ANOTHER "NON-RECOGNITION OF GAIN" TRANSFER UNDER THE TAX CODE

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A. *Preliminary Statement* —

The transfer by the taxpayer of his property to a corporation in exchange for its stock is a "sale or other disposition of property" within the meaning of Section 35 of the National Internal Revenue Code, upon which the transferor realizes gain or loss equal to the difference between the adjusted basis of the property given up and the value of the stock received in exchange.[1] The rule in this case, is that the entire amount of the gain or loss, as the case may be, shall be recognized,[2] except in certain transactions whereby gains or losses are recognized to certain percentages depending upon the length of time the property sold or exchanged is held by the taxpayer,[3] or in certain exchanges which are expressly excepted from the "recognition of gain or loss" provisions.[4]

In the last instance, e.g. certain types of exchanges made without the recognition of gain or loss, the gain or loss is postponed

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1 **Bittker, Federal Income Taxation of Corporations and Shareholders** (1959), 74. Unless a transaction falls within one of the specific exceptions in the Code requiring or permitting the use of a basis other than the original cost of the property, the basis to be used is such original cost, as adjusted for such items as capital charges, losses, depreciation, etc. Ordinarily, the cost of property is readily determinable and usually is the price paid for it (in cash or other property) plus the cost of acquiring it, with appropriate adjustment for capital expenditures, repayments or their equivalent, and other items. 3A, **Mertens, Law of Federal Income Taxation**, Sec. 21.10, Chap. 21, 27-29.

2 Sec. 35 /e/[1], National Internal Revenue Code. If the transfer of the asset is made at book value, no taxable gain will be realized.

3 Sec. 34(b) (1) (2), which provides:

(b) **Percentage taken into account.** — In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income.

(1) One hundred **per centum** if the capital asset has been held for not more than 12 months;

(2) Fifty **per centum** if the capital asset has been for more than 12 months.

4 Sec. 35(c)(2).

until the asset received in exchange is disposed of.[5] These "tax-free" exchanges, otherwise known as "tax-free" reorganizations, are for the most part those in which there is really no realization of economic benefits but merely involve a change in form. More specifically, these type of exchanges relate to cases of merger or consolidation whereby (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 stocks or securities in another corporation, a party to the merger or consolidation.[6]

A fourth case has been added to the foregoing "non-recognition" provisions of Sec. 35 of the Tax Code by Republic Act No. 4522, approved on June 19, 1965. Said Act provides:

> "There is no statutory gain if a person exchanges his property for stock in a corporation of which as a result of such exchange said person alone or together with others, not exceeding four persons, gains control of said corporation. *Provided,* That stocks issued for services shall not be considered as issued in return for property...
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> "The term 'control' shall mean ownership of stocks in a corporation possessing at least 51% of the total voting power of all classes of stocks entitled to vote."

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5 The conflict as to whether the so-called non-recognition provisions provide for a "postponement" of the imposition of the tax or allow an "exemption" from tax is merely one of terminology as the consequences of the non-recognition provisions are clear. As loss is involved as well as gain, it is perhaps erroneous to use the word "exemption". On the other hand, the case is not merely one of postponement, for if the property received on the exchange sufficiently declines in value thereafter, the tax on the exchange gain will never be imposed and, conversely, if the article received sufficiently increases in value thereafter, the loss on the exchange will never be subtracted from gross income or recognized. Cf. 3, **Mertens, op. cit. supra,** note 1, Sec. 20.01, Chap 20, p 8:

6 The corporate reorganization sections cover a great variety of corporate transformations. 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 of gain (generally it would have been as capital gain) or allowance of loss. **Surrey and Warren, Federal Income Taxation,** 1120.

B. *Background* —

The main features of Republic Act No. 4522 have been taken from Section 351 of the United States Federal Tax Code. Said section reads:

> "(a) *General Rule* — No gains or loss shall be recognized if property is transferred to a corporation by one of more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property...

