REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

J. L. MANNING, W. D. McDONALD,
and E. E. SIMMONS,
Petitioners,

versus

Oct. 30/67

CTA CASE NO. 1626

COMMISSIONER OF INTERNAL
REVENUE,
Respondent.

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D E C I S I O N

This is an appeal from the decisions of respondent Commissioner of Internal Revenue, all dated April 14, 1965, assessing and demanding from J. L. Manning, W. D. McDonald and E. E. Simmons, the respective sums of ₱2,430,067.92, ₱2,423,767.92 and ₱2,436,729.12, or a total of ₱7,290,564.96, as deficiency income tax, inclusive of interest, and 50% surcharge, on their receipt of stock dividends from the Manila Trading & Supply Co. in 1958.

In 1952, Julius S. Reese owned 24,700 shares of the Manila Trading & Supply Co. (Mantrasco for short), which had an authorized capital of ₱2,500,000.00 divided into 25,000 shares, par value of ₱100.00 each. Three hundred shares were owned by petitioners (pp. 4-5, t.s.n.).

In pursuance of the desire of Julius S. Reese that, in the event of his death, Mantrasco, the

Manila Trading & Supply Co., Guam Inc. and the Port Motors, Inc., continue to operate under the supervision of petitioners, a trust agreement was entered into on February 29, 1952, by and among Julius S. Reese, designated as Owner; Manila Trading & Supply Co., as the Company; Ross, Selph, Carrascoso and Janda, as Trustees; and petitioners, as Managers. Paragraph 4 of the agreement provides as follows:

> "4. (a) Upon the death of the OWNER and the receipt by the TRUSTEES of the initial payment from the company purchasing the OWNER'S SHARES, the TRUSTEES shall cause the OWNER'S SHARES to be transferred into the name of such company and such company shall thereupon transfer such shares into the name of the TRUSTEES and the TRUSTEES shall hold such shares until payment for all such shares shall have been made by the company as provided in this agreement." (pp. 53-54, CTA rec.)

Julius S. Reese died on October 19, 1954. The provision of the agreement relative to the transfer of the shares to the name of Mantrasco could not be immediately implemented because the corporation did not have sufficient surplus with which to purchase the 24,700 shares owned by the deceased. On February 2, 1955, after partial payment for the shares was made, the certificate of 24,700 shares in the name of Julius S. Reese was cancelled and a new certificate was issued in lieu thereof in the name of Mantrasco and on the same date it was endorsed to Ross, Selph, Carrascoso and Janda, as trustees (p. 8, t.s.n.).

On December 22, 1958, a special meeting of the stockholders of Mantrasco was held wherein the following resolution was unanimously passed:

> "RESOLVED that the 24,700 shares in the Treasury be reverted back to the capital of the company as a stock dividend to be distributed to shareholders of record at the close of business on December 22, 1958, in accordance with action of the Board of Directors at its meeting on December 19, 1958, which action is hereby approved and confirmed." (p. 210, BIR rec.)

On November 25, 1963, the entire purchase price was finally paid by Mantrasco. On May 4, 1964, the trust agreement was terminated and the trustees delivered to Mantrasco, through petitioners, all the shares which the latter held in trust (Exh. B, pp. 36-44, CTA rec.; pp. 11-12, t.s.n.). Aside from the December 22, 1958 declaration of stock dividends by Mantrasco, stock dividends were also declared during the life of the trust agreement. However, during the said period no cash dividend was declared (pp. 14-15, t.s.n.).

As early as July, 1963, respondent had caused the investigation of the respective income tax liabilities for 1958 of petitioners arising from the receipt by each of them of stock dividends from Mantrasco. Respondent's examiners recommended the issuance of deficiency income tax assessments (Exh.

