REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

Oct. 30/70

VICENTE A. RUFINO and
REMEDIOS S. RUFINO,
Petitioners,

- versus - C.T.A. CASE No. 1791

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

x------------------------x

ERNESTO D. RUFINO and
ELVIRA B. RUFINO,
Petitioners,

- versus - C.T.A. CASE No. 1792

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

x------------------------x

RAFAEL R. RUFINO and
JULIETA A. RUFINO,
Petitioners,

- versus - C.T.A. CASE No. 1793

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

x------------------------x

MANUEL S. GALVEZ and
ESTER R. GALVEZ,
Petitioners,

- versus - C.T.A. CASE No. 1794

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

x------------------------x

D E C I S I O N

These are four (4) cases involving appeals interposed by petitioners from the decision of respondent dated July 11, 1966 holding petitioners, namely, Vicente A. Rufino and Remedios S. Rufino, Ernesto D. Rufino and Elvira B. Rufino, Rafael R. Rufino and Julieta A. Rufino, and Manuel S. Galvez and Ester R. Galvez, liable for deficiency income tax, surcharge and interest in the sums of ₱44,294.88, ₱27,229.44, ₱58,082.60 and ₱58,074.24, respectively, for the year 1959. These cases were jointly heard and are, therefore, being considered jointly.

The facts are not disputed. Petitioners were the majority stockholders of the defunct Eastern Theatrical Co., Inc. (hereinafter referred to as the Old Corporation), a corporation organized in 1934, with an original capital stock of ₱500,000.00. Its capital was later increased in 1949 to ₱2,000,000.00 divided into 200,000 shares at ₱10.00 per share. The corporate life of this corporation was for twenty five years terminating on January 25, 1959. It was organized to engage in the business of operating theatres, opera houses, places of amusement and other related business enterprises, but more particularly, the operation of the Lyric and Capitol Theatres in Manila. The President of this corporation during the year in question was Ernesto D. Rufino, one of the petitioners in C.T.A. No. 1792.

Petitioners are also the majority and controlling stockholders of another corporation, the Eastern

Theatrical, Inc. (hereinafter referred to as the New Corporation), which was organized on December 8, 1958 with an original authorized capital stock of ₱200,000 with a par value of ₱10.00 each share. This corporation was and still is engaged in the same kind of business as the Old Corporation and its corporate life is for 50 years. The General Manager of this corporation is Vicente A. Rufino, one of the petitioners in C.T.A. No. 1791.

In a special meeting of stockholders of the Old Corporation on December 17, 1958, having in mind the proximity of the end of its corporate life and the continuation of its corporate business after the end of that term, and upon the recommendation of its Board of Directors, a resolution was passed authorizing its merger with the New Corporation by transferring all its business, assets, goodwill and liabilities to the latter. In consideration of such transfer, the New Corporation would issue and distribute to the shareholders of the Old Corporation one share for each share held in the said Corporation. The decision of the Old Corporation to merge with the New Corporation was due to its desire to continue uninterrupted the conduct of its business -- the exhibition of moving pictures at the Lyric and Capitol theatres -- even after the expiration of its corporate existence because it had still pending booking contracts for the exhibition of moving pictures in said theatres, and also pending collective bargaining agreements with the employees.

On January 9, 1959, the Old Corporation represented by Ernesto D. Rufino as President, and the New Corporation represented by Vicente A. Rufino, as General Manager, entered into and signed a "Deed of Assignment" agreeing to the conveyance and transfer of all the business, property, assets and goodwill of the Old Corporation to the New Corporation in exchange for the latter's shares of stock to be distributed among the shareholders on the basis of one stock for each one stock held in the Old Corporation except that no new and unissued shares would be issued to the shareholders of the Old Corporation; to the delivery by the New Corporation to the Old Corporation of 125,005-3/4 shares to be distributed to the shareholders of the Old Corporation as their corresponding shares of stock in the New Corporation; to the assumption by the New Corporation of all obligations and liabilities of the Old Corporation under its bargaining agreement with the Cinema Stage & Radio Entertainment Theatrical Co., Inc. and the Cinema Stage & Radio Entertainment Free Workers, FFW, which included the retention of all personnel in the latter's employ; and to increase the capitalization of the New Corporation in compliance with their agreement. This assignment and conveyance of the properties, etc. aforesaid was made retroactive to January 1, 1959.