The term "control", as used in Sec. 351, is defined elsewhere in the same Code[7] to mean the ownership of at least 80% of the total combined power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

It is, therefore, not surprising that the "purpose and philosophy" of both pieces of legislation run along parallel lines. The Explanatory Note to H. No. 14472, now Republic Act. No. 4522, has this to say:

> "It is desirable for the Government to encourage individuals in business as sole proprietors to incorporate their properties and businesses in order to enable them to broaden the base of ownership thereof, and to enable sound business enterprises to grow and expand by being able to invite others to invest capital therein.
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> "Similarly, pooling of resources among corporate businesses should also be encouraged by permitting them to organize separate corporations to split up their business and expand the capital base of each of the resulting corporate organizations. However, the present tax laws discourage this because even under existing rulings of the Bureau of Internal Revenue, tax-free incorporations of assets can be effected only if substantially all of the properties of the transferor are transferred to a corporation and if the transfers are made at book value.
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> "This bill seeks to eliminate this difficulty by permitting the assets to be transferred at market value in exchange for

[7] Sec. 368(c).

shares of stock of the transferee corporation and provided that the transferor and transferee, respectively, maintain separate records solely for tax purposes, showing the actual unrecovered cost of the properties transferred.

"It is on the basis of this historical cost, not the market value of the properties at the time of the incorporation, that the income tax will be computed. In this way, there would be no loss of tax revenues."

The United States Senate Finance Committee in recommending the enactment of Section 351's predecessor pointed out that —

"Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interferred with necessary business re-adjustments. The existing law makes a presumption in favor of taxation. The proposed Act... specifies... 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 where... an individual or indivduals transfer property to a corporation and after such transfer are in control of such corporation.

"The preceding amendments [the predecessors of secs. 351, 354 and 1031], 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."[8]

The basic premise, therefore, of both Republic Act No. 4522 and section 351 is that a transfer of appreciated or depreciated property to a corporation that is controlled by the transferor works a change of form only, which should not be an occasion for reckoning up the transferor's gain or loss on the transferred property.[9]

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[8] S. Rept. No. 275, 67th Cong. 1st. Sess., reprinted in 1939 — 1 CB (Part 2), p. 181, 188-9.

[9] **Bittker, op. cit. supra** note 1, at p. 76. See **Portland Oil Co.** v. **Commissioner**, 109 F. 2d 479, 488. 24 AFTR 225 (1st Cir. 1940), where the Court said:

> It is the purpose of [sec. 351] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or "closed out" a losing venture.

C. *Discussion* —

Had our Congress been minded to reproduce *verbatim* the provisions of Section 351 of the Federal Tax Code in Republic Act No. 4522, the implementing Federal regulations and judicial decisions applying and shading the provisions of the said section could have served as useful guides. But Congress, presumably in its desire to present a simplified version of Section 351, has introduced few changes in phraseology. These changes have blurred the "tax-free" corridor through which may flow the transactions intended to be so favored and in fact, rendered difficult the task of guarding this tempting corridor.

1. *Comparison between R. A, 4522 and Sec. 351*

A comparison between Republic Act No. 4522 and Section 351, therefore, appears to be in order.

Both provide for "no recognition of gain", if one or more persons transfer property to a corporation in exchange for stock in said corporation. Republic Act No. 4522, however, limits the number of qualifying persons to not more than five, while Section 351 sets no such numerical limit.

Both require that the person or persons must acquire, because of the exchange, control of the corporation. The Act, though speaks of the control being acquired "as a result of such exchange"; Section 351, "immediately after the exchange".

The Act defines "control" as "ownership of stocks in a corporation possessing at least 51% of the total voting power of all classes of stocks entitled to vote". The Section defines "control" as the ownership of a least 80% of the total combined power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

Both, however, do not consider stocks issued for services rendered as issued in return for property.

No wonder our Bureau of Internal Revenue has not found it easy to implement the provisions of Republic Act No. 4522. As of this writing, no regulation or ruling has yet been promulgated by by the said Bureau. And there is still no assurance of implementing regulations being immediately adopted. It will not be surprising if the Bureau decides to treat transactions to be entered into purportedly under Republic Act No. 4522 on "a case to case" basis.[10] In the meantime, a taxpayer will have to rely on the ingenuity of his tax adviser and act at his own risk.[11]

2. *Major Requirements of Republic Act No. 4522*

The major requirements of Republic Act No. 4522 are these:

(a) One or more persons, not exceeding five, must transfer property to a corporation.[12]

(b) The transfer must be in exchange for stock in such corporation.

