Republic of the Philippines
COURT OF TAX APPEALS
Quezon City

FIRST DIVISION

PREMIUM TOBACCO REDRYING AND FLUECURING CORPORATION,
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CTA Case No. 8897
For: Assessment

Members:

DEL ROSARIO, P.J., *Chairperson*
UY, and
MINDARO-GRULLA, JJ.

Promulgated:

JUL 18 2017 : 2:05 pm

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DECISION

MINDARO-GRULLA, J.:

This resolves the Petition for Review[1] filed on September 22, 2014 by Premium Tobacco Redrying and Fluecuring Corporation pursuant to Section 7(a)(1)[2] of Republic Act (RA) No. 1125[3], as amended, as well as Section 3(a)(1)[4] of Rule 4 and Section 4(a)[5] of

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[1] Docket, vol. I, pp. 14-45.

[2] Sec. 7. *Jurisdiction.* - The CTA shall exercise:
(a) Exclusive appellate jurisdiction to review by appeal, as herein provided:
(1) Decisions of the Commissioner of Internal Revenue in cases involving disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties in relation thereto, or other matters arising under the National Internal Revenue Code or other laws administered by the Bureau of Internal Revenue; xxx.

[3] Act Creating the Court of Tax Appeals.

[4] Sec. 3. *Cases within the jurisdiction of the Court in Division.* – The Court in Division shall exercise:
(a) Exclusive original over or appellate jurisdiction to review by appeal the following:
(1) Decisions of the Commissioner of Internal Revenue in cases involving disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties in relation thereto, or other matters arising under the National Internal Revenue Code or other laws administered by the Bureau of Internal Revenue.

[5] Sec. 4. *Where to appeal; mode of appeal.* –

Rule 8 of the Revised Rules of the Court of Tax Appeals, as amended, against the Commissioner of Internal Revenue.

Petitioner seeks the cancellation of all deficiency tax assessments stated in the Formal Letter of Demand[6] (FLD) that found it liable for alleged deficiency income tax, value-added tax (VAT), and documentary stamp tax (DST) for calendar year 2009 in the total amount of **ONE HUNDRED SEVENTY-NINE MILLION TWENTY THOUSAND THREE HUNDRED NINETEEN PESOS AND 37/100 (₱179,020,319.37)**, inclusive of interest and surcharge, broken down as follows:

Tax Type	Basic	Surcharge	Interest	Total
Income Tax	₱ 66,622,356.27		₱ 48,369,655.92	₱ 114,992,012.19
VAT	31,574,583.20		24,308,103.78	55,882,686.98
DST	3,946,050.00	986,512.50	3,213,057.70	8,145,620.20
Total	**₱102,142,989.47**	**₱986,512.50**	**₱75,890,817.40**	**₱179,020,319.37**

Petitioner Premium Tobacco Redrying and Fluecuring Corporation is a corporation duly organized and existing under Philippine laws, with business address at No. 24 Fortune Avenue, Brgy. Fortune, Marikina City.[7] It is primarily engaged in re-drying of tobacco leaves and providing warehousing services.[8] Petitioner is registered with the Bureau of Internal Revenue (BIR) with Certificate of Registration No. OCN 3RC0000650745.[9]

On the other hand, respondent is the duly appointed Commissioner of the BIR who has the power to decide disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties imposed in relation thereto or other matters arising under the National Internal Revenue Code (NIRC) or other laws or portions

(a) An appeal from a decision or ruling or the inaction of the Commissioner of Internal Revenue on disputed assessments or claim for refund of internal revenue taxes erroneously or illegally collected, the decision or ruling of the Commissioner of Customs, the Secretary of Finance, the Secretary of Trade & Industry, the Secretary of Agriculture, and the Regional Trial Court in the exercise of their original jurisdiction, shall be taken to the Court by filing before it a petition for review as provided in Rule 42 of the Rules of Court. The Court in Division shall act on the appeal.

[6] Exhibit "P-1", Docket, vol. II, pp. 519-520.

[7] Par. 2 Admitted Facts, Joint Stipulation of Facts and Issues (JSFI), Docket, vol. I, p. 373; Exhibit "P-8", Docket, vol. II, pp. 674-675.

[8] Exhibit "P-7", Docket, vol. II, pp. 658-673.

[9] Exhibit "P-9", Docket, vol. II, p. 676.

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thereof administered by the BIR. He holds office at the BIR National Office Building, Agham Road, Diliman, Quezon City.

The primary client of petitioner is Fortune Tobacco Corporation (FTC), which is engaged in the manufacture and sale of tobacco and tobacco-related products.

On October 29, 2009, petitioner entered into a Plan of De facto Merger[10] with FTC to allow the reorganization of their respective holding structures/businesses.

Pursuant to the said *de facto* merger, petitioner transferred to FTC more than eighty percent (80%) of its total assets and some of its liabilities in exchange for One Million Two Hundred Fifteen Thousand Five Hundred Twenty-Six (1,215,526) shares of FTC and additional paid-in-capital (APIC) recorded in its books of accounts.

On October 29, 2009, a Deed of Assignment[11] was executed by and between petitioner and FTC, in order to effect the transfer of petitioner's assets and some of its liabilities.

Thereafter, petitioner, through the Tax Division of SGV and Co., filed a letter-request[12] with the Law Division of the BIR National Office on February 23, 2010 to request the issuance of a confirmatory ruling. Specifically, the letter-request calls for a confirmation from the BIR that the transfer of more than 80% of petitioner's total assets and some of its liability to FTC in exchange for the latter's shares of capital stock and APIC constitutes *de facto* merger pursuant to the provision of Section 40(C)(2) in relation to Section 40(C)(6)(b) of the NIRC of 1997, as amended.

Letter of Authority No. 124-2010-00000068[13] dated May 14, 2010, authorizing the examination of the books of accounts and other accounting records of petitioner for all internal revenue taxes for

[10] Exhibit "P-10", Docket, vol. II, pp. 677-681.
[11] Exhibit "P-11", Docket, vol. II, pp. 682-685.
[12] Exhibit "P-12", Docket, vol. II, pp. 686-730.
[13] Exhibit "P-13", Docket, vol. II, p. 731; Exhibit "R-1", BIR Records, p. 2.

taxable year 2009, was issued against it. Petitioner received the said Letter of Authority on May 25, 2010.

On January 25, 2012, petitioner, acting through its President, Virgilio G. Giron, executed a Waiver of the Statute of Limitation Under the NIRC of 1997, as amended[14]. The same was accepted by respondent, through Alfredo V. Misajon, the OIC-Assistant Commissioner for Large Taxpayers Service, on February 9, 2012 to extend the period of assessment until December 31, 2012.[15]

Petitioner's President, Virgilio G. Giron, signed a Waiver[16] anew on October 2, 2012. Assistant Commissioner Alfredo V. Misajon accepted the Waiver for and on behalf of respondent on October 15, 2012 to extend the period of assessment until September 30, 2013.[17]

On May 28, 2013, a third Waiver of Defense of Prescription Under the Statute of Limitation of the NIRC of 1997, as amended[18] was executed by petitioner's president. It was accepted by Assistant Commissioner Alfredo V. Misajon for and on behalf of respondent on June 17, 2013 to extend the period of assessment until June 30, 2014.

On September 12, 2013, petitioner received a Preliminary Assessment Notice[19] (PAN) with Details of Discrepancies[20] assessing petitioner for deficiency income tax, VAT, EWT, and DST.

Petitioner filed its position paper[21] to dispute the preliminary assessments found in the PAN on October 24, 2013.

