).
[51] Commissioner v. Gilmore Estate *et al.*, 130 F. 2d 791 (3rd Cir., 1942).
[52] Smith v. United States, 121 F. 2d. 692 (3rd Cir., 1941).
[53] Elise W. Hill Estate, 10 T.C. 1090 (1948).
[54] Commissioner v. Quackenbos, 78 F.2d 156 (2d Cir., 1935).
[55] Ferro v. Commissioner, 242 F.2d. 838 (3rd Cir., 1957).
[56] WAGE, Inc., 19 T.C. 249 (1952).
[57] See Republic Act No. 1921; Kirschembaum v. Commissioner, 155 F. 2d. 23 (2d Cir., 1946). Robert S. Holzman, *Sound Business Purpose* (New York: The Ronald Press Company, 1958), p. 17.

then is against the wall, so to speak. The business which once was a living reality had to be stopped completely. No longer will one hear the droning sound of machines in the corporation's shops and factories. No longer will one see the even flow of goods pass the gates to the consumers. The economic organism which only a short time ago was alive with activity must now standstill, unless something is done to keep it moving again. And, of course, the only practical and effective remedy for this economic thrombosis is for the old, worn out corporation to transfer its business, assets and properties to a new entity created for that purpose. Only thus may it preserve the continuation of its business [58] and, perhaps, only thus may it preserve also the only source of income for its employees and stockholders. To the old corporation, therefore, the essential motive that brings the transaction to life is not really the desire to escape, evade or avoid the tax. The compelling motive is the desire to save the corporate business—the desire to continue it without interruption, without disturbance, and without change, except the infusion of a new corporate shell. The new entity is so unlike the Averill Corporation in the *Gregory* case. The new corporation is not created to last only for a week, for a month or for a year. It is not created only to be used as a tax device with no function but that. It is created for a business purpose—to continue the old enterprise for as long as the law allows. Gregory Oh Gregory, where art thou!

A Pure Business Purpose is not Required

A pure, unadulterated business purpose is never required in Republic Act No. 1921. That, indeed, would have been impossible. In the business world every transaction must perforce be accompanied, one way or the other, with tax consideration. With every such transaction lurks the thought of minimizing or avoiding the resulting tax. To expect a contrary attitude is to go against the grain of truth. It is precisely on the basis of this reality that Republic Act No. 1921 requires that transactions there defined are "not *solely* for the purpose of escaping the burden of taxation." [58a] In one of his many loaded and wise remarks, Learned Hand said: "Over and over again courts have said that there is nothing sinister in so

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[58] It has never been doubted that the continuance of a business by a transferee corporation is sufficient to satisfy the business purpose test. Lewis v. Commissioner, 176 F. 2d 646; Cortland Specialty Company v. Commissioner, 60 F. 2d 937; Standard Realization v. Commissioner, 10 T.C. 708; MacLean, "Problems of Reincorporation," *Tax Law Review*, Vol. 13, No. 4 (May, 1958), p. 410; Norris Darrel, "Scope of Commissioner v. Bedford," *TAXES—The Tax Magazine*, Vol. 24, p. 266.

[58a] See Republic Act No. 1921.

arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."[59]

Continuity of Interest is a Requisite

But the presence of a business purpose is not enough. The stockholders must also satisfy another important requirement. The owners of the business must maintain their stake in the enterprise.[60] They must evince a genuine intention to continue to participate in the business under a new corporate form.[61] Nothing less will suffice.[62] If they withdraw their interest in the business completely, no amount of argument will wipe out their tax liability. But, if they retain a definite, substantial[63] and proprietary[63a] interest in the enterprise, deferment of the tax is proper.