(c) The transferor or transferors must be in control of the corporation as a result of the exchange.

Not so easy, however, is the task of providing for the implementing details. Perplexity will necessarily arise on whether the term "person" or "persons" include corporations; or whether the the transferors, not exceeding five persons, must collectively own the properties transfered by them to the corporation, and if not so, whether these properties must be simultaneously contributed to the corporation; or whether the "property" to be transferred should be a capital asset or not; or how the 51% of the total voting power of all classes of stocks entitled to vote is to be determined. There are other legal problems flowing from the treatment of these questions. In the meantime, an attempt will be made to answer the questions above isolated out of the vague contours of the Act under discussion.

(a) *One or more person: the transferor or transferors —*

(1) *Meaning of "person" or "persons"*

The Federal Regulations, construing Section 351, provides that the phrase "one or more persons" includes individuals, trusts,

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10 The Federal Treasury, for instance, has announced that it will not issue rulings in regard to whether or not the transfer of appreciated stocks or securities to a newly organized investment company in exchange for shares of stocks of such investment company will constitute non-taxable exchanges within the meaning of Sec. 351. TIR No. 303. Feb. 9, 1961 as amended by TIR No. 3N, March 3, 1961. Sec. 351, Fed. Tax Code, as previously noted, is the precursor of our R.A. 4522.

11 Knowledge of the tax law is imputed to all taxpayers. A taxpayer interprets at his risk. He has a right to go as near the line as he pleases, but if he misconceives the exact position of the line, his mistake is on his own head. Cf. **Paul, Studies in Federal Taxation**, 133.

12 Some maintain that the phrase "said person alone or together with others, not exceeding four persons gain control of said corporation" means that all in all there must be not more than **four** persons.

estates, partnerships, associations companies or corporations.[13]

Doubts perambulate on whether Republic Act No. 4522 is to be understood as having the same all-inclusive coverage. For note that while Section 351 does not put a limit as to the number of qualifying persons, the Republic Act prescribes a maximum number, namely "said person alone or together with others, *not exceeding* four persons." The fixing of not more than five persons appears to be significant because of the requirement of our Corporation Law that there must be *at least five* incorporators[14] who must be *natural* persons.[15] Note too, that the Explanatory Note to H. No. 14472, which was enacted into Republic Act No. 4522, states that the measure is intended "to encourage *individuals* in business as *sole proprietors* to incorporate their *properties* and *businesses*." But then, the Explanatory Note Continues to state:

> "Similarly, pooling of resources among **corporate businesses** should also be encouraged by permitting them to organize separate corporations to split up their business and expand the capital base of each of the resulting corporate organizations." (Bolds supplied).[16]

Taking the two objectives of the Republic Act together, the following interpretations may be safely stated:

(i) The phrase "said person alone or together with others, not exceeding four persons..." includes individuals, trusts, estates, partnerships, associations, companies or corporations.

(ii) It is, however, required that these "persons" be not more than five. Thus, an individual alone or together with other individuals, not exceeding four, must transfer property to a corporation in exchange for stock of the latter; or an artificial person, alone or together with others, not exceeding four, must transfer part of their assets to *another* corporation in exchange for stock of the latter.

(iii) If an individual, instead of a corporation, transfers assets to a corporation for its stock and is thereafter in control of the corporation, the Republic Act under consideration can clearly apply.

(iv) If, however, a corporation is the transferor, it may fall

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13 Sec. 1.351-1.

14 Sec. 6, Act No. 1459, as amended.

15 A corporation cannot become an incorporator of another corporation. **State v. Ruthland Ry**, etc. Co., 85 Vt. 91, 81 Atp. 252 (1911).