The assets, properties and goodwill aforesaid were actually transferred by the Old Corporation, and the operation of the Lyric and Capitol theatres was continued by the New Corporation. All obligations and liabilities of the Old Corporation were assumed and paid by the New Corporation since January 1, 1959.

The resolution of the Old Corporation of December 17, 1958 and the deed of assignment of Janusry 9, 1959 were approved in a resolution by the stockholders of the New Corporation in their special meeting dated January 12, 1959. In the same meeting, the increased capitalization of said New Corporation to ₱2,000,000.00 divided into 200,000 shares at ₱10.00 par value each share was also approved, and the increase in capitalization was registered on March 5, 1959 with the Securities and Exchange Commission which approved the same on August 20, 1959.

As a result of the transfer of the properties, assets and goodwill of the Old Corporation to the New Corporation, the stockholders of the former received by way of exchange stocks in the New Corporation equal to the stocks each one held in the Old Corporation. The petitioners, as stockholders of the Old Corporation, received by way of exchange stocks of the New Corporation as follows:

Mr. & Mrs. Vicente A. Rufino	---- 17,083	shares
Mr. & Mrs. Rafael R. Rufino	---- 16,881	"
Mr. & Mrs. Ernesto D. Rufino	---- 15,347	"
Mr. & Mrs. Manuel S. Galvez	---- 16,882	"

As a consequence of these transactions, respondent, after investigation, found that the merger of the aforesaid corporations was not undertaken for a bona fide business purpose, but was a scheme to avoid liability for the tax on the capital gain on the exchange of the old for the new shares of stock. Hence, the deficiency assessments against petitioners for the amounts already adverted to above.

Against these assessments, petitioners filed, through counsel, a request for reconsideration dated April 27, 1965 on the ground that the merger was for a bona fide purpose, and not solely for the purpose of escaping the burden of taxation. The request was denied in a letter dated July 11, 1966 of the Acting Deputy Commissioner of Internal Revenue, and received by petitioners on August 23, 1966. On September 5, 1966, well within the period to appeal, petitioners filed their respective appeals to this Court.

The issues submitted by the parties for adjudication in these cases are as follows:

1. Whether or not petitioners are subject to tax on their alleged capital gains derived from the exchange of their stocks in the Old Corporation with an equal number of stocks in the New Corporation;

2. Whether or not there was a tax-exempt merger between the Old and the New Corporation within the contemplation of Section 35 of the National Internal Revenue Code, as amended by Republic Act 1921; and

3. Whether or not the 50% surcharge and interest on the deficiency income tax assessments against petitioners are legal and justified.

Petitioners contend that there was a merger of the Old and the New Corporation which was undertaken for a bona fide business purpose within the meaning of Section 35(c)(5) of the National Internal Revenue Code, and no gain or loss is to be recognized by the stockholders as a result of the exchange of their old shares with the new ones. It is argued in support thereof that the merger was entered into for the purpose of continuing and carrying on all of the Old Corporation's business and there is no intention to dissolve and liquidate the New Corporation and distribute its assets among its stockholders.

On the other hand, respondent contends the contrary. Respondent contends that there was no merger because it was only a scheme of petitioners to avoid taxes, and there was no business purpose for the merger or no continuity of interest of the stockholders in the New Corporation, and cites the following reasons for his conclusion: Firstly, it is not possible for a small corporation (the New Corporation) with only ₱200,000.00 capitalization to absorb a bigger corporation (the Old Corporation) with a capitalization of ₱2,000,000.00 at the time when the assets, properties and goodwill were transferred, conveyed and assigned and that the subsequent increase made in the capitalization of the New Corporation to equal the capital structure of the Old Corporation could not be made retroactive to that time, and therefore there could not be any merger. Secondly, in view of the unequal capital structure of the two corporations, there is consequently no continuity of proprietary and business interest of the Old Corporation in the New Corporation. Thirdly, there was no completed merger at any time before the end of the corporate life of the Old Corporation on January 25, 1959 since there was no concrete and tangible value received by the stockholders of the Old Corporation in the form of stocks at the time the assets, properties and goodwill were transferred by it to the New Corporation.

