REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

MODESTO R. FLORES, as
Co-Administrator of the
Testate Estate of the
late Mary McDonald Bachrach,
Petitioner

versus

CASE NO. 1349

12/29/64

JOSE B. LINGAD, in his
capacity as Commissioner
of Internal Revenue,
Respondent.

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

D E C I S I O N

Respondent assessed and demanded, on February 12, 1963, the sum of ₱673,576.81 as deficiency income tax for the period covering January 1, 1960 to August 7, 1960 and interests, from the testate estate of the late Mary McDonald Bachrach. Not satisfied with the assessment, Modesto R. Flores, as co-administrator of the above testate estate, appealed to this Court.

Mary McDonald Bachrach was the widow of the late Emil Bachrach, who bequeathed to her the usufruct of certain properties, among which were shares of stock in the Bachrach Motor Co., Inc., Consolidated Mines, Inc., People's Bank and Trust Co. and the Meralco. The bequest was valued at ₱731,442.19 in accordance with the American Tropical Experience Table (Sec. 9, N.I.R.C.). Mary M. Bachrach paid inheritance tax in the amount of ₱247,-062.41 based on said valuation.

On August 7, 1960, Mary M. Bachrach died. The administrator of her estate filed an income tax return for Mary M. Bachrach for the period from January 1, 1960 to August 7, 1960 and another one for her estate for the remaining period of 1960.

The bulk of the deceased's properties consisted of shares of stock of the Bachrach Motor Co., Inc. (hereinafter referred to as old Bachrach Motor Co.). This company was a domestic corporation organized on May 28, 1910 for a term of fifty (50) years, expiring on May 28, 1960. It imported, manufactured and dealt in cars, trucks and spare parts, and engaged in land transportation. It had an original authorized capital of ₱150,000.00, divided into 1,500 shares with par value of ₱100.00 each (See Exhibit "A," petitioner's exhibits, p. 2). Out of this authorized capital stock, the following were subscribed and paid for as of the date of the incorporation:

Incorporators	No. of Shares	Amount of C/S subscribed & paid in
1. E.M. Bachrach	519	₱ 51,900.00
2. J. H. Sifert	1	100.00
3. P. M. Scott	1	100.00
4. H. B. Macje	1	100.00
5. D. M. Fleming	1	100.00

The authorized capital stock was increased to ₱649,000.00, ₱1,500,000.00, and finally to ₱5,000,000.00 (See Exhibits "C," "D," "E," petitioner's exhibits, pp. 20, 25, 30). The shares issued and outstanding as of May 28, 1960 amounted to ₱1,993,400.00 in the names of the following:

Names	No. of Shares	Amount
1. Mary M. Bachrach	13,236.3	₱1,323,630.00
2. Estate of Emil Bachrach	6,683.7	668,370.00
3. Neil Hankins	2.0	200.00
4. H. M. Levine	2.0	200.00
5. Elmer Madsen	2.0	200.00
6. Joseph Kaplin	2.0	200.00
7. Pedro Cayetano	2.0	200.00
8. Leogardo Velilla	2.0	200.00
9. Modesto Flores	2.0	200.00

In the course of its operation, the old Bachrach Motor Co. declared stock dividends. The stock dividends in December 1957 amounted to 6% of the earned surplus account or ₱98,000.00; in May 1960, 15% or ₱260,000.00 (See pp. 264-265, t.s.n.; Exhibit "EE," p. 197, petitioner's exhibits).

Before the expiration of the franchisal life of the old Bachrach Motor Co., two corporations, the Bachrach Motor Co. (hereof referred to as new Bachrach Motor Co.) and the Bachrach Transportation Co., Inc., were organized to carry on its businesses. The assets and liabilities of the old Bachrach Motor Co. pertaining to its business as importer, manufacturer and dealer in cars, trucks and spare parts were transferred to the new Bachrach Motor Co., and those pertaining to its land transportation business were transferred to the Bachrach Transportation Co., Inc. In consideration of these transfers of assets and liabilities, the stockholders of the old Bachrach Motor Co. received shares of stock in the two new corporations in proportion to their stockholdings in the old corporation.