16 The two-fold objectives of R.A. 4522 seem to indicate that it will deal not only with the reformation of the assets or business of persons of all sorts, but also with the reformation of corporations — a matter already covered by Section 35(c)(2) of our Tax Code.

under the Republic Act; or present other requisites for merger and consolidation, it may also fall under the "tax-free" reorganization provisions of Section 35(c) (2) of our Tax Code.[17] Thus, if a corporation exchanges its property for stock in another corporation and as a result of such exchange it gains control of said corporation, i.e. ownership of stocks in the latter corporation possessing at least 51% of the total voting power of all classes of stock entitled to vote, the exchange falls within the intended ambit of Republic Act No. 4522. But suppose the exchange is made pursuant to a plan of merger or consolidation, the transferor corporation exchanging *all or substantially all*[18] of its properties for stock in another corporation, the exchange can also qualify under Section 35 (c) (2 of our Tax Code.

While in both types of exchanges, no gain or loss is recognized, the transferor corporation under the Republic Act continues to exist after the transfer. This is not so under Sec. 35(c) (2).[19]

(2) *Must transferred properties be collectively owned by the transferors?*

The next question that crops up is this: If "a person... together with others, not exceeding four persons" will contribute property to a corporation in exchange for stock of the latter, is it required that this property be collectively owned by him and the others.

It would seem that the interpretation given to Section 351 would be apposite, and that is, that the transferors need not be previously associated nor that the "property" transferred be collectively owned by them. The reasons for this is that "instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred pro-

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17 **Supra**, pp. 2-3.

18 "Substantially all" 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. G.C. No. V-253 of the BIR.

19 The ordinary "merger" or "consolidation" is generally determined by the effect and result of the merger or consolidation to the personality of the parties. Thus it is generally recognized that in a merger, one corporation absorbs the other but remains in existence. The inquiry, therefore, lies in the ascertainment of whether the existence of one of the corporations has been preserved, and the other ceased to exist. On the other hand, there is consolidation where a new corporation is created, and the consolidating corporations are extinguished. In this case a new and distinct corporation evolved which acquires all the assets, property rights and franchise of the dissolved corporations, and their stockholders become its stockholders. (**Pinellas Ice & Cold Storage v. Commissioner** (CCA 5) 57 F. (2d) 188 (1932).

perty, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it.[20]

In fact, the most essential though not expressed requirement of all to bring a case within the provision of Sec. 351, and for that matter, of Republic Act No. 4522, is the intention to carry on in a coporate form a venture or business formerly carried on in some other form. This includes the creation of a new corporation[21] intended to endure in order to commence a new business or venture. This is because of the striking similiarity between the provisions covering transfers to a controlled corporation and the statutory provision covering reorganization schemes, like merger and consolidation, qualified for non-recognition of gain or loss treatment. The underlying justification for such "exemption" is the "continuity of interest" on the part of the transferors in the venture, i.e. to carry on their former business venture and assets in merely changed form.[22]

(3) *Nature of the "property" to be transferred*

It is to be noted that Republic Act No. 452[2] does not define the "property" that must be transferred.[23] Federal tax authorities hold that the "property" transferred may be real, personal or mixed; the term includes securities of another corporation and money.[24] There is a compelling reason for so construing the term "property" as to include "money". A newly organized corporation almost always needs cash for working capital and if section 351 did not permit the tax-free transfer of money to such a corporation, it would either lose much of its usefulness or invite evasion in the form of a transfer of cash in an allegedly independent transaction after the other assets had been transferred under Section 351.[25] Furthermore, a common reason for incorporation is to get in new interests to supply cash so that the original venture may continue.[26]

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20 **American Compress Warehouse Co. v. Bender**, 70 F. 2d 655, 657, 13 AFTR 1052 (5th Cir. 1934). Thus, if one person transfers his land for 30% of the voting stock of a newly organized corporation, and another person transfers his patent in exchange for 21% of the voting stock, the language of Republic Act No. 4522 is broad enough to confer "non-recognition of gain" status on both of these hypothetical transfers.

21 Section 351 and R.A. 4522 apply to transfers to existing corporations as well as newly organized ones.

22 Mertens, op. cit. supra, note 1 sec. 2046, Chap. 20, p. 108:

23 The term "property" as used in Section 351 is also not defined by statute.

24 3 C.C.H., 32,009. By statutory provision, however, stock issued for services shall not be considered as issued in returned for property.

25 **Bittker, op. cit. supra**, note 1, at p. 79, citing GCM 24415, 1944 CB 219; **Holstein v. Commissioner**, 23 TC 923 (1955).