On January 27, 2014, petitioner received an FLD[22] together with Audit Result/Assessment Notices[23] (FANs) No. ELTAD-II-IT-09-0002, ELTAD-II-VT-09-0002, and ELTAD-II-DS-09-0002 as well as its Details

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[14] Exhibit "P-14", Docket, vol. II, p. 732; Exhibit "R-6", BIR Records, p. 219.
[15] Par. 3, Admitted Facts, JSFI, Docket, vol. I, p. 373.
[16] Exhibit "P-15", Docket, vol. II, p. 733; Exhibit "R-7", BIR Records, p. 293.
[17] Par. 4, Admitted Facts, JSFI, Docket, vol. I, p. 373.
[18] Exhibit "R-8", BIR Records, p. 295.
[19] Exhibit "P-16", Docket, vol. II, pp. 734-736; Exhibit "R-5", BIR Records, p. 422.
[20] Exhibit "P-17", Docket, vol. II, pp. 737-740.
[21] Exhibit "P-18", Docket, vol. II, pp. 741-753.
[22] Exhibit "P-1", Docket, vol. II, pp. 519-520.
[23] Exhibits "P-3", "P-4", and "P-5", Docket, vol. II, pp. 523, 524, and 525.

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of Discrepancies[24] signed by former BIR Commissioner Kim S. Jacinto-Henares, dated January 24, 2014.[25]

The Formal Letter of Demand showed the following assessments:

Tax Type	Basic	Surcharge	Interest	Total
IT	₱ 66,622,356.27		₱48,369,655.92	₱ 114,992,012.19
VAT	31,574,583.20		24,308,103.78	55,882,686.98
DST	3,946,050.00	₱986,512.50	3,213,057.70	8,145,620.20
Total	₱102,142,989.47	₱986,512.50	₱75,890,817.40	**₱179,020,319.37**

On February 25, 2014, petitioner filed an administrative protest by way of a request for reconsideration with the Office of Assistant Commissioner Alfredo V. Misajon, invoking the defense of prescription.

Due to the inaction of respondent, petitioner filed the instant Petition for Review[26] on September 22, 2014.

Within the extended time granted by the Court[27], respondent filed his Answer[28] through registered mail on December 22, 2014 and received by this Court on January 8, 2015. Respondent interposed the following special and affirmative defenses:

"**SPECIAL AND AFFIRMATIVE DEFENSES**

4. Respondent incorporates and re-pleads all the foregoing averments and in further support of the Specific Denials herein set forth, respondent respectfully alleges as her defenses that:

The period to assess petitioner has not prescribed.

[24] Exhibit "P-2", Docket, vol. II, pp. 521-522.
[25] Par. 5, Admitted Facts, JSFI, Docket, vol. I, p. 373.
[26] Docket, vol. I, pp. 14-45.
[27] Order dated October 27, 2014 and Resolution dated December 3, 2014, Docket, vol. I, pp. 179 and 186.
[28] Docket, vol. I, pp. 205-219.

5. Petitioner expounded in detail that respondent's right to assess has prescribed anchoring its claim on Section 203 of the National Internal Revenue Code ('Tax Code'), to wit:

> **SEC. 203. Period of Limitation Upon Assessment and Collection.** - Except as provided in Section 222, internal revenue taxes shall be assessed within three (3) years after the last day prescribed by law for the filing of the return, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period: Provided, That in a case where a return is filed beyond the period prescribed by law, the three (3)-year period shall be counted from the day the return was filed. For purposes of this Section, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day.

6. Respondent disagrees. An exception to the aforementioned rule is when both the taxpayer and the Commissioner have agreed in writing to extend the time for assessment. Section 222 states:

> **SEC. 222. Exceptions as to Period of Limitation of Assessment and Collection of Taxes. –**
>
> -xxx-
>
> **(b) If before the expiration of the time prescribed in Section 203 for the assessment of the tax, both the Commissioner and the taxpayer have agreed in writing to its assessment after such time, the tax may be assessed within the period agreed upon.**
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> The period so agreed upon may be extended by subsequent written agreement made before the expiration of the period previously agreed upon. (**Emphasis supplied**).

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7. Petitioner tried to pull a fast one against respondent by stressing repeatedly in its Petition for Review that there were only two waivers of the prescription executed in this case that at the time of the issuance of the FLD and FAN, the agreed period indicated in the second waiver had already elapsed.

8. However, upon verifying with the BIR docket, it was found that petitioner actually voluntarily executed three (3) waivers for the extension of the period to assess, which were accepted by OIC-Assistant Commissioner Alfredo V. Misajon on 25 January 2012, 02 October 2012 and 28 May 2013, respectively.

9. The waiver made on 28 May 2013 extended the period to assess up until 30 June 2014. Notably, the Formal Letter of Demand and the Final Assessment Notice were issued on 24 January 2014, or well within the period to assess as agreed upon in the said waiver.

10. Accordingly, petitioner's contention that the Final Assessment Notice was issued beyond the three (3) year prescriptive period of assessment deserves no consideration.

11. Assuming for the sake of argument that the period to assess were not extended by the waivers, respondent maintains that a false and/or fraudulent return has been filed and accordingly, respondent has ten (10) years to assess petitioner.

12. Section 222 of the Tax Code states that when a false or fraudulent return is filed, the period to assess is ten (10) years from the discovery of the falsity, fraud or omission, specifically:

> **SEC. 222. Exceptions as to Period of Limitation of Assessment and Collection of Taxes. –**
>
> (a) In the case of a **false** or fraudulent **return** with intent to evade tax or of failure to file a return, **the tax may be assessed**, or a proceeding in court for the collection of such tax may be filed without assessment, **at any**

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> **time within ten (10) years after the discovery of the falsity, fraud or omission:** -xxx-(**Emphasis supplied**).

13. In relation to the aforementioned provision Revenue Regulations No. 18-2001 ('RR 18-2001') mandates the inclusion of certain information in the Final Adjustment Return and in the audited financial statements in cases of tax free exchanges of property for shares under Section 40(C)(2) of the Tax Code, viz:

> **SECTION 8. Information to be Included in the Final Adjustment Return and in the Audited Financial Statements Accompanying the Final Adjustment Return; Records to be Maintained by Parties. —**
>
> (a) The transferor and the transferee or the surviving/consolidated corporation, as the case may be, as well as the shareholders of such surviving/consolidated corporation (in case of a merger or consolidation) **shall enclose with their respective income tax returns for the taxable year in which the tax-free exchange occurred, a copy of the request for ruling filed with, and the corresponding certification/ruling issued by, the Bureau of Internal Revenue, both duly stamped received by the appropriate office of the Bureau of Internal Revenue.**
>
> **(b) Such persons shall likewise include as a note to their respective audited financial statements for the taxable year in which such exchange occurred a statement to the effect that they hold such assets/shares acquired in a tax-free exchange and the year in which such exchange occurred, and in the succeeding taxable years until the subject property/ies is/are subsequently transferred to another transferee.**

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> (c) In addition to the foregoing, the parties to the transaction shall maintain permanent records of the transaction, consisting of, among others, the request for ruling, certification or ruling issued by the Bureau of Internal Revenue, the Deed of Assignment/Exchange, or the Articles of Merger, as the case may be, and such other documents as may be required to facilitate the determination of gain or loss from a subsequent disposition of the stocks/unit of participation/interest/properties received or transferred in the exchange. (**Emphasis supplied**).

14. Tax-free exchange transactions partake the nature of tax exemptions which are a derogation of the power of taxation of the State. Consequently, they are construed strictly against a taxpayer and liberally in favor of the state. As such, the taxpayer is charged with the heavy burden of proving that it has complied with and satisfied all the statutory and administrative requirements to be entitled thereto.

15. Therefore, a taxpayer cannot unilaterally assert that a transaction it entered into was a tax free exchange. Compliance with RR-18-2001 is an indispensable requirement to such claim.