The requirement of continuity of interest first appeared in *Cortland Specialty Company v. Commissioner,*[64] but it was in *Pinelas Ice & Cold Storage Company v. Commissioner*[65] that the "test of continuing interest" was crystallized.[66] Perhaps, there is no clearer formulation of the doctrine of continuing interest than what is said in *Mead Coal Co. v. Commissioner.*[67] In that case the court observed that—

> "If there is not merely a sale of the assets, but a continuity of interest on the part of the old stockholders in the new business, so that the old stockholder does not actually liquidate his holdings, but continues to be a participant in the enterprise without actual realization of profit,

[59] Learned Hand's dissent in Commissioner v. Newman, 159 F. 2d. 848 (2d Cir., 1947). The same thought may be found in Commissioner v. Kolb, 100 F. 2d 1960 (9th Cir., 1938) where the court said: "Where for legitimate business purposes, a person has a choice of conducting his business transaction without tax liability, such a liability does not arise simply because it would have arisen if another process had been chosen." In Sawtell v. Commissioner, 82 F. 2d 221 (1st Cir., 1936) the same idea was echoed: "A purpose to minimize to avoid taxation is an illicit motive." And in Alprosa Watch Corp., 11 T.C. 240 (1948) it was said: "A man's tax avoidance motives do not alone establish his liability." This is also confirmed in Sam Pickard, 40 B.T.A., 258 (1939) affirmed in 113 F. 2d 488 (2d Cir., 1940): "'His purpose to avoid tax is material only as indicating a nonbusiness purpose."

[60] Cortland Specialty Company v. Commissioner, 60 F. 2d 937.

[61] Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan and Company, 1942), Vol. 3, p. 184.

[62] *Idem.*

[63] Nelson v. Helvering, 296 U.S. 374; Minnesota Tea Company v. Commissioner, 296 U.S. 378.

[63a] Le Tulle v. Scofield, 308 U.S. 415.

[64] 60 F. 2d 937.

[65] 287 U.S. 462.

[66] Randolph Paul, *op. cit.*, p. 92.

[67] 72 F. 2d 22.

and if the transaction partakes of the nature of a merger or consolidation in a liberal view, it is not the purpose of the acts to recognize either a gain or loss in the transaction, and no such gain or loss will affect the income tax of the stockholder until the new stock or securities are disposed of."

The Continuity of Interest Test is a Built-in Requirement of Republic Act No. 1921

The doctrine of continuing interest although not expressly called by that name is a built-in requirement of Republic Act No. 1921. This is the reason for the requirement in that statute that all or substantially all assets, properties and business of the old corporation must be transferred to and *solely for shares* in the new corporation.[68] This is also the reason for the requirement that the stockholder in the old corporation must exchange his old shares *solely* for shares issued by the new entity. Finally, this is also the reason for the condition that the security-holder must exchange his securities in the old company *solely* for either shares or securities issued by the new corporation.

In a transaction where an expiring corporation transfers its entire business and assets to a newly created corporation all the conditions in Republic Act No. 1921 which are required to satisfy the doctrine of continuing interest are usually present. Normally and in point of fact, there is not only a continuity of the interest of the owners but a continuation of the entire business itself. Sometimes and surprisingly, there is even a complete identity between the old and the new entities, so much so that to the general public the passing away of the old company is hardly noticed. The new corporation usually has the same powers and purposes, the same capital structure, the same place of business, the same officers and employees, the same customers and suppliers, the same business, the same properties and assets, the same liabilities and creditors, and the same name, as the old company—at least immediately after the transaction is put through. Nothing is new except the corporate shell. The proportionate interest of the stockholders in the old company—in its assets, profits and management—is maintained in absolute mathematical parity in the new entity. In other words, there is a complete satisfaction of the continuing interest test.

A Careful Preparation is Necessary

Of course, whether the test of continuing interest is satisfied depends upon the care and foresight of those who are responsible

[68] See heading "Requirement for tax deferment" of this material.

for the success of the transaction, especially the lawyer and the accountant. It depends in a large measure on the ability of the lawyer to prepare and supply the documents needed to convey clearly the intent behind every step and facet of the transaction. It is extremely risky for the lawyer to just copy documents on file in public records bearing on an analogous transaction to document the transaction he has on hand. He must in every case exercise fresh and independent thinking, realizing always that no two corporations have identical circumstances and problems. The transaction as a whole, in fact every step to be taken, must be carefully scrutinized, planned and executed. Mistake is costly.