26 Mertens, op. cit. supra, note 1, Sec. 20.47, Chap 20, p 114.

Such ruling, however, may not find easy acceptance in the local setting. Like its foreign counterpart, initial opposition to the inclusion of "cash" within the coverage of "property" can be expected. A meticulous literal interpretation will be insisted and it will turn on the lack of the word "money" in the statute. Thus, the first rule was stated:

> "It is the opinion of this office that the word 'property' as used in section 203(b) (4) means property other than money. This subdivision refers to an 'exchange' in four instances. The word 'purchase' is not used. The payment of cash for stock is a purchase, not an exchange. The language must be construed according to its commonly accepted meaning. This position is supported by the manner in which the word 'exchange' is used throughout the Act, and also by the manner in which references are made to 'property' as distinguished from 'money' in the provisions with reference to exchanges, particularly in section 203(d), (e), and (f). To sustain the taxpayer's contention would necessitate placing a strained construction upon the language used.
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> "It is, therefore, the opinion of this office, supported by the decision in the Abrams case, supra, that the entire amount of the gain or loss to the taxpayers must be recognized in the manner provided for in section 203(a)." [The case referred to in this early ruling is Louis Abrams, 3 BTA 385][27]

Most likely, a cautious tax lawyer will advise that real, personal or mixed property, *excluding cash,* be contributed to the corporation. Such "property" may be business or non-business property.[28] A beneficial owner of, or equitable claimant to property, has an an interest which is "property" which may be transferred in a qualifying exchange. It has been held, however, that "property" does not include the worthless stock of a corporation which has an excess of liabilities over assets for the reason that the requirement of an "exchange" connotes the transfer of something of value for the stock of the controlled corporation.[29]

(b) *Transfer must be in exchange for stock*

Republic Act No. 4522 permits the "tax-free" transfer of property to a corporation only if the transfer is in exchange for stock in such corporation. The Act does not define the term "stock", presumably upon the belief of our Congress that the term is virtually self-defining. It may be stated that the term has the same meaning here as in the non-recognition of gain or loss provisions of Section 35(c) (2) of our Tax Code dealing on an ex-

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27 GCM 2862, CB VII-1, p. 161, revoked by GCM 24415, CB 1944, p. 219. The current and sounder rule is that the term "property" does include "cash".

28 "Business property" refers to items held by the taxpayer in connection with his trade or business. "Non-business" property is something apart from the regular run of the taxpayer's business; it is a capital asset. Cf. Sec. 34(1), National Internal Revenue Code.

29 Mertens, op. cit. supra, note 1, Chap. 20, Sec 20.47, pp 114-115.

change in the course of a corporate merger or consolidation.[30] The term "stock", therefore, also means "stocks or securities" or "stocks and securities". Piecemeal definitions have been worked out by the courts in connection with the reorganization cases. But implicit in all is the requirement that the stock or securities must evidence a continuity of interest in the corporation, which is substantial as to time.[31]

The reason for the restrictive nature of the "stock" to be exchanged with the "property" is that the "non-recognition" provision is available only if the transfer is one of true exchange and not of sale, a transaction which falls entirely outside the purview of the reorganization section. This being the underlying purpose, the term "stock" will not include "short term notes",[32] bonds or other evidences of indebtedness,[33] stock rights and stock warrants.[34]

(1) *Stock issued for services*

Republic Act No. 4522 expressly provides that stock issued for services shall not be considered as issued in return for property. The reason for this is that payment for services rendered to a corporation is taxable income and, to an employee, is compensation.[35] An exchange, however, is not automatically cast out of the Act merely because the corporation issues stocks or securities for services. As aptly put by a tax authority on Federal income taxation:

> "While the Code rules out such stock as 'property' where issued for services, it says nothing expressly about a contract to render services, which in a technical sense would represent 'property'. The Regulations provide, however, that stock or securities issued for services to be rendered likewise are treated as not issued for property. The Regulations speak of services rendered or to be rendered 'to or for the benefit of the issuing corporation,' leaving open the possibility that, where services are rendered to one of the other transferors of property in exchange for stock of the corporate transferee, such transferors may be construed to have received such stock in determining whether they have the required control of the transferee. Should the amount of stock issued for services preclude acquisition of the necessary 'control' by other persons transferring property,

30 Supra, pp. 2-3 of this paper.

31 Montgomery, Federal Taxes, 38th ed. (1961), 15-10.

32 But 10-year notes will suffice. Where short-term notes are received for the property, the transaction is akin to a sale, and any gain realized by the transferor should be recognized to the extent of the value of the short-term notes. Pinellas Ice Cold Storage Co. v. Commissioner, 287 US 462 (1933). The same case ruled that the notes were not securities within the intendment of the Act (at pp. 468-469).