16. As here, a careful examination of petitioner's Income Tax Return and accompanying Financial Statements for the taxable year 2009 would show that petitioner did not attach the request for ruling filed with, and the corresponding certification/ruling issued by, the Bureau of internal Revenue.

17. Accordingly, premised on the afore-quoted provisions of the Tax Code, petitioner's utter failure to comply, despite being aware of the mandatory provisions of RR 18-2001 constitutes an intentional wrong-doing with the sole intent to evade the taxes due on the exchange transaction it entered into.

18. Therefore, petitioner having filed a false return, the period to assess petitioner for deficiency internal revenue tax has not yet prescribed. Consequently, respondent has ten (10)

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years from the discovery of such falsity to assess petitioner.

Petitioner is liable to pay deficiency Income Tax, VAT and DST.

Income Tax

19. Petitioner contended that the transaction it entered into is exempt from income tax since it is a tax free exchange pursuant to Section 40 (C) (2) of the Tax Code.

20. Tax free exchanges are governed by Section 40 (C) paragraph 2 of the Tax Code. It states:

> **SECTION 40. Determination of Amount and Recognition of Gain or Loss. —**
>
> **-xxx-**
>
> **(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) Exception. —** No gain or loss shall be recognized if in pursuance of a plan of merger or consolidation —
>
> -xxx-
>
> (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; or
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> -xxx-

21. Tax-free exchange transactions are tax exemptions. Being an exemption, it is incumbent upon a taxpayer to prove in a very clear manner that it is entitled to such exemption.

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22. It must be remembered that any claim for exemption shall be allowed only when sufficient proof has been adduced to support the claim. Therefore, a taxpayer insisting on its tax exemption, contrary to the BIR's position, must pay the tax under protest and subsequently claim for a refund should it be proven that it is entitled to the exemption.

23. Accordingly, for an exchange transaction to come within the ambit of the definition of a tax free transaction, all the requisites provided by law must be present; and to confirm the exemption, a tax free exchange ruling must be secured.

24. The importance of which is that if the specific requirements of the law are not present in the transaction alleged to be a tax free exchange transaction, then, a different tax consequence will result therefrom.

25. As here, petitioner, not having secured the tax free exchange ruling, should have initially treated the transaction as taxable and reported it to the Bureau of Internal Revenue. Petitioner cannot unilaterally assume that the exchange transaction it entered into was not subject to tax.

26. Moreover, the exchange transaction petitioner entered into failed to meet the requirement that the transaction must be undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation. Revenue Memorandum Ruling 1-2002 provides:

> 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. (Emphasis supplied).**

27. To determine whether a *bona fide* business purpose exists, each and every step of the transaction shall be considered and the transaction or series of transactions shall be treated as a single unit.

28. Further, the element of permanence and not mere momentary holding is an essential requirement so as to come within the ambit of the phrase 'substantially all the properties of another corporation.'

29. Revenue Memorandum Ruling 1-2002 further provides:

> 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. (**Emphasis supplied**).

30. Petitioner posited that the element of permanence and not mere momentary holding is not an element of a *de facto* merger. This is clearly misguided.

31. It bears stressing that the requirement of permanence and not mere momentary holding is proof that the exchange transaction is for a *bona fide* business purpose and not for the purpose of escaping the burden of taxation. Clearly,

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without the element of permanence it cannot be said that the transaction was a legitimate business transaction.

32. In the case at hand, petitioner effected the exchange transaction in October 2009. After four months, however, the assets of the subject merger were immediately transferred to a newly formed corporation, PMFTC, Inc. Clearly, this cannot be considered as a *bona fide* business transaction; but rather a preliminary action on the part of petitioner to escape the burden of taxation.

33. Accordingly, respondent's assessment for deficiency Income Tax in the aggregate amount of P114,992,012.19 must stand.

Value Added Tax

34. Petitioner argued that the exchange transaction was also exempt from Value Added Tax ('VAT') pursuant to Revenue Memorandum Ruling No. 1-2002.

35. Respondent reiterates that the exchange transaction petitioner entered into was not a tax free exchange for failure to meet the elements provided under Revenue Memorandum Circular 1-2002. Accordingly, the exchange transaction is subject to the twelve percent (12%) VAT.

36. While it is true that it is within the prerogative of management to enter into transactions it deems beneficial for the corporation, this prerogative must be exercised within the bounds of law.

37. As here, petitioner's actions indicated that the exchange transaction was only preliminary to the business combination it subsequently entered into.

38. Accordingly, respondent's assessment for deficiency VAT in the aggregate amount of P55,882,686.98 must be upheld.

Documentary Stamp Tax

39. Again, petitioner unilaterally concluded that the exchange transaction was exempt from tax and exempted from Documentary Stamp Tax ('DST').

40. At the risk of being repetitive, respondent manifests that the transaction failed to meet the elements of a tax free exchange transaction under Section 40 (C) (2) of the Tax Code.

41. Thus, the transaction is subject to DST pursuant to Section 196 of the Tax Code, to wit

> **SEC. 196. Stamp tax on Deeds of Sale and Conveyances of Real Property.** – On all conveyances, deeds, instruments, or writings, other than grants, patents or original certificates of adjudication issued by the Government, whereby any land, tenement, or other realty sold shall be granted, assigned, transferred or otherwise conveyed to the purchaser, or purchasers, or to any other person or persons designated by such purchaser or purchasers, there shall be collected a documentary stamp tax, at the rates herein below prescribed, based on the consideration contracted to be paid for such realty or on its fair market value determined in accordance with Section 6(E) of this Code, whichever is higher: Provided, That when one of the contracting parties is the Government the tax herein imposed shall be based on the actual consideration.
>
> (a) When the consideration, or value received or contracted to be paid for such realty after making proper allowance of any encumbrance, does not exceed One thousand pesos (P1,000) fifteen pesos (P15.00).
>
> (b) For each additional One thousand Pesos (P1,000), or fractional part thereof in excess of One thousand pesos (P1,000) of such consideration or value, Fifteen pesos (P15.00).
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> When it appears that the amount of the documentary stamp tax payable hereunder has been reduced by an incorrect statement of the consideration in any conveyance, deed,

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> instrument or writing subject to such tax the Commissioner, provincial or city Treasurer, or other revenue officer shall, from the assessment rolls or other reliable source of information, assess the property of its true market value and collect the proper tax thereon.

42. Accordingly, absent proof to the contrary, respondents assessment of deficiency DST in the total amount of P8,145,620.20 must be held as valid.

43. Assessments are presumed correct and made in good faith. The taxpayer has the duty of proving otherwise. In the absence of proof of any irregularities in the performance of official duties, an assessment will not be disturbed. Even an assessment based on estimates is *prima facie* valid and lawful where it does not appear to have been arrived at arbitrarily or capriciously.

44. The burden of proof is on the taxpayer contesting the validity or correctness of an assessment to prove not only that the Commissioner of Internal Revenue is wrong but the taxpayer is right. Otherwise the presumption of correctness of tax assessment stands. The presumption in favor of the correctness of tax assessment stands where evidence to the contrary is wanting.

45. All presumptions are in favor of the correctness of tax assessments. Dereliction on the part of petitioner to satisfactorily overcome the presumption of regularity and correctness of the assessment will justify the judicial upholding of said assessment notice."

The Pre-Trial Conference was set on April 16, 2015.[29] Thus, Petitioner's Pre-Trial Brief[30] was filed on April 13, 2015; while Respondent's Pre-Trial Brief[31] was filed on May 19, 2015.

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[29] Notice of Pre-Trial Conference, Docket, vol. I, p. 223.
[30] Docket, vol. I, pp. 238-244.
[31] Docket, vol. I, pp. 255-259.

On June 17, 2015, the parties filed their Joint Stipulation of Facts and Issues[32]. This was approved by the Court in the Resolution[33] dated June 25, 2015, which also terminated the Pre-Trial. Subsequently, the Court issued the Pre-Trial Order[34] on July 24, 2015.

