[BIR REVENUE MEMORANDUM RULING NO. 1-2002, APRIL 25, 2002, April 25, 2002]

TAX CONSEQUENCES OF DE FACTO MERGER PURSUANT TO SECTION 40(C)(2) AND (6)(B) OF THE NATIONAL INTERNAL REVENUE CODE OF 1997

Pursuant to Section 4, in relation to Sections 40(C)(2), (4), (5), (6), 175, 176, and 196, and pertinent provisions of Titles II, IV and VII of the National Internal Revenue Code of 1997 (Tax Code of 1997), this Revenue Memorandum Ruling is issued to consolidate, provide, clarify and harmonize the existing guidelines on the tax consequences of a de facto merger under Section 40(C)(2) and (6)(b) of the Tax Code of 1997. This Revenue Memorandum Ruling shall apply solely and exclusively to, and may be relied upon only in, situations in which the facts are substantially similar to the facts stated below, but subject to the principle that for such transaction to be considered a de facto merger within the purview of Section 40(C)(2) in relation to 40(6)(b) of the Tax Code of 1997, the same must be undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation.

I Facts

1. A domestic corporation (the "Transferor") owns certain property, consisting, for example, of the following:

1.1 Land encumbered by a real estate mortgage (REM);

1.2 Buildings;

1.3 100 shares of stock in G Corporation with a par value of P10 per share;

1.4 50 shares of stock in D Corporation without par value;

1.5 Unsecured receivables;

1.6 Loans to Q ("Borrower/Mortgagor"), secured by a real estate mortgage;

1.7 Cash.

2. The property transferred by the Transferor constitutes at least 80% of the Transferor's assets, including cash.

3. The Transferor transfers the property to the Transferee. In exchange, the Transferee issues shares to the Transferor out of the unissued portion of its existing authorized capital stock, or, if such existing authorized capital stock is insufficient, out of shares from an increase in the Transferee's authorized capital stock. The

Transferor does not receive any money or property other than the aforementioned shares of the transferee.

4. In addition to the transfer of the property, the Transferee assumes liabilities of the Transferor. However, the sum total of the amount of liabilities assumed, plus the amount of the encumbrance or REM on the Land (as stated in Section 40(C)(4) of the Tax Code of 1997 — "liabilities to which the property is subject") do not exceed the basis of the property transferred.

II. GENERAL PRINCIPLES

1. A de facto merger involves the acquisition by one corporation of all or substantially all the properties of another solely for stock. Section 40(C)(6)(b) of the Tax Code of 1997 states:

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

The phrase "substantially all the properties of another corporation" is defined in BIR General Circular No V-253 dated July 16, 1957 to mean "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'.

To constitute a de facto merger, the following elements must concur: (1) there must be a transfer of all or substantially all of the properties of the transferor corporation solely for stock, and (2) it must be undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation.

One basic difference between a de facto merger and a statutory merger is that the Transferor is not automatically dissolved in the case of the former. Likewise, there is no automatic transfer to the Transferee of all the rights, privileges, and liabilities of the Transferor. It is, in fact, in procedure, similar to a transfer to a controlled corporation under the same Section 40(C)(2) of the Tax Code of 1997, except that at least 80% of the Transferor's assets, including cash, are transferred to the Transferee, with the element of permanence and not merely momentary holding. However, a de facto merger and a transfer to a controlled corporation are different in that, (1) the Transferor in a de facto merger is a corporation, while in a transfer to a controlled corporation, the Transferors may either be a corporation or an individual, and (2) in a de facto merger, there is no requirement that the transferor gains control (that is, 51% of the total voting powers of all classes of stocks of the Transferee entitled to vote) of the Transferee as a prerequisite to enjoying the benefit of non-recognition of gain or loss. What is essential in a de facto merger is that the Transferee acquires all or substantially all of the properties of the Transferor.