33 Letulle v. Scofield, 308 U.S. 415 (1940).

34 Helvering v. Southwest Consolidated Corp., 315 US (1942), 28 AFTR 573.

35 Sec. 29, National Internal Revenue Code; Sec. 41, Revenue Regulations No. 2.

it may be desirable for the persons performing the services to transfer some property in addition in order that their stock might be included in determining the required 'control'. The risk remains, however, that a token transfer of property might be disregarded, and on a more substantial transfer of property there might be an allocation of the stock between the property and the services."[36]

To illustrate: If A and B transferred property to a newly organized corporation for 48% of its stock and C, as part of the same transaction, received 52% of the stock for services rendered to the corporation, the transfer does not qualify under the Act because the transferors of property (A and B) have less than 51% of the stock and hence do not have "control" as that term is defined by the Act. If, however, A and B received 51% or more of the stock and C received the rest of the stock or less, the exchange would qualify. Moreover, if A and B received 48% of the stock for property and C received 52% for a combination of services and property, the transfer would qualify (though as to C, the stock received for services would produce taxable income), unless C's transfer of property was only a sham designed to support a claim by A and B for non-recognition of gain or loss.

Another example: An individual proprietor incorporates his business, taking part of the stock himself and directing that the rest be issued to an employee as compensation for services performed in years past. Such a transaction is to be treated as though all the stock had been issued first to the proprietor in exchange for the assets of the business, with part of it being used by him to pay his debts. The incorporation would qualify if the proprietor retained at least 51% of the stock.

(c) *Transferor or transferors in control as a result of the exchange* —

Republic Act No. 4522 applies only if the transferors of property "gain control" of the corporation. To be in control, the transferor or transferors must have acquired at least 51% of the total voting power of all classes of stocks entitled to vote in the corporation. This would refer to 51% of the subscribed capital stock. Non-issued but authorized stock is obviously disregarded since it can give no control and is not existing.[38] In other words, "the total voting power of all classes of stock entitled to vote" has come to mean the power to elect the directors. Where the transaction feror or transferrors received all stocks of all classes, the requirement

[36] Mertens, op. cit. supra, note 1, Chap. 20, pp 116-117.
[37] Adopted from Bittker, op. cit. supra, note 1 at pp. 79-80.
[38] CCH, op. cit. supra, note 24, ¶2,015.

is satisfied if he received 51% of the total number of shares of each class of stock.

The Act speaks of control being acquired 'as a result of such exchange". Upon the other hand, Section 351 requires that the control be acquired "immediately after the exchange". The slight difference in phraseology will not call for a substantial difference in interpretation. The condition of "control" does not necessarily require simultaneous exchanges by two or more persons but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.[39] Under this interpretation, the stockholdings of two or more transferors can be aggregated in determining whether they control the corporation "immediately after the exchange" if their transfers are part of a single transaction. Thus, if A owns all the stock of a corporation, consisting of 100 shares and if the corporation is to be expanded by issuing 200 shares to B for property and 200 more shares to C for other property, B and C will be in control of the corporation "immediately after the exchange" (by virtue of owning 400 out of 500 shares or 80 percent) even though B's exchange is not simultaneous with C's.[40]

(1) *Control — for how long?*

Assuming that under the Act, the "control requirement" has been met, what is the effect of the subsequent divestment of such conrol? Such a loss of "control" may occur if the transferors thereafter dispose of part of their stocks to donees or purchasers, or in some other manner so that they are left with less than the 51% required by the Act. Decisions touching on the "control requirement" of Section 351 have gone both ways. The tendency, however, is to hold that the subsequent divestment of control will not negate a section 351 transaction, if the transfer of property to the corporation and the subsequent disposition or sale of stock are not mutually interdependent but are distinct transactions.[41] Conversely, if the transferors agreed beforehand to transfer enough of their stock to lose control or if such a transfer is an integral part of the incorporation, then the requisite control is not deemed sufficiently met.[42]