During trial, petitioner presented the following witnesses: Ms. Melody Grace Ong Ngo[35], Finance Officer of petitioner; and Mr. Prudencio Tatunay[36], Managing Partner of P.F. Tatunay & Co., Certified Public Accountants.

The Formal Offer of Evidence for the Petitioner[37] was filed on November 12, 2015. In the Resolution[38] dated January 25, 2016, the Court admitted petitioner's Exhibits "P-1", "P2", "P-3 to P-5", "P6", "P-7", "P-8", "P-9", "P-10", "P-11", "P-12", "P-13", "P-14", "P-15", "P-16", "P-17", "P-18", "P-19", "P-20", "P-22", "P-23", "P-24", "P-24-1 to 9", "P-24-8-1", "P-25", "P-25-1 to "P-25-3", "P-25-2-1", "P-26", and "P-26-A".

Petitioner's documentary evidence are as follows:

Exhibit:	Description:
P-1	Formal Letter of Demand dated January 24, 2014
P-2	Details of Discrepancies
P-3 to P-5	Assessment Notices for IT, VAT, DST; all dated January 14, 2014 and received January 27, 2014
P-6	Administrative Protest prepared by Alba Romeo and Co., CPAs, dated February 25, 2014, received by BIR on the same date consisting of 28 pages (w/ Attachments, Annexes "A" to "P")
P-7	Articles of Incorporation of Premium Tobacco Redrying & Fluecuring Corporation ("PTRFC")
P-8	SEC Certification of PTFRC
P-9	BIR Certificate of Registration, District Office No. 07 Revenue Region No. 45, Taxpayer's Identification Number 000-315-532-000

[32] Docket, vol. I, pp. 372-377.
[33] Docket, vol. I, p. 379.
[34] Docket, vol. I, pp. 392-399.
[35] Minutes of the Hearing dated August 18, 2015, Docket, vol. I, pp. 445-448; Judicial Affidavit of Melody Grace Ong Ngo, Docket, vol. I, pp. 267-276; Supplemental Judicial Affidavit of Melody Grace Ong Ngo, Docket, vol. I, pp. 400-403.
[36] Minutes of the Hearing dated October 29, 2015, Docket, vol. II, pp. 505-506; Judicial Affidavit of Prudencio F. Tatutay, Docket, vol. I, pp. 452-465.
[37] Docket, vol. II, pp. 510-518.
[38] Docket, vol. II, pp. 792-793.

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P-10	Plan of *De facto* Merger between Premium Tobacco Redrying & Fluecuring Co., Inc. and Fortune Tobacco, dated October 29, 2009
P-11	Deed of Assignment between Premium Tobacco Redrying & Fluecuring Co., Inc. and Fortune Tobacco, dated October 29, 2009
P-12	Letter-request for confirmatory ruling with BIR Law Division prepared by SGV, dated February 23, 2010 and received by BIR on the same date
P-13	Letter of Authority No. 124-2010-00000068, dated May 14, 2010
P-14	Waiver of the Statute of Limitation of the NIRC executed on January 25, 2012
P-15	Waiver of the Statute of Limitation of the NIRC (dated October 2, 2012; to expire on September 30, 2013)
P-16	Preliminary Assessment Notice (PAN), received by the Petitioner on September 12, 2013
P-17	Details of Discrepancies
P-18	Position Paper of Premium Tobacco to Preliminary Assessment Notice, dated October 23, 2013; received by the BIR on October 24, 2013
P-19	Income Tax Return, Taxable year 2009
P-20	Audited Financial Statement, Taxable Year 2009
P-22	PRC ID No. 32367 of Prudencio F. Tatunay
P-23	PICPA ID of Prudencio F. Tatunay
P-24	Judicial Affidavits of Melody Grace O. Ngo
P-24-1 to 9 P-24-8-1	Signature of Melody Grace O. Ngo
P-25	Supplemental Judicial Affidavit of Melody Grace O. Ngo
P-25-1 to P-25-3 P-25-2-1	Signature of Melody Grace O. Ngo
P-26	Judicial Affidavit of Prudencio F. Tatunay
P-26-A	Signature of Prudencio F. Tatunay

Thereafter, respondent presented Revenue Officer Flor Jasmin Soriano[39] as his lone witness.

Respondent filed his Formal Offer of Evidence[40] on March 14, 2016. The Court admitted respondent's Exhibits "R-1", "R-2", "R-3",

[39] Minutes of the Hearing dated March 8, 2016, Docket, vol. II, pp. 794-795; Judicial Affidavit of Revenue Officer Flor Jasmin Soriano, Docket, vol. I, pp. 249-254.

[40] Docket, vol. II, pp. 800-804.

"R-4", "R-5", "R-6", "R-7", "R-8", "R-9", "R-10", "R-11", and "R-11-1" in the Resolution[41] dated June 3, 2016.

Respondent formally offered the following documents:

Exhibits:	Description:
R-1	Letter of Authority LOA 124-2010-0000068
R-2	Memorandum of Assignment dated 19 January 2011
R-3	A letter dated 17 February 2011 from respondent to petitioner, stating that RO Jasmin Soriano has been assigned to handle the tax audit for petitioner
R-4	Memorandum for the issuance of PAN
R-5	PAN which the petitioner received on 13 September 2013
R-6	A waiver for the period to assess "First Waiver" extending the period to assess up until 31 December 2012
R-7	A waiver for the period to assess "Second Waiver" extending the period to assess up until September 2013
R-8	A waiver for the period to assess "Third Waiver" extending the period to assess up until 30 June 2014
R-9	A memorandum for the issuance of the FAN
R-10	A Final Letter of Demand
R-11	Judicial Affidavit of RO Flor Jasmine Soriano
R-11-1	Signature of RO Flor Jasmine Soriano in her judicial affidavit

On July 7, 2016, respondent filed a Manifestation[42] stating that he is adopting the arguments he raised in his Answer dated December 22, 2014 as his Memorandum. The Memorandum for the Petitioner[43] was filed on July 11, 2016. Thus, in the Resolution[44] dated July 21, 2016, the instant Petition for Review was submitted for decision.

The parties stipulated the following main issue[45] for resolution of this Court:

> Whether or not petitioner is liable to pay deficiency Income Tax, VAT and DST assessments for taxable year

[41] Docket, vol. II, pp. 817-818.
[42] Docket, vol. II, pp. 822-824.
[43] Docket, vol. II, pp. 828-852.
[44] Docket, vol. II, p. 856.
[45] Issues, JSFI, Docket, vol. I, pp. 373.

2009 in the amount of Php179,020,319.37 inclusive of surcharges and interests.

The foregoing issue is broken down into the following sub-issues:[46]

1. Whether or not a de-facto merger has indeed transpired, which is not a taxable event.

2. Whether or not the Audit Result/Assessment Notices (FANs) were issued within the prescriptive period.

3. Whether or not the right of respondent to assess petitioner for alleged deficiency internal revenue taxes already prescribed.

4. Whether or not the waiver executed by petitioner had validly extended the period of assessment for 2009.

5. Whether a confirmatory ruling is required to make the tax-free provision of the law operative.

Petitioner argues that it is not liable for deficiency income tax amounting to ₱114,992,012.19. It contends that the transfer of properties constitutes *de facto* merger, a tax-free exchange. Petitioner alleges that its *de facto* merger possesses all the essential requirements to warrant the non-recognition of gains as it was undertaken for a *bona fide* business purpose. Moreover, petitioner avers that the element of permanence is not contemplated under the law and that compliance with Revenue Regulations No. 18-2001 on "confirmatory ruling" is not indispensable.

According to petitioner, the alleged gain on transfer of assets amounting to ₱222,390,592.46 is not taxable income. Petitioner asserts that respondent's assessment is a departure from Section 40 of the NIRC of 1997, as amended, on the computation of gain or loss.