III TAX CONSEQUENCES

1. *Income tax.* The Transferor shall not recognize any gain or loss on the transfer of the property to the Transferee. Consequently, the Transferor will not be subject to capital gains tax, income tax, nor to creditable withholding tax on the transfer of such property to the Transferee. Neither may the Transferor recognize a loss, if any, incurred on the transfer.

In addition, the assumption of liabilities or the transfer of property that is subject to a liability does not affect the non-recognition of gain or loss under Section 40(C)(2) of the Tax Code of 1997, since in this case, the total amount of such liabilities does not exceed the basis of the property transferred. Section 40(C)(4) of the Tax Code of 1997 states:

"(4) Assumption of liability. —

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

(b) If the amount of the liabilities assumed plus the amount of the liabilities to which the property is subject exceed the total amount of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

Moreover, the Transferee is not subject to income tax on its receipt of the property as contribution to its capital, even if the value of such property exceeds the par value or stated value of the shares issued to the Transferor: Section 55 of Revenue Regulations No. 2 ("Income Tax Regulations") states:

"Section 55. Acquisition or disposition by a corporation of its own capital stock. — xxx The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than the par or stated value of such stock.

xxx xxx xxx"

However, stocks shall not be issued for a consideration less than par or issued price thereof. (Section 62, Corporation Code of the Philippines)

2. Donor's tax. The Transferor is not subject to donor's tax, regardless of whether the value of the property transferred exceeds the par/stated value of the Transferee

shares issued to the Transferor, there being no intent to donate on the part of the Transferor.

3. Value-added tax. The Transferor is not subject to value-added tax ("VAT") on the transfer of the property if it is not engaged in a business that is subject to the VAT under Title IV of the Tax Code of 1997. Even if the Transferor is engaged in an activity that is subject to VAT, it is nonetheless not subject to VAT on the transfer of the property to the Transferee. Section 4.100-5(b)(1) & (3) of Revenue Regulations No. 7-95, as amended states:

"(b) Not subject to output tax. — The VAT shall not apply to goods or properties existing as of the occurrence of the following:

1) Change of control of a corporation by the acquisition of the controlling interest of such corporation by another stockholder or group of stockholders, Example: transfer of property to a corporation in exchange for its shares of stock under Section 34(c)(2) and (6)(c) of the Code *[now 40(C)(2) and (6)(c) of the Tax Code of 1997].*

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3) Merger or consolidation of corporations. The unused input tax of the dissolved corporation as of the date of merger or consolidation shall be absorbed by the surviving or new corporation."

Thus, since a de facto merger is considered within the definition of a merger under Section 40(C)(6) of the Tax Code of 1997, the transfer of the property by the Transferor to the Transferee shall not be subject to VAT. However, the second sentence of Section 4.100-5(b)(3), supra, is inapplicable in de facto mergers, and therefore, the Transferor's unused input tax cannot be absorbed by or transferred to the Transferee. The above sentence contemplates only a statutory merger or consolidation that, by operation of law, results in a "dissolved corporation" and a "surviving or new corporation". Furthermore, pursuant to Section 80 of the Corporation Code of the Philippines, the unused input tax, being an asset, is transferred in statutory merger by operation of law.

4. *Documentary stamp tax.* The documentary stamp tax consequences of the transfer are as follows:

4.1 Either the Transferor or the Transferee is subject to documentary stamp tax as follows:

4.1.1 On the transfer of real property (Section 196, Tax Code of 1997) — P15 on each P1,000 or fractional part thereof, based on the higher of: (i) the consideration contracted to be paid for such real property, and (ii) the fair market value as determined in accordance with Section 6(E) of the Tax Code of 1997.

4.1.1.1 The "consideration contracted to be paid for such real property" shall be computed in accordance with the following rules. "Stock in a corporation is a valuable consideration for the transfer of real property." (Section 177, Revenue Regulations No. 26) Therefore, the consideration for the real property shall be computed as the par/stated value of the Transferee shares issued to the Transferor in exchange for such property plus the value of such property in excess of such