1, *supra*), and in letters, all dated August 20, 1963, he proposed the adjustment of petitioners' taxable income (p. 79, BIR rec.). On March 30, 1964, petitioners, through their accountant, Sycip, Gorres, Velayo & Co., protested the proposed assessments and filed their memorandum to support their claim that the stock dividends were not taxable (Exhs. C & 22, pp. 212-225, BIR rec.). Notwithstanding said protest, respondent, on April 14, 1965, separately assessed petitioners in the following amounts:

<u>J. L. Manning</u> - 90-AR-41313-64/58

Net income per return	₱ 138,491.47
Add: Undeclared treasury stock dividends	2,657,886.00
Net income per investigation..	₱2,796,377.47
Less: Personal & additional exemptions	4,800.00
Amount subject to tax	₱2,791,577.47
Tax due thereon	₱1,487,126.00
Less: Amount already assessed	40,657.00
B a l a n c e	₱1,446,469.00
Add: 50% surcharge	723,234.50
½% monthly interest from 6-20-59 to 6-20-62	260,364.42
TOTAL AMOUNT DUE & COLLECTIBLE	₱2,430,067.92

(Exh. 28, pp. 417-418, BIR rec.)

<u>M. D. McDonald</u> - 90-AR-42445-64/58

Net income per return	₱ 119,136.71
Add: Undeclared treasury stock dividends	2,657,887.00
Net income per investigation..	₱2,777,023.71
Less: Personal & additional exemptions	4,200.00
Amount subject to tax	₱2,772,823.71
Tax due thereon	₱1,475,874.00
Less: Amount already assessed	33,155.00
B a l a n c e	₱1,442,719.00

B a l a n c e	₱1,442,719.00
Add: 50% surcharge	721,359.50
½% monthly interest from 6-20-59 to 6-20-62 ...	259,689.42
TOTAL AMOUNT DUE & COLLECTIBLE	₱2,423,767.92

(Exh. 27, pp. 413-414, BIR rec.)

E. K. Simmons - 90-AR-42448-64/58

Net income per return	₱ 156,902.07
Add: Undeclared treasury stock dividends	2,657,887.00
Net Income per investigation ..	₱2,814,789.07
Less: Personal exemption	3,000.00
Amount subject to tax	₱2,811,789.07
Tax due thereon	₱1,499,253.00
Less: Amount already assessed..	48,819.00
B a l a n c e	₱1,450,434.00
Add: 50% surcharge	725,217.00
½% monthly interest from 6-20-59 to 6-20-62 ...	261,078.12
TOTAL AMOUNT DUE & COLLECTIBLE	₱2,436,729.12

(Exh. 26, pp. 408-409, BIR rec.)

On May 5, 1965, petitioners instituted the present petition for review.

The only issue to be resolved in this case is whether or not the value of the stock dividends received by petitioners is taxable income.

Petitioners contend that the dividends they received from Mantrasco out of its treasury stock are stock dividends not taxable under Section 83(b) of the Revenue Code. On the other hand, respondent claims that the stock dividends comprise in reality distribution of the property of the corporation and therefore taxable to the recipient.

The law and regulations pertinent to the question at issue provide:

SEC. 83. Distribution of dividends or assets by corporations.—(a) Definition of dividends.—The term "dividends" when used in this Title means any distribution made by a corporation to its shareholders out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in money or in other property.

Where a corporation distributes all of its assets in complete liquidation or dissolution, the gain realized or loss sustained by the stockholder, whether individual or corporate, is a taxable income or a deductible loss, as the case may be.

(b) Stock dividend.—A stock dividend representing the transfer of surplus to capital account shall not be subject to tax. However, if a corporation cancels or redeems stock issued as a dividend at such time and in such manner as to make the distribution and cancellation or redemption, in whole or in part, essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock shall be considered as taxable income to the extent that it represents a distribution of earnings or profits accumulated after March first, nineteen hundred and thirteen. (National Internal Revenue Code; underlining supplied.)

SEC. 251. Dividends paid in property.—Dividends paid in securities or other property (other than its own stock), in which the earnings of a corporation have been invested, are income to the recipients to the amount of the full market value of such property when receivable by individual stockholders. When receivable by corporations, the amount of such dividends includible for purposes of the tax on corporations are specified in Section 24 of the Code. (See also section 250 of these regulations.) A dividend paid in stock of another corporation is not a stock dividend, even though the stock distributed was acquired through the transfer by the corporation declaring the dividends of property to the corporation the stock of which is distributed as a dividend. Where a corporation declares a dividend payable in a stock of another corporation, setting aside the stock to be so distributed and notifying the stockholders of its action, the income arising to the recipients of such stock is its market value at the time the dividend becomes payable. Script dividends are subject to tax in the year in which the warrants are issued.