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[46] Sub-issues, Pre-Trial Order, Docket, vol. I, p. 394.

Moreover, petitioner argues that it is not liable for deficiency VAT, citing Revenue Memorandum Ruling (RMR) No. 01-02 which states that as a tax consequence, the transfer of property by the transferor to the transferee in a *de facto* merger shall not be subject to VAT.

Finally, petitioner claims that it is not liable for deficiency DST as RMR No. 01-02 is clear when it states that it is the transferee and not the transferor that shall be liable to pay the DST. Considering that petitioner is the transferor, it has no obligation to pay the DST.

Respondent claims that the period to assess petitioner has not yet prescribed. Respondent alleges that a tax-free exchange is construed strictly against a taxpayer and liberally in favor of the State considering that it partakes the nature of tax exemption which is a derogation of the power of taxation of the State.

According to respondent, a taxpayer cannot unilaterally assert that a transaction it entered into was a tax-free exchange. Compliance with RR No. 18-2001 is an indispensable requirement to such claim.

Respondent argues that petitioner is liable to pay deficiency income tax, VAT, and DST. He avers that petitioner, not having secured the tax-free exchange ruling, should have initially treated the transaction as taxable and reported it to the BIR. Respondent likewise claims that the exchange transaction petitioner entered into failed to meet the requirement that the transaction must be undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation.

Moreover, respondent alleges that the element of permanence and not mere momentary holding is an element of a *de facto* merger. Respondent stresses that the requirement of permanence and not mere momentary holding is proof that the exchange transaction is for a *bona fide* business purpose and not for the purpose of escaping the burden of taxation.

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Furthermore, respondent reiterates that the exchange transaction petitioner entered into was not a tax-free exchange for failure to meet the elements provided under RMR No. 01-02. Accordingly, the exchange transaction is subject to the twelve percent (12%) VAT.

Lastly, respondent contends that petitioner is liable for deficiency DST as the transaction is subject to DST pursuant to Section 196 of the NIRC of 1997, as amended.

The Court shall first determine the timeliness of the filing of the present petition.

The Court has jurisdiction to entertain the present case.

Section 228 of the NIRC of 1997, as amended, governs the periods for filing an administrative protest and the subsequent appeal before this Court, to wit:

> "SEC. 228. *Protesting of Assessment.* – When the Commissioner or his duly authorized representative finds that proper taxes should be assessed, he shall first notify the taxpayer of his findings: *Provided, however*, That a preassessment notice shall not be required in the following cases:
>
> xxx xxx xxx
>
> The taxpayers shall be informed in writing of the law and the facts on which the assessment is made; otherwise, the assessment shall be void.
>
> Within a period to be prescribed by implementing rules and regulations, the taxpayer shall be required to respond to said notice. If the taxpayer fails to respond, the Commissioner or his duly authorized representative shall issue an assessment based on his findings.

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> **Such assessment may be protested administratively by filing a request for reconsideration or reinvestigation within thirty (30) days from receipt of the assessment in such form and manner as may be prescribed by implementing rules and regulations.** Within sixty (60) days from filing of the protest, all relevant supporting documents shall have been submitted; otherwise, the assessment shall become final.
>
> **If the protest is denied in whole or in part, or is not acted upon within one hundred eighty (180) days from submission of documents, the taxpayer adversely affected by the decision or inaction may appeal to the Court of Tax Appeals within thirty (30) days from receipt of the said decision, or from the lapse of the one hundred eighty (180)-day period; otherwise, the decision shall become final, executory and demandable.**" *(Emphasis supplied)*

In the present case, petitioner received the FLD[47] with attached Details of Discrepancies[48] and Audit Result/Assessment Notice Nos. ELTAD-II-IT-09-0002[49], ELTAD-II-VT-09-0002[50], and ELTAD-II-DS-09-0002[51], assessing petitioner for alleged deficiency income tax, VAT, and DST, inclusive of interests and surcharges, for taxable year 2009 on January 27, 2014. Within thirty (30) days from receipt of the FLD, petitioner filed its administrative protest[52] by way of a request for reconsideration on February 25, 2014.

Pursuant to Section 228 of the NIRC of 1997, as amended, respondent is given a period of one hundred eighty (180) days to act on petitioner's protest from February 25, 2014 or until August 24, 2014 since no supporting documents were filed subsequent to the filing of the protest. Since the 180-day period lapsed without action on the part of respondent, petitioner had thirty (30) days from August 24, 2014 or until September 23, 2014 within which to file an appeal before this Court. Clearly, petitioner timely filed the instant Petition for Review with this Court on September 22, 2014.

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[47] Exhibit "P-1", Docket, vol. II, pp. 519-520.
[48] Exhibit "P-2", Docket, vol. II, pp. 521-522.
[49] Exhibit "P-3", Dcket, vol. II, p. 523.
[50] Exhibit "P-4", Docket, vol. II, p. 524.
[51] Exhibit "P-5", Docket, vol. II, p. 525.
[52] Exhibit "P-6", Docket, vol. II, pp. 526-553.

Considering that the instant Petition for Review was filed on time, this Court has jurisdiction to take cognizance of the same pursuant to Section 7(a)(2) of RA No. 1125, as amended by RA No. 9282.[53]

The Court shall now proceed to determine the propriety of the deficiency tax assessments.

DEFICIENCY INCOME TAX – ₱114,992,012.19

Respondent computed the deficiency income tax assessment of ₱114,992,012.19 by imputing against petitioner an alleged gain on transfer of assets, subject of *de facto* merger, in the amount of ₱222,390,592.46 and disallowing petitioner's excess tax credits carried over to the succeeding year 2010 in the amount of ₱8,619,317.54, as shown below:[54]

Gross/Taxable Income per Return		-
Add: Adjustments		
(1) Gain on Transfer of Assets (De facto Merger)		₱ 222,390,592.46
Taxable Income Per Audit		₱ 222,390,592.46
Income Tax Due per Audit		₱ 66,717,177.74
Less:		
Tax Paid per Returns	-	
Prior Year's Excess Tax Credit	₱ 8,464,139.01	
Creditable Withholding Tax	250,000.00	
Total	₱ 8,714,139.01	
Less: Amount Carried Over as Tax Credit Next Year (2010) per ITR	8,619,317.54	94,821.47
Deficiency Income Tax		₱ 66,622,356.27
Add: Interest 20% p.a. 4/15/2010 11/30/2013 1325	72.60%	48,369,655.92
TOTAL AMOUNT DUE		**₱114,992,012.19**

[53] SEC. 7. *Jurisdiction.* - The CTA shall exercise:
(a) Exclusive appellate jurisdiction to review by appeal, as herein provided:
xxx
(2) Inaction by the Commissioner of Internal Revenue in cases involving disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties in relations thereto, or other matters arising under the National Internal Revenue Code or other laws administered by the Bureau of Internal Revenue, where the National Internal Revenue Code provides a specific period of action, in which case the inaction shall be deemed a denial.
[54] Exhibit "P-1", Docket, vol. II, p. 519.

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(1) Gain on Transfer of Assets (De facto Merger) – ₱222,390,592.46

On October 29, 2009, petitioner and Fortune Tobacco Corporation executed a Plan of *De facto* Merger[55] which required the transfer of more than 80% of the total assets of petitioner in exchange for the 1,215,526 shares of stocks and additional paid-in-capital (APIC) recorded in FTC. Since the transfer constitutes "substantially all the properties of another corporation", petitioner considered it a *de facto* merger, a tax-free exchange contemplated under Section 40(C)(2) and (6)(b) of the NIRC of 1997, as amended.