At the time of the transfer of assets and liabilities of the old Bachrach Motor Co., the estate of E. Bachrach owned 33.33% of the capital stock issued and outstanding of the corporation and the rest were in the names of Mary Bachrach and nominal stockholders. It was ascertained that the shares of stock of the nominal stockholders were all endorsed in blank and were in the possession of the administrator of the estate of Mary Bachrach. The book value of Mary's holdings at the time of the transfer was ₱2,043,486.02.

The following tabulation shows the stockholdings in the old and new corporations, to wit:

Name	No. of Shares in old corp.	No. of Shares in the two new corporations BMC	DTC	Total
1. Mary Bachrach	13,236.3	9,985.6	3,250.7	13,236.3
2. Estate of E. Bachrach	6,683.7	5,040.4	1,643.3	6,683.7
3. Neil Hankins	2	1	1	2
4. H. M. Levine	2	1	1	2
5. Elmer Madsen	2	1	1	2
6. Modesto T. Flores	2	1	1	2
7. Joseph Kaplin	2	1	1	2
8. L. L. Velilla	2	1	1	2
9. Pedro Cayetano	2	1	1	2
Total	19,934			19,934

A verification of the income tax return of the deceased for the period from January 1 to August 7, 1960 showed that the following proceeds received by Mary Bachrach were reported, not as part of her taxable income, but as usufruct:

Bachrach Motors, Inc.	₱100,250.00
Consolidated Mines, Inc.	2,000.00
People's Bank & Trust Co.	4,440.00
Meralco	1,158.26
T o t a l	₱107,848.26

(See Exhibit "W," p. 155, petitioner's exhibits.)

These proceeds, respondent claims, are in excess of the usufructuary benefits received by Mary M. Bachrach which, for transfer tax purposes, had been valued at ₱731,442.19. Accordingly, they are taxable as income of the bequest or usufruct.

On February 12, 1963, respondent assessed the estate of Mary M. Bachrach for deficiency income tax covering the period January 1 to August 7, 1960 and interest in the amount of ₱673,576.81, after crediting the claim for refund of the estate in the sum of ₱6,359.00 (See Exhibit "6," pp. 191, 193, BIR rec.).

There being allegedly no way of determining how much of the issued and outstanding shares were cash subscriptions or capital paid in, respondent considered the difference between the book value (₱2,043,436.02) of the shares in the old Bachrach Motor Co. at the time of the exchange and the original authorized capital (₱150,000.00) of said corporation as liquidating stock dividends, 50% of which are taxable as capital gains. The liquidating dividends pertaining to the 33.33% interest of Emil Bachrach were taken up by respondent as income of Mary M. Bachrach.

From this assessment, Modesto M. Flores, the co-administrator of the testate estate of Mary Bachrach, appealed to this Court.

As correctly stated by respondent, the issues involved in the instant case are:

1. Did the exchange of shares of stock result in a taxable gain to the taxpayer?

2. If in the affirmative, what was the cost basis of the shares of stock in the old Bachrach Motor Co., Inc.?

3. Is the sum of ₱107,848.26 representing the usufruct received from the estate of E. M. Bachrach taxable as income?

The controversy hinges on whether Mary M. Bachrach realized taxable income as stockholder of the old Bachrach Motor Company upon acquisition of the shares of stock of the new Bachrach Motor Co. and Bachrach Transportation Co., through exchange of share for share with the old Bachrach Motor Company.

It is petitioner's theory that there was no such corporate liquidation as to give rise to taxable liquidating dividends. He argues that, although what took place between the old corporation and the two new corporations was not ordinary merger or consolidation, nevertheless, it was well within the statutory "acquisition by one corporation of all or substantially all the properties of another corporation solely for stock." Consequently, it is urged that the gain resulting from the acquisition or exchange of stocks should not be recognized under Section 35(2) of our Revenue Code, as amended by Republic Act No. 1921.

We agree with respondent. When the corporate term of the old Bachrach Motor Company expired on May 28, 1960, this corporation automatically dissolved.

> "x x x That the corporate existence ipso facto ceases upon the expiration of the period for which it was created is as a general rule, and apart from the operation of a modifying statute, undoubted; when that date is reached, the corporation is ipso facto dissolved, without any direct action on the part of the state or the members of the corporation. x x" (13 Am. Jur. par. 1266, p. 1158.)