SEC. 252. Stock dividend.— A stock dividend which represents the transfer of surplus to capital account is not subject to income tax. However, a dividend in stock may constitute taxable income to the recipients thereof notwithstanding the fact that the officers or directors of the corporation (as defined in section 84) choose to call such distribution as a stock dividend. The distinction between a stock dividend which does not, and one which does, constitute income taxable to the shareholders is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old rep-

> resenting the same proportionate interest in the net assets of the corporation as did the old. (Revenue Regulations No. 2; underscoring supplied.)

There is no dispute that Julius S. Reese owned 24,700 shares of Mantrasco which were sold to the corporation in 1955. The corporation held the shares in its treasury and, on December 22, 1958, <u>it declared stock dividends out of said treasury stock</u> and distributed them to petitioners in proportion to their shareholdings. Thus, dividends were declared, but these dividends were paid by Mantrasco <u>in its own stock</u>, i.e., the treasury stocks in question. Section 251 of the Income Tax Regulations, implementing Section 83 of the Revenue Code, provides that "dividends paid in securities or other property (<u>other than its own stock</u>), in which the earnings of a corporation have been invested, are income to the recipients . . ." Needless to say, the very regulations evidently do not include the stock dividends in question, which are stocks of Mantrasco itself, as income taxable to petitioners.

We cannot accept respondent's claim that the distribution of the stock dividends in question resulted in a change in the proportionate interest of the stockholders in the corporation.

Section 252 of the Income Tax Regulations establishes the rule for determining the taxability of a stock dividend. Under it, a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, is a stock dividend which does not constitute income taxable to the stockholder. And a stock dividend does not constitute income if the new shares confer no different rights or interests than did the old - the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old. Inferentially, the converse situation would make the stock dividend taxable.

It appears that in 1952, Mantrasco had an authorized capital stock of ₱2,500,000.00 divided into 25,000 shares with a par value of ₱100 each share. All the shares were common, outstanding and fully paid. Julius S. Reese owned 24,700 shares and the rest were owned by petitioners at 100 shares each. Upon the death of Reese and in accordance with the trust agreement, Mantrasco purchased the 24,700 shares in 1955, leaving petitioners the sole stockholders of the corporation, in equal shares, each owning one-third of the outstanding shares of stock. Petitioners, the minority stockholders, became the majority stockholders after the purchase of the shares of Mr. Reese. The purchased shares were held in the treasury of the corporation until December 22, 1958 when it declared stock dividends out of the treasury shares. It is evident that, after the declaration of the stock dividends, petitioners continued to own the same proportionate interest in the corporation, the same equity as before the stock dividends were declared, i.e., each continued to own one-third of the outstanding shares of stock of said corporation. The only change that occurred after the declaration of the stock dividends was in the number of shares held by them. Instead of having only 100 shares each, petitioners' shareholdings increased to 8,333.33 (100 plus 1/3 of 24,700) each after the stock dividend declaration. Even respondent's examiner, Dionisio M. Herrera, admitted that the equity of each of the petitioners in Mantrasco before and after the declaration of stock dividend was the same (pp. 44-46, t.s.n.).

It is significant to mention at this juncture that our Revenue Code was patterned after the Internal Revenue Law of the United States (See Poco v. Posadas, 64 Phil. 640). The test which we have adopted as to the taxability or non-taxability of stock dividend is the "change in proportionate interest" test (Sec. 252, Income Tax Regs., *supra*) which was also the test prevailing in the United States until the law was amended in 1954 (Sec. 305

(a), 1954 U. S. Revenue Code) laying down the general rule that there is no tax to the stockholder upon receipt by him of stock of the distributing corporation (whether the same or different from the class of stock he holds) as a stock dividend (See Michie's Federal Tax Handbook, par. 612, 1964 ed.). Since our law (Sec. 83, Commonwealth Act No. 466) on stock dividend remains unchanged from the time it was enacted to the present, the jurisprudence in the United States prevailing prior to the 1954 amendment has a strong persuasive effect in the interpretation of said legal provision.