The Triumph of Form over Substance

In the preceding pages we have seen how the transaction between the old company and its successor fits Republic Act No. 1921. We have seen that that transaction is in every way a merger in the sense of the statute. We have demonstrated that it has a business purpose behind it and that it satisfies the continuity of interest test.

Now, we turn to the broader issue whether Republic Act No. 1921 was in fact intended to shelter that type of transaction. Did Congress intend to protect a transaction of that kind?

Before we attempt to give an answer to that question, let us trace the background of Republic Act No. 1921 and try to understand why it was made a part of our legal system. Only thus may we gain the knowledge necessary to resolve the precise issue before us. To theorize before a thorough search for the facts would be a futile pastime.

Gain or Loss in Exchanges of Property

It has always been a rule in our income tax law that gain or loss, if any, is deemed realized when a property is exchanged with another property. Of course, this rule assumes that the property received is "essentially different from the property disposed of." [69] A property is said to be essentially different from the property given away when the transaction results in a change in the substance and not merely in the form of that property.[70] A change in substance results in a gain or loss; a mere change in form does not. Thus, where a property was transferred to a corporation in exchange for its stock, the owner was said to have realized a gain or loss, as the case may be, on the theory of a substantial change

[69] See Section 140, Regulation No. 2.
[70] *Idem.*

in his right to the property given away.[71] But in a situation where the owner of 623 shares each with a par value of $100 surrendered them to the corporation that issued these shares and received in turn 155 shares of the same corporation with the same par value, although with much reduced fair market value because of the impaired capital of the corporation, no loss was deemed realized on the theory that the change was merely in form and not in substance—the 623 shares surrendered and the 155 shares received in lieu thereof "being supported by the same assets." [72]

Because of the vagueness of the formula adopted to resolve whether gain or loss was realized or not in an exchange of property, it was inevitable that Mr. Taxpayer and Mr. Tax Collector should clash in a mortal combat for supremacy. Form or substance—that was the basic point in issue.

The United States' Experience

So that we may have a clear picture of the background of the contest between form and substance as tests of liability in matters of taxation, let us go back to that era in American income tax history before the appearance of corporate reorganization statutes. That was circa 1913 [73] to 1920.[74] That was a period barren of any legislative rules on corporate reorganization, just as ours was before June 22, 1957, when Republic Act No. 1921 was passed. However,

[71] See Bureau of Internal Revenue Ruling dated March 22, 1921, cited in Dalupan, *National Internal Revenue Code Annotated*, Vol. I, pp. 249-250. This ruling was reversed on February 23, 1937, when the Bureau of Internal Revenue ruled that "increase in the valuation of properties of an individual incident to incorporation is not taxable." (See Bureau of Internal Revenue letter dated February 23, 1937, to Toribio Teodoro). Then in 1955 the Bureau of Internal Revenue reverted to its 1921 position (See Bureau of Internal Revenue letter dated January 5, 1955 to Messrs. Carlos, Laurea, Fernando and Padilla). Recently, the Bureau of Internal Revenue went back to its 1937 position (See BIR Ruling No. 74, series of 1960, in connection with the Blue Network incorporation).

[72] Philippine Sugar Estate Development Co. v. Posadas, 68 Phil. 216.

[73] The first income tax law in the United States became effective on March 1, 1913, after the adoption of the Sixteenth Amendment to the United States Constitution. The 1913 U.S. Revenue Act was extended to the Philippines and remained the basis for taxing income here until it was superseded by the 1916 U.S. Revenue Act. When this latter Act was amended by the 1917 U.S. Revenue Act, a provision was inserted in the 1917 Act authorizing the Philippine Legislature to amend, alter, modify, or repeal the Federal income tax law then operating in the Philippines, thus giving us tax autonomy for the first time. As a consequence of this authority, Act No. 2833 was enacted and this became the nucleus of our income tax law. The income tax provisions were included in the present Internal Revenue Code (Com. Act No. 466) during the codification held in 1939.