Section 35 of the National Internal Revenue Code, as amended by Republic Act 1921, the law involved in these cases, insofar as it is material, reads as follows:

Sec. 35. Determination of gain or loss from the sale or other disposition of property.- The gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, shall be determined in accordance with the following schedule:

(a) In the case of property acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen.

(b) In the case of property acquired on or after March first, nineteen hundred and thirteen, the cost thereof if such property was acquired by purchase or the fair market price or value as of the date of the acquisition if the same was acquired by gratuitous title.

(c) Exchange of property -

(1) General rule.- Except as herein provided, upon the sale or exchange of property, the entire amount of the gain or loss, as the case may be, shall be recognized.

(2) Exceptions.- No gain or loss shall be recognized if in pursuance of a plan or merger or consolidation (a) a corporation which is a party to a merger or consolidation, exchanges property solely for stock in a corporation which is a party to the merger or consolidation, (b) a shareholder exchanges stock in a corporation which is a party to the merger or consolidation solely for the stock of another corporation, also a party to the merger or consolidation, or (c) a security holder of a corporation which is a party to the merger or consolidation exchanges his securities in such corporation solely for stock or securities in another corporation, a party to the merger or consolidation.

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(5) Definitions. - (a) The term "securities" means bonds and debentures but not "notes" of whatever class or duration.

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

(c) The Commissioner of Internal Revenue is hereby authorized to issue rules and regulations for the purpose of determining the proper amount of transferred assets which meet the standard of the phrase "substantially all" and for the proper implementation of this section. (As amended by Republic Act No. 1921.)

The exemption from the tax of the gain derived from exchanges of stock solely for stock of another corporation resulting from corporate mergers or consolidations under the above provision, as amended, was intended to encourage corporations in pooling, combining or expanding their resources conducive to the economic development of the country. (Explanatory Note, H.B. No. 7235, now Rep. Act 1921.) The provisions of Section 35 of the Revenue Code quoted above are similar to those of the various United States Revenue Acts on the subject which were intended to remove the impediments, tax-wise, to corporate readjustments by relieving men engaged in industrial, commercial, financial or other enterprises who might wish to consolidate, divide, add to, or subtract from their holdings, from the payment of capital gains tax (Helvering v. Gregory, 69 F 2d 809, cited in Mertens, Law on Federal Income Taxation, Vol. 3, Chap. 20, Sec. 20.55, p. 165) upon purely fictitious gains, or upon what are referred to as purely "paper profits," a situation where there is in fact no realization of such gains in the business sense because it is merely the recasting by the participants of the same interest in a different form (like the exchange of stock in one corporation solely for stock in another corporation, parties to a merger or consolidation), the tax being postponed to a future date when more tangible gain is realized (i.e. when the stocks received are later on sold or exchanged to a third person resulting in a realized capital gain). (Helvering v. Leary, 93 F 2d 826; Comm'r v. Gilmore Estate, 130 F 2d 791, 794.))

Said Section 35, being a derivative of the U.S. Revenue Acts, the authorities set out in that jurisdiction in construing and applying their corporate reorganization and readjustment provisions are equally authoritative here.

The provisions of Section 35(c)(2), in relation to (c)(5), allowing exemption from the payment of capital gains tax by reason of the exchange of stocks with stocks of another corporation, both parties to a merger or consolidation, contains the following requirements:

> (1) There must be an ordinary merger or consolidation undertaken under a definite plan;
>
> (2) There must be a transfer of all or substantially all the properties of the transferor corporation to the transferee corporation in pursuance of the plan of merger or consolidation;
>
> (3) The merger or consolidation must be entered into for a bona fide business purpose, and not solely to escape the burden of taxation, and 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; and
>
> (4) The shareholder exchanges stock in the corporation party to the merger or consolidation, solely for stock of another corporation, also a party to the merger or consolidation.

Respondent in his memorandum admits compliance with only the fourth requirement and disclaims compliance with the rest of the requirements. In effect, he denies the existence of a merger between the Old and the New Corporations because it was not entered into for a *bona fide* business purpose and was a scheme to evade taxation.

On the question of whether or not there was a tax exempt merger under Section 35(c)(2), in relation to (c)(5), based upon the facts of these cases, we believe that there was such a merger pursuant to a definite plan evidenced by the resolution of the Old Corporation approved on December 17, 1958, the resolution approved on January 12, 1959 by the New Corporation, and the "Deed of Assignment" of the two corporations executed on January 9, 1959.