However, in the Details of Discrepancies[56] attached to the Formal Letter of Demand, respondent contends that the phrase "substantially all the properties of another corporation", as defined in BIR General Circular No. V-253, dated July 16, 1957, shall mean "the acquisition of one corporation of at least 80 percent of the assets, including cash, of another corporation which has the element of permanence and not merely momentary holding." Respondent views this requirement of permanence as essential to a *de facto* merger.

According to respondent, a *de facto* merger is the acquisition by one corporation of all, or substantially all, the properties of another corporation solely for stock usually undertaken for a *bona fide* business and not solely to escape the burden of taxation. For the acquisition to be considered substantial, at least 80% of the assets acquired must have an element of permanence; that is, not acquired for immediate disposal.

Respondent further argues that the *de facto* merger was effected in October 2009. However, the transferee (FTC) entered into a business combination in February 2010 wherein all its assets were transferred to a newly formed corporation. This allegedly means that the assets subject of a *de facto* merger in 2009 were subsequently transferred four months later. Thus, respondent posits that the

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[55] Exhibit "P-10", Docket, vol. II, pp. 677-681.
[56] Exhibit "P-2", Docket, vol. II, pp. 521-522.

requirement of "element of permanence and not merely momentary holding" has not been met, making the gains derived in the transaction taxable; hence, petitioner is liable for the corresponding deficiency income tax.

Petitioner counter-argues that the gain must be realized or received, actually or constructively, in order to be liable for the payment of income tax.

Petitioner points out that the subject of the deficiency assessment is allegedly the gain from the transfer of certain assets of petitioner to FTC in exchange for 1,215,526 shares of stocks and APIC recorded in the books of FTC. The gain in the amount of ₱222,390,592.46 was reflected in the Audited Financial Statements (AFS) as well as in the Annual Income Tax Return (ITR) as a non-taxable item.

The gain was arrived at by deducting the book values of land improvements and machinery and equipment from their assessed/fair values, as follows:

Fair Values of Assets:	
Land Improvements	₱ 6,436,430.46
Machinery and Equipment	245,167,226.53
Total	*251,603,656.99*
Less:	
Book Value of the Properties	
Land Improvements	51,879.40
Machinery and Equipment	29,161,185.13
Total	*29,213,064.53*
Gain on Transfer of Assets	**₱222,390,592.46**

Petitioner argues that the above computation shows that the alleged gain from which respondent assessed petitioner of deficiency income tax is only an appraisal increase that merely constitutes theoretical or paper gain since petitioner did not actually or constructively receive said gain.

Petitioner asserts that the subject transaction constitutes *de facto* merger, a tax-free exchange under Section 40(C)(2) and (6)(b) of the NIRC of 1997, as amended, in relation to RMR No. 01-02. Petitioner stresses that the NIRC of 1997, as amended and RMR No. 01-02 have provided only two requirements to constitute a tax-free *de facto* merger, to wit: (1) there must be a transfer of all or substantially all of the properties of the transferor corporation 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.

Clearly, petitioner posits, the "element of permanence and not merely momentary holding", is not one of the requirements stated by the law and RMR No. 01-02. The said "element" must have been mistakenly taken by respondent from the definition of the phrase "substantially all the properties of another corporation" in BIR General Circular No. V-253 dated July 16, 1957 quoted under said RMR as:

> "The phrase 'substantially all the properties of another corporation' is defined in BIR General Circular No. V-253 dated July 16, 1957 to mean 'acquisition by one corporation of at least 80% of the assets, including cash of another corporation,' which 'has the element of permanence and not momentary holding'."

Assuming again without however conceding that the "element of permanence and not momentary holding", is indeed an essential element of a *de facto* merger, petitioner remains steadfast on its stand.

Petitioner admits that on February 25, 2010, FTC and Philip Morris Philippine Manufacturing, Inc. (PMPMI) combined their respective businesses by transferring selected assets and liabilities to a new company called PMFTC, Inc. FTC and PMPMI hold equal economic interests in PMFTC, while Philip Morris International Inc. (PMI), the immediate and ultimate parent company, manages the day-to-day operations of PMFTC.

Petitioner avers that contrary to the claim of respondent, the business combination did not result in the transfer of all FTC's assets to the new entity as it is very clear that only selected assets of the

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parties are subject of the transfer. In addition, the business combination did not result in the dissolution of FTC. In fact, FTC has continuously operated its business despite the business combination in 2010. Both FTC and PMPMI continue to exist and are both major stockholders of PMFTC. This allegedly belies the position taken by respondent that FTC transferred all its assets, including the assets subject of the *de facto* merger, to the new entity.

In addition, petitioner states that whether said property would be disposed of subsequently by the transferee is already beside the point. It is a management prerogative to take said initiative. The disposal of property should not in any way be taken against the initial transfer of assets. Thus, the subsequent transfer has nothing to do with the "element of permanence and not momentary holding" taken by respondent.

Finally, petitioner argues that the *de facto* merger, which is the subject of assessment, pertains to taxable year 2009. The assessment for 2009 is separate and distinct from the transaction that happened in 2010. Respondent should allegedly limit the assessment to transactions involving 2009, *ergo*, the business combination which occurred in 2010 has nothing to do with the *de facto* merger that happened in 2009. Should the business combination have an effect on the *de facto* merger, the same should have been reflected in the assessment for taxable year 2010. Respondent should not consider the business in the 2009 assessment because the latter transpired after the close of taxable year 2009.

The Court agrees with petitioner.

There was no actual or constructive gain received in the exchange. The gain was merely theoretical.

Respondent's assessment was derived from petitioner's own declaration in its 2009 Statement of Comprehensive Income recognizing "Gain on transfer subject of *de facto* merger" as part of its

"Other Comprehensive Income (Loss)"[57] and in its 2009 Annual ITR as Non-taxable Income[58].

Petitioner reported "Gain on transfer subject of *de facto* merger" only for financial reporting purposes in line with the fair valuation rule under Philippine Accounting Standards (PAS) 16. This was disclosed in Note 6 of the AFS[59], where for purposes of booking up the shares of stock received on account of the transfer of assets, such shares were valued at fair market value of the assets (land improvements, machinery and equipment) given up. What was compared for purposes of determining the "gain" was the historical cost of the assets (land improvements, machinery and equipment) given up as against the fair market value of the same.[60] This is mere appraisal increase in the recorded value of the asset given up in the exchange and not actual income, as when the shares of stocks received in the exchange have higher value than that of the asset given up.

Even assuming that the subject transaction is taxable, petitioner would even suffer a loss if the appraised value of the assets given up would be compared against the par value and APIC of the shares of stocks acquired.

The assessed "Gain on exchange of assets" is merely a theoretical gain considering that petitioner did not actually or constructively receive said gain. Though reflected in petitioner's books as gain, it is however an unrealized gain for purposes of computing the income tax. In order that the same may be subjected to income tax, such income must be realized or received during the taxable year.[61]

In the case of *Chamber of Real Estate and Builders Association, Inc. vs. The Hon. Executive Secretary Alberto Romulo, et al.*[62], the Supreme Court held that:

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[57] Exhibit "P-20", Docket, vol. II, p. 760.
[58] Exhibit "P-19", Section E, line 123, Docket, vol. II, p. 756.
[59] Exhibit "P-20", Docket, vol. II, p. 777.
[60] Exhibit "P-6", Docket, vol. II, p. 534.
[61] *Chamber of Real Estate and Builders Association, Inc. vs. The Hon. Executive Secretary Alberto Romulo, et al.*, G.R. No. 160756, March 9, 2010.
[62] G.R. No. 160756, March 9, 2010.