[74] The 1918 Revenue Act of the United States included a rule on corporate reorganization, although it was rather crude in its treatment of the subject. In Section 202(b) of that Act, it was provided that—

". . . but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securiit was during this period that *Towne v. Eisner* [75] was decided and declared that a true stock dividend was not income. It was also about this time that *Peabody v. Eisner* [76] held that a dividend declared by a corporation in shares of another company was a taxable income. And, of course, it was also during this epoch when *Eisner v. Macomber* [77] gave expression to the now settled rule that income tax liability does not arise from the fact alone of an increase in the value of an investment. Because of these cases, it was inevitable for men of business and their advisers to tailor transactions to fit the lines already set. But resistance from the enforcers of tax laws was equally unavoidable. Thus the stage was set for the five cases [78] that followed.

The first of these cases was *United States v. Phellis.* [79] This case involved the reorganization of the duPont Co., a New Jersey corporation, which then had a capitalization of a little over $60 million and a large surplus of accumulated profits. A new corporation was formed under the laws of Delaware with an authorized capital of $240 million. These authorized capital consisted partly in common stock and partly in debenture stock bearing 6% cumulative dividends. All assets of the old company were transferred to the new company at valuation of $120 million. In return, the new company issued to the old company debenture stock in the aggregate par value of $59,661,700, common stock with a total par value of $58,854,200, and $1,484,100 in cash. The new company also assumed all the liability of the old company except its funded debt. At that time, the funded debt of the old company and its capital stock were—

5 per cent mortgage bonds	$ 1,230,000
4½ per cent thirty-year bonds	14,166,000
Preferred stock ($100 shares)	16,068,600
Common stock ($100 shares)	29,427,100
TOTAL	$60,891,700

ties 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 received shall be treated as taking the place of the stock, securities, or property exchanged."

[75] 245 U.S. 418, 60 L. Ed. 372 (1918).

[76] 247 U.S. 347, 62 L. Ed. 1152 (1918).

[77] 252 U.S. 189, 64 L. Ed. 521 (1920).

[78] United States v. Phellis, 257 U.S. 156, 66 L. Ed. 180 (1921); Rockefeller v. United States, 257 U.S. 176, 66 L. Ed. 186 (1921); Cullinan v. Walker, 262 U.S. 134, 67 L. Ed. 906 (1923); Weiss v. Stearns, 265 U.S. 242, 68 L. Ed. 1001 (1924); Marr v. United States, 268 U.S. 536, 69 L .Ed. 1079 (1925).

[79] See No. 78.

The $1,484,100 in cash was used by the old company to redeem its outstanding 5 per cent mortgage bonds. Out of the $59,661,700 debenture stock, $30,234,600 was used to retire, share for share and dollar for dollar, $16,068,600 preferred stock of the old company and to redeem ₱14,166,000 4½ per cent thirty-year bonds. The remaining $29,427,100 debenture stock equal to its own outstanding stock was kept by the old company. The $58,854,200 common stock of the new company was distributed "as a dividend" to its stockholders at a ratio of two shares of the new corporation for every share of the old company.

The New Jersey company continued to exist, but it did no business except to collect the 6% cumulative dividends on the $29,427,100 debenture stock and to pay the dividends thereon to its stockholders. The shareholders and officers of the two corporations were the same. The aggregate market value of the new corporation's and the old company's shares which were outstanding immediately after the transaction equalled exactly the aggregate market value of the old company's common shares which were outstanding immediately before the transaction.

Phellis was the owner of 250 common shares in the old company. As a result of the transaction, he received 500 common shares of the new corporation. Phellis was taxed on the market value of these 500 shares on the theory that the 500 shares was a dividend on his common shares in the old company.