It is doubtful at the moment whether our Bureau of Internal

39 Sec. 351-1 (a)(1), Federal Revenue Regulations.

40 Bittker, op. cit. supra, note 1 at p. 92. Under Republic Act No: 4522, it will suffice if B and C will own 51% of the 500 shares.

41 Montgomery, loc. cit. supra, note 31.

42 Bittker, op. cit. supra, note 1 at pp. 93-97.

Revenue would readily subscribe to the above interpretation. It would rather be happy with the "control interest" being continously maintained for the due protection of the government. This attitude, however, will not stop efforts of taxpayers to pass off as "tax-exempt" a sale of property which in substance is fully taxable or to establish a deductible loss on what is in substance a nontaxable transfer of assets to a controlled corporation.[43]

D. *Conclusion*

Congress has passed off, so to speak, to the taxpayers and tax collection agencies another "non-recognition of gain or loss" scheme, at a time when turmoil still rages over the question of whether the appearance of the "merger and consolidation" provisions in our Tax Code would suffice to exempt exchanges involved therein from immediate recognition of gain or loss treatment. The judicial gloss on these corporate reorganizations, including the transaction covered by Section 351 of the Federal Tax Code — the parent of our Republic Act No. 4522 — is, to borrow a phrase, "all things to all men".[44] Much of the decisions involve ingenuity both on the part of the taxpayers and the administrative and judicial agencies utilizing and applying these "tax-free" reorganization provisions. The tax avoidance potential of former Section 112 (g) of the Federal Tax Code,[45] for instance, led to its elimination. Of great relevance to the topic at hand is the description of the Gregory case[46] by Judge Learned Hand, to wit:

> "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. 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 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, supra, 293 U.S. 465, 55 S. Ct. 266, the incorporators adopted the usual form for creating business corporations; but their intent or purpose, was merely to draught the papers, in fact not

43 Cf. Montgomery, 15-9.

44 Paul, op cit. p. 125.

45 It provided for no gain to the shareholder on the distribution by a corporation, a party to a reorganization, of stock or securities of another corporation, also a party to the reorganization, even though the shareholder did not surrender any shares, so that it in effect exempted a dividend distribution of such stocks or securities.

46 Gregory v. Helvering, 293 U.S. 465 (1935), is one of the landmark tax decisions on reorganization schemes.

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."

In the effort of our Congress to keep abreast with the Federal Income Tax Code, first, with the adoption of the merger and consolidation provisions, and now, with its modified version of Section 351 of the said Code, it may have indeed built another"tempting avenue of tax avoidance to persons who were not intended to be the recipient of such a safeconduct pass".[47] By choosing not to reproduce the specific terms of Section 351, due to the overriding desire for either improvement or novelty, the Republic Act under discussion has increased many times more the problems of actual implementation which attended even its parent mold. Indeed, tax code provisions are not answered by mere reference to dictionary definitions, and "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 particularly can over obviate recourse to the setting in which all appear, and which all collectively create".[48]

It is said that "anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern that will best pay the treasury; there is not even a patriotic duty to increase one's taxes."[49]

For the same reasons, a taxpayer intended to be benefitted by Republic Act No. 4522 may so arange his affairs and exercise his legal rights to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the Act permits. The problem is to distinguish the rightful pedestrian from the ubiquitous trespasser who may wish to pass thru the "tax-free" corridor opened by the Act.

But then, that is no longer the problem of its architect — the Congress, but of the implementing agencies of our Government.

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47 Surrey and Warren, op cit. supra, note 6 at p. 1125:
48 Judge Learned Hand, in Gregory v. Helvering, 293 US 465 (1935).
49 Ibid, citing US v. Isham, 17 Wall: 496, 506 (1873); Bullen v. Wisconsin, 240 US 625, 630, 36 S. Ct. 473 (1916).