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"xxx Income means all the wealth which flows into the taxpayer other than a mere return on capital. Capital is a fund or property existing at one distinct point in time while income denotes a flow of wealth during a definite period of time. Income is gain derived and severed from capital.[46] **For income to be taxable, the following requisites must exist**:

(1) there must be gain;
(2) **the gain must be realized or received**; and
(3) the gain must not be excluded by law or treaty from taxation." *(Emphasis supplied)*

Petitioner's transfer of properties constitutes *de facto* merger, a tax-free exchange under Section 40(C)(2) and (6)(b) of the NIRC of 1997, as amended, and a tax ruling is not a condition precedent for its application.

Section 40(C)(2) of the NIRC of 1997, as amended, is clear as to the non-recognition of gain or loss in the case of a plan of merger or consolidation, to wit:

"SEC. 40. *Determination of Amount and Recognition of Gain or Loss. –*

xxx xxx xxx

(C) *Exchange of Property. –*

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

(2) *Exception.* – No gain or loss shall be recognized if in pursuance of a plan of 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; or"

In relation to this, the term "merger" or "consolidation" is defined under Section 40(C)(6)(b) of the same code, as follows:

"SEC. 40. *Determination of Amount and Recognition of Gain or Loss.* –

xxx xxx xxx

(C) *Exchange of Property.* –

xxx xxx xxx

(6) *Definitions.* –

xxx xxx xxx

(b) 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 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."

Further, RMR No. 01-02, which clarified and harmonized the existing guidelines on the tax consequences of a *de facto* merger under

Section 40(C)(2) and (6)(b) of the NIRC of 1997, as amended, provides that:

"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 *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*.' (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. xxx

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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.* — . . . 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)."

From the foregoing provisions of Section 40(C)(2) and (6)(b) of the NIRC of 1997, as amended and RMR No. 01-02, for taxation purposes, there are two (2) kinds of merger or consolidation, to wit: (1) ordinary merger or consolidation and (2) *de facto* merger.

As correctly pointed out by petitioner, the said provisions of law and RMR have provided only two requirements to constitute a tax-free *de facto* merger: (1) there must be a transfer of all or substantially all of the properties of the transferor corporation 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.

The definition of the phrase "substantially all the properties of another corporation" is provided for in RMR No. 01-02, which states:

> "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'."

The statement "the element of permanence and not merely momentary holding" pertains to the permanent transfer of the assets to the transferee corporation and not merely momentary or temporary holding. This means that the transferred assets cannot be returned to the transferor corporation. The transfer of properties should not be merely temporary. This interpretation makes the most sense as it would relate to the second requisite that the *de facto* merger is undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation.

However, any subsequent disposition of the properties involved in the exchange shall be subject to the corresponding income tax on the gain or income derived by the transferor or transferee corporation.

In connection with the first requisite of transferring substantially all of the properties of the transferor corporation solely for stock of the transferee corporation, the same was complied with by petitioner.

The Deed of Assignment[63], which was executed pursuant to the Plan of *De facto* Merger between petitioner and FTC, shows that petitioner transferred to FTC the following assets in the total amount of ₱62,424,182.64 and liabilities in the total amount of ₱78,098.76 or a net asset value of ₱62,346,084.88:[64]

ASSETS	
CASH	₱ 1,000,000.00
ACCOUNTS RECEIVABLE	19,864,800.00
ADVANCES TO SUPPLIERS	750,350.65
LAND IMPROVEMENTS – NET	51,879.40
BUILDING IMPROVEMENTS – NET	11,466,069.48
MACHINERY AND EQUIPMENT – NET	29,161,185.13
TRANSPORTATION EQUIPMENT – NET	32,574.26
OFFICE MACHINES – FUR & FIX – NET	97,133.72
LAB & MEDICAL EQUIPMENT – NET	190.00

[63] Exhibit "P-11", Docket, vol. II, pp. 682-685.
[64] Exhibit "P-11", Docket, vol. II, p. 685.

TOTAL ASSETS	**₱62,424,182.64**
LIABILITIES	
ACCOUNTS PAYABLE	₱ 78,098.76
TOTAL LIABILITIES	**₱ 78,098.76**
NET ASSETS TRANSFERRED	**₱62,346,084.88**

In consideration of the above transfer, petitioner received 1,215,526 shares of the capital stock of FTC with par value of ₱1.00/share or ₱1,215,526.00 and APIC recorded in FTC of ₱61,130,558.88, computed below:[65]

Shares of stocks of FTC:	
1,215,526 shares at P1.00 per share	₱ 1,215,526.00
APIC-FTC	61,130,558.88
Total	**₱ 62,346,084.88**

As can be gleaned from above, the assets involved in the exchange can be considered as permanent assets of petitioner. Also, based on petitioner's Statements of Financial Position as of December 31, 2009 and December 31, 2008, the transferred assets comprised substantially of petitioner's total assets prior to the transfer.

The second requisite of a *de facto* merger was likewise satisfied. It can be gleaned from the Plan of *De facto* Merger[66] executed between petitioner and FTC that such *de facto* merger "will allow the reorganization of their group holding structures which will bring about reduced operating and administrative expenses owing to the elimination of extraneous facilities, simplified management, and optimal use of resources."[67] Hence, the purpose for the *de facto* merger was mainly to streamline processes and maximize resources, which is a *bona fide* business purpose.

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[65] Exhibit "P-11", Docket, vol. II, p. 683.
[66] Exhibit "P-10", Docket, vol. II, pp. 677-681.
[67] Exhibit "P-10", Docket, vol. II, p. 678.

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As to respondent's claim[68] that a tax-free exchange ruling must be secured as required under RR No. 18-01 before petitioner can avail of the tax exemption under Section 40(C)(2) of the NIRC of 1997, as amended, the Court finds no basis for such requirement.

In the case of *Commissioner of Internal Revenue vs. Dakudao & Sons, Inc.*[69], the CTA *En Banc* ruled that RR No. 18-01 relied upon by respondent merely provides the guidelines in monitoring tax-free exchanges of property, and in order that, in cases of subsequent sales of said property, they shall be taxed accordingly. Therefore, the BIR ruling or certification required under RR No. 18-01 is for determining gain or loss on a subsequent sale or disposition of property subject of the tax-free exchange, and not a precondition for a taxpayer to be entitled to an exemption. There is nothing therein explicitly requiring a party, in exchanging property for shares of stocks, to first secure a BIR confirmatory certification or tax ruling before it can avail itself of tax exemption.

Clearly, petitioner's transfer of substantial assets to FTC in exchange of the latter's shares of capital stock and APIC constitutes a *de facto* merger, a tax-free exchange under Section 40(C)(2) and (6)(b) of the NIRC of 1997, as amended.

(2) Excess Tax Credits carried over to succeeding year - ₱8,619,317.54

In arriving at petitioner's alleged deficiency income tax liability for the year 2009, respondent disallowed the excess tax credits of ₱8,619,317.54 reflected in petitioner's 2009 Annual ITR[70]. Respondent, however, did not explain the basis for the disallowance of the excess tax credits, thus, pursuant to Section 228 of the NIRC of 1997, as amended, this item of assessment shall be considered void.

Furthermore, it was improper for respondent to disallow the said excess tax credits because any tax benefit derived by petitioner from the carry-over of the said amount redounds to the succeeding year

[68] Respondent's Answer, pars. 14-17 and 21-25, Docket, vol. I, pp. 210 and 212.
[69] CTA EB No. 1150 (CTA Case No. 8501), May 12, 2015.
[70] Exhibit "P-19", line 33, Docket, vol. II, p. 754.

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2010. Since the tax benefit will be in the succeeding year, at most, petitioner may only be assessed in the said succeeding year.

In fine, respondent's deficiency income tax assessment of ₱114,992,012.19 is devoid of merit and must be cancelled and/or withdrawn.