The Court of Claims held that Phellis had realized no income because the total value of his holdings after the reorganization (250 shares of the New Jersey company and 500 shares of the new corporation) was the same before and after the transaction, and because the distribution was in effect a stock dividend. The Court of Claims regarded the whole transaction as mere financial reorganization. The United States Supreme Court, however, disagreed.

The United States Supreme Court reasoned that the new corporation's common stock which the old company received was asset which represented the surplus of the latter and, therefore, "when this common stock was distributed as a dividend among the common stockholders of the old corporation, then at once—unless the two companies must be regarded as substantially identical—the stockholders of the company . . . received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as a result of a division of former corporate profits and drawn by them severally for their individual and separate use and benefit." [80]

Although the United States Supreme Court was speaking in the language of the realization doctrine in *Eisner v. Macomber*,[81] a closer look at the decision in the *Phellis* case would indicate that the decision turned primarily on the fact that the new corporation was not, in the language of the court, "virtually identical" with the old company. The conclusion of the court that the old company and the new corporation were not "virtually identical" was based on the circumstance that the new corporation was formed in a different state—it was formed under the laws of Delaware whereas the old corporation was formed under the laws of New Jersey—and because it had a capital structure essentially different from its predecessor. As a consequence, Phellis was held liable for the tax. *This was the first victory of form over substance.*

The next case was *Rockefeller v. United States*.[82] This involved the reorganization of the Prairie Oil Gas Company, a Kansas corporation. The business of this company consisted in producing crude petroleum and in transporting it through pipe lines. To avoid a threatened anti-trust suit, it was decided to segregate the pipe line business of Prairie Oil. To do this, a new corporation, the Prairie Pipe Line Company was organized also under the laws of Kansas. The pipe line property of Prairie Oil was transferred to this new corporation in consideration of the *pro rata* issue and delivery of the entire capital stock of the new corporation direct to the stockholders of Prairie Oil. The surplus profits of Prairie Oil at that time exceeded the value of the pipe line property and the par value of the total shares in the capital stock of the new company. The transfer of the pipe line property and the distribution of the stock of the new corporation received for the property left the capital stock of Prairie Oil unimpaired.

Being one of the stockholders of Prairie Oil, Rockefeller was made to pay income tax based on the value of the shares in the new corporation which he received. The Commissioner of Internal Revenue in making the assessment claimed that the shares received by Rockefeller constituted taxable dividends. The tax was sustained by the United States Supreme Court on the ground that "the facts

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[80] United States v. Phellis, *supra*, at p. 170.
[81] See No. 77.
[82] See No. 78.

are in all essentials indistinguishable from those presented in *United States v. Phellis*." [83]

It is interesting to note that the *Phellis* and *Rockefeller* cases differ in one respect. In the *Phellis* case the new corporation was organized in a different state; in the *Rockefeller* case the new corporation and the old company were both organized under the laws of the same state. This fact, however, did not spare Rockefeller from the tax. The tax on Rockefeller was sustained "on the theory of a dividend in kind." [84] As the court there said, "the new stock represented assets of the oil company standing in the place of the pipe line property that before had constituted portion of its surplus assets, and it was capable of division among stockholders as the pipe line property was not." [85] *Thus, form as a test of tax liability weakened and substance gathered strength.*

Then came *Cullinan v. Walker*.[86] This case was decided three years after the *Phellis* and *Rockefeller* cases, and it presented a different factual setting.

The Farmers Petroleum Co., a Texas corporation, had a capital stock of $100,000. It was engaged in producing and transporting oil. This corporation was dissolved and its assets were turned over to a group of trustees. After the trustees took over the assets, they organized two new Texas corporations—the Republic Production Co., which was a producing concern, and the American Petroleum Co., which was a pipe line corporation. The trustees then transferred the former assets of Farmers Petroleum Co. to these two new corporations—one-half in value to each—in exchange for $1,500,000 worth of shares and $1,500,000 worth of bonds from each of the new corporations. Then the trustees organized a third corporation under the laws of Delaware, and to this Delaware corporation they transferred all of the $3,000,000 worth of shares which they previously received from the two new Texas corporations in exchange for $3,000,000 worth of shares in the capital stock of this Delaware corporation. This $3,000,000 worth of shares in the Delaware corporation and the $3,000,000 worth of bonds from the two new Texas corporations were then distributed to the former stockholders of Farmers Petroleum Co. upon surrender by them of their shares in the capital stock of the latter.