The case of Schmitt v. Commissioner of Internal Revenue, 208 F 2d 819 is squarely in point. The facts of this case show that Schmitt and Lehren on December 31, 1946, owned, respectively, 168 shares and 199 shares in Wolverine Supply & Mfg. Co. On that date the Citizens National Bank of Washington also held 892 shares which it returned to Wolverine on April 21, 1947. As a result of this return, there was left in the treasury of the company 1486 shares of its capital stock. Schmitt and Lehren owned all the rest. In July 1947, the shares thus held in the treasury of the corporation were distributed to shareholders Schmitt and Lehren in proportion to their holdings. The Court ruled that:

"[1] On the above statement of facts it would appear that no taxable event has occurred. To quote previous language from this Court: 'The Supreme Court has decided where the proportional interest of the stockholders remains the same and where stock dividends are paid strictly in kind, where there is no severance of capital, that the incidence of income taxation does not occur.' Wiegand v. Commissioner, 3 Cir., 1952, 194 F. 2d 479, 481. The Supreme Court cases are there listed and discussed.

"[2] Unless facts to be recited later change this case, the distribution described above fits clearly into the type of transaction first held nontaxable in Eisner v. Macomber, 1920, 252 U.S. 189, 40 S. Ct. 189, 64 L. Ed. 521, and so held ever since. Only two persons owned any stock of this corporation. The rest of it had been acquired by the corporation and was in its treasury. The two shareholders got certificates for these shares which had been held in the treasury in the same proportion as that evidenced by certificates which they already held. Nothing was changed thereby except that they had two pieces of paper instead of one. The proportion of the corporation's assets owned by each of the shareholders was just the same as it was before. Neither was richer; neither was poorer. The situation appears to be just the same as the one that has been presented in all the cases involving taxability or nontaxability of stock dividends.

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"Whether this was a plan or not we do not see how the distribution of the common stock held in the treasury in proportion to what the shareholders already owned was a taxable event. During these years when Wolverine was buying its own shares it, of course, was subject to income tax as a corporation. Mrs. Green was subject to tax on whatever profit she made by the sale of these shares to the corporation. But what happened to warrant imposing a tax upon Schmitt and Lehren? If one owns a piece of real estate and, because of its favorable location in a city, the land becomes increasingly valuable over a period of years, the owner is not subject to income taxation upon the annual increase of value. In the same way, if a man owns shares in a corporation which gradually become more valuable through the years he is not taxed because of the increase in value even though he is richer at the end of each year than he was at the end of the year before. If he disposes of that which has increased, of course he must pay tax upon his profit. All of this is hornbook law of taxation; nobody denies it.

"But if we take the proposition that increase in value is not a subject for tax until there is some sale or other disposal to make a taxable event, and then add to that the proposition that a stock distribution which does not change any proportional interest is not a taxable event, then it seems to us that we have this case. Schmitt and Lehren undoubtedly became richer because of their ownership of shares in Wolverine, which, for several years at any rate, was a highly prosperous company. They did not become any richer when each got another piece of paper evidencing more shares but not any greater proportional interest in the company's assets than they had before.

"Some stress is laid upon the company's purchase, prior to the agreement with Mrs. Green, of the small number of shares held by two employees. These employees had an agreement whereby they could repurchase their shares later and in 1947 did do so. We see the facts. But we do not see any significance that these facts have with regard to the stock distribution to Schmitt and Lehren.

"These taxpayers have had the good luck to have something which they own become more valuable. When they sell it they will have to pay tax on the profit. But until they do they are in the same situation as anyone who holds an object which gains in value as the years go by. The stock dividend did not change the situation."

In David Bruckheimer, 46 BTA 234, the taxability of dividends paid in treasury stock was at issue. The M. Bruckheimer Sons, Inc. purchased, for cash from its surplus, some of its own common stock from some stockholders. The stock was subsequently distributed as dividend to all its stockholders. The U. S. Board of Tax Appeals, holding that the distribution of treasury common stock to the stockholders did not constitute income to the distributees, said:

> "The corporation involved here had only one kind of stock outstanding, common stock. The stock which was distributed, the treasury stock, was distributed to all of the stockholders in proportion to their stockholdings in December of 1937. In Eisner v. Macomber, 252 U. S. 189, it was held that a distribution of common stock as a dividend on common stock did not constitute income. Is not that holding applicable here? Does it make a material difference that the stock distributed here was treasury stock? It is clear that the distribution of the stock in question did not confer any different rights or interests than did the stock already held by the stockholders. The new certificates, plus the old, represented the same proportionate interest in the net assets of the corporation as did the old. Cf. Koshland v. Helvering, supra. In our opinion it makes no difference that the stock which was distributed was treasury stock."