DEFICIENCY VALUE-ADDED TAX - ₱55,882,686.98

On the basis that the transfer of assets, subject of a *de facto* merger, did not meet the essential element of "permanence" as alleged in the deficiency income tax assessment, respondent, citing Section 14 of Revenue Regulations No. 04-07, assessed petitioner of deficiency 12% VAT on the following appraised values of the assets transferred (excluding Cash, Accounts Receivable and Advances to Suppliers):

Taxable Sales/Receipts per VAT Return		₱ 5,000,000.00
Add: Adjustments		
(1) Taxable Exchange (De facto Merger)		
Investment at Appraised Value	₱ 284,736,677.34	
Less: Assets Transferred not Subject to VAT		
Cash	₱ 1,000,000.00	
Accounts Receivable	19,864,800.00	
Advances to Suppliers	750,350.65	
Total Not Subject to VAT	₱ 21,615,150.65	263,121,526.69
Taxable Sales/Receipts per Audit		₱ 268,121,526.69
OUTPUT TAX PER AUDIT		₱ 32,174,583.20
Less: Input Tax Per Return		553,140.26
VAT PAYABLE PER AUDIT		₱ 31,621,442.94
Less: VAT Paid Per Return		46,859.74
Deficiency VAT		₱ 31,574,583.20
Add: Interest 20% p.a. 1/25/10 to 11/30/13 1405	76.99%	24,308,103.78
TOTAL AMOUNT DUE		**₱55,882,686.98**

Petitioner's transfer of substantial assets in exchange for shares of stocks in FTC is in the nature of a stock subscription and not sale of assets. In the case of *Delpher Trades Corporation and Delfin Pacheco*

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vs. Intermediate Appellate Court and Hydro Pipes Philippines, Inc.[71], the Supreme Court ruled:

> "After incorporation, one becomes a stockholder of a corporation by subscription or by purchasing stock directly from the corporation or from individual owners thereof (Salmon, Dexter & Co. v. Unson, 47 Phil. 649, citing Bole v. Fulton [1912], 233 Pa., 609). In the case at bar, in exchange for their properties, the Pachecos acquired 2,500 original unissued no par value shares of stocks of the Delpher Trades Corporation. Consequently, the Pachecos became stockholders of the corporation by subscription. **'The essence of the stock subscription is an agreement to take and pay for original unissued shares of a corporation, formed or to be formed.'** (Rohrlich 243, cited in Agbayani, Commentaries and Jurisprudence on the Commercial Laws of the Philippines, Vol. III, 1980 Edition, p. 430) It is significant that the Pachecos took no par value shares in exchange for their properties.
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> xxx xxx xxx
>
> **The 'Deed of Exchange'** of property between the Pachecos and Delpher Trades Corporation **cannot be considered a contract of sale. There was no transfer of actual ownership interests** by the Pachecos **to a third party**. The Pacheco family **merely changed their ownership from one form to another. The ownership remained in the same hands**. xxx" *(Emphasis supplied)*

In the instant case, petitioner entered into a Plan of *De facto* Merger whereby it transferred substantially all of its assets in exchange for shares of stocks of FTC. Thus, there was no sale since petitioner's assets were only transformed into another form of asset. The assets merely changed from land, building, machinery and equipment, etc., to one of an intangible asset – shares of stocks. Consequently, this should not be subjected to VAT.

Moreover, RMR No. 01-02 provides for the value-added tax treatment of tax-free exchanges, including a *de facto* merger, to wit:

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[71] G.R. No. L-69259, January 26, 1988.

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"III. TAX CONSEQUENCES

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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 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**:
>
> xxx xxx xxx
>
> 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 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 a statutory merger by operation of law." *(Emphasis supplied)*

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The above-mentioned RMR is in consonance with Section 4.106-8(b)(3) of RR No. 16-05, as amended, which provides that transfer by way of a merger is not subject to VAT, thus:

> "SECTION 4.106-8. *Change or Cessation of Status as VAT-registered Person.* –
>
> xxx xxx xxx
>
> (b) Not subject to output tax
>
> The VAT shall not apply to goods or properties existing as of the occurrence of the following:
>
> xxx xxx xxx
>
> (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."

Since petitioner's transfer of substantial assets to FTC in exchange for the latter's shares of stocks is considered as a legitimate *de facto* merger not subject to tax, respondent's deficiency VAT assessment in the amount of ₱55,882,686.98 is hereby cancelled.

DEFICIENCY DOCUMENTARY STAMP TAX – ₱8,145,620.20

Finding that the subject transfer of assets is a taxable transaction, respondent imposed against petitioner a deficiency documentary stamp tax on conveyance of real estate pursuant to Section 196 of the NIRC of 1997, as amended, computed as follows:

TRANFER OF ASSETS (De facto Merger)		
Land Improvements		₱ 6,436,430.46
Machinery and Equipment		245,167,226.53
Building Improvements		11,466,069.48
TOTAL		263,069,726.47

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Documentary Stamp Tax Due (1.5%)		₱ 3,946,050.00
Add: Increments		
Surcharge 25%	₱ 986,512.50	
Interest 20% p.a. Until Nov 30, 2013 81.42%	3,213,057.70	4,199,570.20
TOTAL AMOUNT DUE		**₱ 8,145,620.20**

The assessment must be cancelled.

As stated earlier, petitioner's transfer of substantial assets in exchange for FTC's shares of stocks constitutes a *de facto* merger under Section 40(C)(2) and (6)(b) of the NIRC of 1997, as amended. In relation thereto, Section 199 of the NIRC of 1997, as amended by Section 9 of Republic Act No. 9243, explicitly exempts from DST the transfer of properties by virtue of tax-free exchanges, *e.g.*, *de facto* merger, under Section 40(C)(2) of the NIRC of 1997, as amended, to wit:

> "SEC. 199. *Documents and Papers Not Subject to Stamp Tax.* – The provisions of Section 173 to the contrary notwithstanding, the following instruments, documents and papers shall be exempt from the documentary stamp tax:
>
> xxx xxx xxx
>
> (m) Transfer of property pursuant to Section 40(C)(2) of the National Internal Revenue Code of 1997, as amended."

The exemption on transfer of property pursuant to Section 40(C)(2) referred to above pertains to the DST due on the deed transferring the property.

On the other hand, the original issuance of shares of stocks in exchange of the said property is subject to the DST pursuant to Section 174 of the NIRC of 1997, as amended. However, it is the transferee corporation, *i.e.*, FTC, which is liable to pay the DST and not the transferor-petitioner. Section 174 reads as follows:

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> "SEC. 174. *Stamp Tax on Original Issue of Shares of Stock.* – On every original issue, whether on organization, reorganization or for any lawful purpose, of shares of stock by any association, company or corporation, there shall be collected a documentary stamp of One peso (P1.00) on each Two hundred pesos (P200), or fractional part thereof, of the par value, of such shares of stock: *Provided*, That in the case of the original issue of shares of stock without par value, the amount of the documentary stamp tax herein prescribed shall be based upon the actual consideration for the issuance of such shares of stock: *Provided, further*, That in the case of stock dividends, on the actual value represented by each share."

The prescriptive periods provided under Sections 203 and 222 of the NIRC of 1997, as amended, will not apply.

Since petitioner is exempt from paying income tax, VAT, and DST on the subject transfer of assets, the Court will no longer address the issue of prescription.

WHEREFORE, premises considered, the instant Petition for Review is hereby **GRANTED**. Accordingly, the assessments issued by respondent against petitioner for taxable year 2009 covering deficiency income tax, value-added tax, and documentary stamp tax are hereby **CANCELLED AND WITHDRAWN**.

SO ORDERED.

Cielito N. Mindaro-Grulla
CIELITO N. MINDARO-GRULLA
Associate Justice

WE CONCUR:

ROMAN G. DEL ROSARIO
Presiding Justice

ERLINDA P. UY
Associate Justice

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

ROMAN G. DEL ROSARIO
Presiding Justice
Chairperson, 1st Division