Cullinan owned 26.64% of the capital stock in Farmers Petroleum Co. representing an investment of $26,640 in cash. Income

[83] Rockefeller v. United States, *supra*, at p. 183.
[84] Randolph Paul, *op. cit.*, p. 14.
[85] Rockefeller v. United States, *supra*, at p. 183.
[86] See No. 78.

tax was assessed against him on the excess of the value of what he received as "dividend" over the cost of his original investment in Farmers Petroleum Co. The tax against Cullinan was sustained because, according to the court, there was no substantial identity between the Delaware corporation and the Farmers Petroleum Co.—the former being a holding company and not an operating company like Farmers Petroleum Co.—and because the Delaware corporation was organized in another state. *Again, form regained its strength and substance was pushed aside.*

The next case to appear was *Weiss v. Stearns.*[87] This case is a complete *victory for substance over form.* In this case the Supreme Court of the United States declared a corporate reorganization non-taxable under the realization doctrine established in *Eisner v. Macomber.*

In the *Weiss* case the stockholders of an Ohio corporation transferred their shares of stock with an aggregate par value of $5,000,000 to the Cleveland Trust Co. as depositary. Eastman, Dillon & Co. deposited $7,500,000 in cash with the same trust company. A new Ohio corporation with similar powers was then organized and it thereupon purchased and took over the entire property, assets and business, and assuming at the same time all outstanding contracts and liabilities, of the old corporation. In payment therefor the new corporation issued to the trust company its entire authorized capital stock with a total par value of $25,000,000. The old Ohio corporation dissolved and the new Ohio corporation continued the business under the former management. Half of the new stock went to Eastman, Dillon & Co. The other half, together with the $7,500,000 in cash, was distributed *pro rata* to the stockholders of the old Ohio corporation. Each holder of $100 par of the old stock thus obtained $150 in cash and $250 par of new stock, representing an interest in the enterprise half as large as he had before. The United States Supreme Court declared that the entire arrangement amounted merely "to a financial reorganization under which each old stockholder retained half of his interest and disposed of the remainder."[88] In the course of its opinion, the court stated—

> "*We cannot conclude that mere change for purposes of reorganization in the technical ownership of an enterprise,* under circumstances like those here disclosed, *followed by issuance of new certificates, constitutes gains separated from the original capital interest.* Something more is necessary—something which gives the stockholder a thing really

[87] See No. 78.

[88] Weiss v. Stearns, *supra,* at p. 254.

> different from what he theretofore had. (Towne v. Eisner, 245 U.S. 418; Southern Pacific Company v. Lowe, 247 U.S. 330; Gulf Oil Corporation v. Lewellyn, 248 U.S. 71)." (Emphasis supplied).

The last case in the series was *Marr v. United States.* Here the General Motors Co., a New Jersey corporation, had an outstanding $15,000,000 of 7% voting preferred stock and $15,000,000 of common, each with a $100 par value, and a large surplus. A new corporation was organized under the laws of Delaware with a capital of $20,000,000 in 6% non-voting preferred and $82,600,000 of common, each with a $100 par value. The stockholders of the New Jersey corporation exchanged their common and preferred stocks for common and preferred stock of the Delaware corporation in the following ratio: For every share of common stock of the New Jersey corporation, 5 shares of the common stock of the Delaware corporation was issued and received; and for every share of the New Jersey preferred stock, one and one-third shares of Delaware preferred stock was also issued and received. The Delaware corporation thus acquired all the stock of the New Jersey corporation, caused the latter corporation to transfer its assets to it, and the New Jersey corporation was thereafter dissolved.