✓ Pursuant to this plan of merger, the Old Corporation transferred to the New Corporation all its properties on condition that its stockholders would receive shares from the New Corporation equal to their stockholdings in the Old Corporation which would be absorbed. To enable the New Corporation to transfer its stocks equal to the stocks held by the stockholders of the Old Corporation, it went on to increase its capital structure from ₱200,000.00 to ₱2,000,000.00 to equal the capital structure of the latter. These acts of the two merging corporations were accomplished in one whole transaction, or series of transactions, interrelated with one another with the sole objective of dissolving the Old Corporation. We note, too, that the merger of the two corporations, viewed from the "business purpose" or "continuity of interest" tests, was undertaken for the purpose of continuing the business of the Old Corporation, which was mainly to operate the Lyric and Capitol theaters, in the New Corporation, which was germane to the venture of the Old Corporation (Mertens, op. cit., chap. 20, Sec. 20.55, p. 165, citing Helvering v. Gregory, 69 F 2d 809), and there was a genuine intention on the part of the controlling stockholders of the Old Corporation participating in the exchange and controlling it to continue the former corporate business under a new corporate form (Mertens, ibid., p. 162; Robert Campbell, 15 TC 312), as in fact the stockholders of the Old Corporation acquired a substantial and permanent interest in the New Corporation other than as ordinary creditors. (Pinellas Ice and Cold Storage Co. v. Comm'r, 287 US 462, 77 L ed 428; Le Tulle v. Scoffield, 84 L ed 315; Helvering v. Alabama Limestone Co., 315 US 179, 183, 86 L ed 775, 778.) The transactions that took place between the Old Corporation and the New Corporation conform to the term "merger" which means the combination of two or more corporate entities in one corporation with the corporate existence of all the participating corporations terminating, except one which survives and which acquires the properties and continues the business and activities of the others. (New York University, Institute of Federal Taxation, Vol. 10, pp. 1267-1268; 60-2 CCH 2551.27; Helvering v. Leary, op. cit.; Pillar Rock Packing Co., 34 BTA 571; Fisher v. Comm'r., op. cit.; Cortland Specialty Co. v. Comm'r., 60 F 2d 937; Helvering v. Winston Bros. Co., 76 F 2d 381, 382.) And contrary to the conclusion reached by respondent, there is nothing on record to show that the merger of the two corporations was resorted to with a view to evade the payment of the capital gains tax.

It is well established that where stocks for stocks were exchanged, and distributed to the stockholders of the corporations, parties to the merger or consolidation, pursuant to a plan of reorganization, such exchange is exempt from capital gains tax. (Fisher v. Comm'r., 108 F 2d 707, 708; Comm'r. v. Gilmore Estate, 130 F 2d 791, 795-797; Lewis v. Comm'r., 176 F 2d 646; Robert Campbell, 15 TC 312; J.S. Alexander, 2 TC 917; Helvering v. Leary, op. cit.; R.C. Love, 39 BTA 172, 113 F 2d 236; Becher et al v. Comm'r., 221 F 2d 252; Georgia Savings Bank & Trust Co., 28 BTA 1153; Harrison Inc., 30 BTA 455; Hazelton Corp., 36 BTA 908; Bacon Inc., 4 TC 1107.)

In view of the foregoing, we are of the opinion and so hold that no taxable gain was derived by petitioners from the exchange of their old stocks solely for stocks of the New Corporation pursuant to Section

35(c)(2), in relation to (c)(5), of the National Internal Revenue Code, as amended by Republic Act 1921.

Having held that petitioners are not liable for capital gains tax on the stocks they have received from the New Corporation, the determination of the third issue becomes unnecessary.

WHEREFORE, the decision of respondent against petitioners in the above entitled cases dated July 11, 1966 is hereby reversed.

SO ORDERED.

Quezon City, October 30, 1970.

R M Umali
ROMAN M. UMALI
Presiding Judge

WE CONCUR:

Estanislao R. Alvarez
ESTANISLAO R. ALVAREZ
Associate Judge

Ramon L. Avanceña
RAMON L. AVANCEÑA
Associate Judge