In James Kay v. Commissioner of Internal Revenue, 28 BTA 331, the Board ruled that under the circumstances of the case, the distribution by the corporation of 1,762 shares held in treasury amounted to a stock dividend, and the price paid for such stock by the corporation could not be added to the cost of petitioners' shareholdings, in determining the gain realized by petitioners from a subsequent sale of the stock owned by them. Then the Board said:

> "We hold that the 1,762 shares of stock were purchased by the corporation in 1914 for its own account and were distributed as a stock dividend in 1917 among the remaining shareholders in proportion to their holdings. A corporation which has acquired its own stock may cancel the same, or hold it as treasury stock, or distribute it among the shareholders, without changing its financial situation. During the period the corporation owned the 1,762 shares and after their distribution to the shareholders each shareholder's proportionate interest in the total outstanding shares was exactly the same. The distribution added nothing to the interest of these shareholders; the additional shares so received were acquired by them without cost."

Respondent cites the case of Berthel Gmur, et al. v. Collector of Internal Revenue, CTA Case No. 171, July 20, 1954, to support his position that the stock dividends in question are taxable. The Gmur case is not analogous to the present case. The facts of said case are stated in the decision as follows:

"The petitioners' authorized capital

is ₱400,000.00, divided into 2,000 shares at ₱200.00 per share. As of June 29, 1948, 1996 shares were issued and subscribed, leaving only 4 shares unissued. The petitioners acquired from its stockholders 327 shares of its own capital, thus converting said stocks to treasury stocks. The petitioners had surplus profits to distribute but instead of distributing them in cash, what it did was to retire the treasury stocks, thus reducing its authorized capital and creating artificially unissued stocks consisting of the same treasury stocks by the simple expedient of declaring stock dividends for the same number of 327 shares plus the four remaining unissued shares. This is evidenced by the petitioners' record in which it appears that on 'June 30, 1948, at a stockholders meeting, it was decided to retire the treasury stocks and thus made a debit of ₱65,400.00. At the same meeting, the stockholders declared stock dividends in the same amount as that of the treasury stocks retired and thus made a cross credit of ₱65,400.00.

"It is therefore evident that there was an unauthorized reduction of capital and at the same time an unauthorized increase of capital as shown by the following illustration:

Authorized capital stock -----------	₱400,000.00
Retirement of treasury stock ---	65,400.00
Reduced authorized capital ----------	₱334,600.00
Add, stock dividends -----------	65,400.00
Reincreased capital	₱400,000.00

"What was actually distributed to the stockholders was nothing but petitioners' treasury stock, which is an asset or property of the corporation as shown graphically in the agents' equation thus:

Cash paid out	=	Acquired treasury stock
Retired treasury stock	=	Reduced capital stock
Stock dividend issued	=	Increased capital stock
Stock dividend (treasury) issued	=	Cash paid out

During the hearing, counsel for petitioners admitted that the treasury stock was acquired by cash purchase from the stockholders and thus it became an asset or property of the corporation. By converting the treasury stock to stock dividends does not alter the fact that property was distributed."

Needless to say, in the Gmur case, after manipulations of corporate stocks, the stockholders still had the same number of shares although they had received cash distribution out of the earnings or profits of the corporation. The stock manipulations were evidently made to disguise a distribution in cash of profits of the corporation and the clear intent was to allow the stockholders to evade payment of taxes for cash dividends in the year of receipt. In the case at bar, petitioners did not receive any cash or property after the transaction; there was merely an increase in the number of their shares.

With due regard to the very essence of the transaction involved herein, we hold that petitioners did not realize income subject to the tax prescribed in Sections 83(b) and 29(a) of the National Internal Revenue Code. Having arrived at this conclusion, it necessarily follows that petitioners are not liable for interest and 50% surcharge.

WHEREFORE, the decisions appealed from are hereby reversed and petitioners are declared not liable for deficiency income tax for their receipt of stock dividends in 1958. No costs.

SO ORDERED.

Quezon City, October 30, 1967.

RAMON L. AVANCEÑA
Associate Judge

WE CONCUR:

ROMAN M. UMALI
Presiding Judge

ESTANISLAO R. ALVAREZ
Associate Judge