Marr was the holder of preferred and common stock of the New Jersey corporation. As a result of the exchange, he received shares in the Delaware corporation with an aggregate market value of $400,866 in lieu of his shares in the old corporation which cost him $76,400. Having been compelled to pay a tax on the difference, he sued to recover. The United States Supreme Court sustained the assessment in a 5 to 4 decision.

Note the arguments *pro* and *con* in the *Marr* case. Marr insisted that since the new corporation was organized to take over the assets and continue the business of the old corporation, and his capital remained invested in the same business enterprise, the additional security distributed to him were in legal effect a stock dividend; and that under the rule of *Eisner v. Macomber*, applied in *Weiss v. Stearns*, he was not taxable thereon because he still held the whole investment. On the other hand, the government maintained that identity of the business enterprise was not conclusive; that the taxpayer realized income under the rule of the *Phellis, Rockefeller* and *Cullinan* cases; that gain in value resulting from profits was taxable as income, not only when it was represented by an interest in a different business enterprise or property, but also when it was represented by an essentially different interest in the same business enterprise or property; that in the *Marr* case, the gain actually made was represented by securities with essentially different characteristics in an essentially different corporation.

To sustain the view of the government, the court went back to the convenient circumstance that the new corporation was organized under the laws of a different state[89]—a circumstance that was deemed unimportant by the same court in the *Rockefeller* case.[90] *Thus, once more, form triumphed over substance.*

The United States Congress Intervened

Although the *Phellis, Rockefeller, Cullinan, Weiss* and *Marr* cases were all decided between 1921 to 1925, they arose under the 1913 and 1916 Acts.[91] While these cases were before the courts, uncertainty polluted the air in the business world. Businessmen were no longer sure of their grounds. They had to walk in measured steps lest the quicksand of tax liability would swallow irretrievably the transactions they had so painstakingly conceived, planned and executed. Predictability was no longer theirs to command. As one noted scholar in taxation observed—

> "It would be a masterpiece of understatement to call the net result of the cases . . . far from satisfactory. One gets the impression that there was a great deal of churning the void to make very little cheese. Logic had its fling at the expense of practical values in a world of metaphysics. The strain involved in reaching desired results was constantly apparent. Rationalization was hard at work to put desired results in acceptable legalistic form. The result was complete confusion. Predictability, an item of particular concern in matters of taxation, was out of the question." [92]

In the meantime, however, Congress came to the rescue. It inserted a provision in the Revenue Bill of 1918 "to establish the rule for determining taxable gains in the case of exchanging of property and to negative the assertion of tax in the case of certain purely paper transactions." [93] But the first generic attempt to deal with the problem of corporate reorganization was made in the 1921 Revenue Act.[94]

As far as one could gather, Congress was impelled to pass the necessary legislation because of its desire to eliminate uncertainty

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[89] Randolph Paul, *op. cit.*, at p. 17.

[90] Roswell Magill, *Taxable Income* (New York: The Ronald Press Company, 1945), p. 67.

[91] Randolph Paul, *op. cit.*, at p. 10.

[92] *Idem*, p. 18.

[93] Robert S. Holzman, *Corporate Reorganization* (New York: The Ronald Press Company, 1956), p. 2.2 quoting the Report of the Finance Committee that accompanied the Revenue Bill of 1918.

[94] Randolph Paul, *op. cit.*, at p. 21.

in the law dealing with gains and losses from exchanges of property in general and from corporate reorganizations in particular, so that obstacles to necessary business readjustments could be avoided; and because of its desire to eliminate the economically unsound construction of realized income as well as its desire to prevent taxpayers from taking imaginary losses.[95]

The Philippines' Experience:
Form Trimphed Over Substance

That we should feel the effect of the cases discussed above was not surprising. Our tax laws were copied from their American counterparts. It was only natural, therefore, that we should hear the echoes of those cases in the halls of our tribunals. This, however, did not happen soon enough. It happened twenty-four years after the *Marr* decision. And the case was *Ogan v. Meer.*[96]

In *Ogan v. Meer,* Central Motor Supply, a corporation, had a capital stock of ₱300,000 divided into 3,000 shares with a par value of ₱100 each. Central Motor Supply had no business and its only assets were 3,000 shares in Motor Service Company, also a corporation, which had a capital stock of ₱300,000, divided into 3,000 shares with a par value of ₱100 each. Motor Service Company was an operating concern and its shares had a fair market value of ₱166.66 each. The stockholders of Central Motor Supply adopted a resolution under which they would surrender their shares in and to Central Motor Supply and in return they would receive an equal number of Motor Service Company shares. So 3,000 shares of Central Motor Supply were surrendered to it and in turn it delivered to its stockholders its 3,000 shares in Motor Service Company. The stockholders of Central Motor Supply were required to pay income tax on ₱66.66 per share—the difference between the cost of each Central Motor Supply share and the fair market value of each Motor Service Company share. The stockholders paid and sued to recover. The Supreme Court denied recovery.

Here was a clear example where form was made the test of tax liability. The two corporations were so closely related that in substance they should have been considered as one. Both had the same authorized and outstanding capital stock. The shares issued in one had identical par value as those issued in the other. The shares issued in both corporations were supported by the same assets and business, and very likely had the same fair market value. All that

[95] Baar and Morris, *Hidden Taxes In Corporate Reorganization,* 1935, p. 5.
[96] 83 Phil. 845 (1949).

the individual stockholders did was to reform the corporate relationship in order to place themselves where they really belonged in the first place. And, of course, it was normal for them to have expected that there should have been no resulting tax liability because they received no tangible or concrete economic value in rearranging the affairs of the two corporations. But the court considered all these as mere "subtleties that cannot stand the realities involved in this case."[97] And what were these "realities"? The fact that, according to the court, "the two corporations are different from each other, each having distinct legal personalities, and one cannot be identified with the other, both having different rights and responsibilities under the law."[98] Thus, the *Phellis, Cullinan* and *Marr* cases once more rose from their cold tombs where they were interred by the United States Congress to haunt taxpayers in our country. Form, not substance, that must be the test of liability. Paper profits must be taxed; paper losses must be deducted. A complete triumph of form over substance!

Philippine Congress Put Ogan v. Meer to Death

A little less than a decade after *Ogan v. Meer* reared its ugly head and before the doctrine of corporate entity[99] which was there stretched to its furthest limits could wrought havoc to our national economic progress, Congress spoke and said: "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 . . ."[100] Not only that, and this is the more significant one, Congress found that "method . . . *unrealistic*" because "when . . . the Government imposes a tax on the supposed gain or when it allows the reduction 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'*."[101]

The intention of Congress is unmistakable. In "corporate combinations," where there is no "substantial alteration in the interests of those who own the business affected,"[102] paper profits are not to

[97] *Idem*, at p. 851.

[98] *Idem*.

[99] This doctrine holds that "a corporation will be regarded as a legal entity entirely distinct from those who own and control it." Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan and Company, 1948), Vol. 10A, p. 234.

[100] Explanatory Note to House Bill 6485 which later on became Republic Act No. 1921.

[101] *Idem*.

[102] *Idem*.

be taxed and paper losses are not to be deducted from gross income. This is the evident legislative policy behind Republic Act No. 1921. *Ogan v. Meer* is dead. Substance finally triumphed over form—a triumph which we hope would last, although we notice once again the dark clouds of a gathering storm. The tax wind is shifting its course toward the direction of expired corporations. But, the stockholders are consoled by the thought that at last they have a legislative shelter beneath Republic Act No. 1921.

Although it has been said more than once that the power to tax carries with it the power to embarrass and destroy, we have faith in the administration of our tax laws. We are confident that those who are charged with the duty and responsibility to administer and enforce our revenue laws will exercise their power with the balancing influence of our national goals. We entertain the thought that they will temper their enthusiasm with restraint and moderation to the end that the effects of our tax laws shall be consistent with the economic and social objectives of the community and the institutions and economic processes conducive to those objectives.