> "If the law under which a corporation is organized, or the special act creating the corporation, fixes a definite time when its corporate life must end, it is evident that when that date is reached said corporation is ipso facto dissolved, without any direct action on the part of the state or its members." (47 ALR, p. 1298.)

The transfer of the assets and liabilities of the old Bachrach Motor Co. to the new Bachrach Motor Co. and Bachrach Transportation Co., Inc. was in effect a corporate liquidation. While the assets were never converted into cash for distribution to the stockholders or for the settlement of corporate obligations, there was, however, a liquidation as the stockholders received the equivalent value of their holdings when shares of stock of the two new corporations were received in exchange of the transferred assets and liabilities in proportion to their stockholdings in the old corporation. Thus -

> "Where a corporation surrendered its charter, dissolved, and transferred all of its assets, including its surplus, to a partnership composed of the shareholders in the corporation, who retained the same proportionate interests, under an agreement entered into beforehand to carry on the business as it had before been carried on by the corporation, the transaction was in effect a transfer to each shareholder of the value of his shares of stock, and resulted in taxable income as to the surplus so transferred. Huffman's Appeal /1924/ 1 B. T. A. /Fed./ 52." (65 ALR, p. 150.)

There being a dissolution and liquidation of the old corporation, the gain realized by the stockholders in the dissolution and liquidation is subject to income tax pursuant to Section 83(a) of the Revenue Code, the pertinent provisions of which read:

> "Sec. 83. <u>Distribution of dividends or assets by corporations.</u>--
>
> x x x x x
>
> "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."

The petitioner cannot claim non-recognition of the gain realized by Mary M. Bachrach. Section 35(2) of the Revenue Code, upon which his claim is based, provides:

"(c) Exchange of property--

x x x x x

"(2) Exceptions.--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, (b) a shareholder exchanges stock in a corporation which is a party to the merger or consolidation solely for the stock of another corporation, also a party to the merger or consolidation, or (c) a security holder of a corporation which is a party to the merger or consolidation exchanges his securities in such corporation solely for stock or securities in another corporation, a party to the merger or consolidation."

The general rule is that upon the sale or exchange of property, the gain realized therein is subject to income tax and the loss is allowed as deduction for income tax purposes. The law, however, admits of exceptions, that is, 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 the merger or consolidation exchanges property solely for stock in a corporation, also a party thereto; (b) a shareholder exchanges stock in a corporation which is a party thereto solely for stock of another corporation, likewise a party thereto; and (c) a security holder of a corporation which is a party thereto exchanges his securities in such corporation solely for stock or securities in another corporation, also a party thereto.

The Code defines "merger" and "consolidation," thus -

> "Sec. 35. x x x x
>
> "(5) Definitions.—(a) x x
>
> "(b) The term 'merger' or 'consolidation,' when used in this section, shall be understood to mean: (1) the ordinary merger or consolidation, or (2) the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock: Provided, That for a transaction to be regarded as a merger or consolidation within the purview of this section, it must be undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation: Provided, further, That in determining whether a *bona fide* business purpose exists, each and every step of the transaction shall be considered and the whole transaction or series of transactions shall be treated as a single unit: Provided, finally, That in determining whether the property transferred constitutes a substantial portion of the property of the transferor, the term 'property' shall be taken to include the cash assets of the transferor."

In a merger, two or more corporations unite by the transfer of property of all to one of them, which continues to exist (Metropolitan Edison Co. vs. Commissioner of Internal Revenue, 98 F. 2d 807). A consolidation occurs where two or more existing corporations are united into a single corporation and the existence of the uniting corporation is terminated and the organization succeeds in a general way to the franchise of and acquires the property and assets and assumes the obligations of the constituent companies (Words & Phrases, Vol. 8-A, pp. 346-347, quoting Collinsville Nat. Bank v. Esau, 176 P. 514, 515, 74 Okl. 45). Both merger and consolidation are promotive of corporate unions or combines. It is precisely for the promotion of corporate combinations, which bring about the pooling of resources, that Congress, in Republic Act No. 1921, decreed a different treatment in gains and losses resulting from exchanges of properties, As explained by the authors of H. B. No. 6485:

> "This method of Philippine Income tax in dealing with the problem of recognition of gain or loss from exchange of property in connection with corporate combinations is a deterrent factor to the economic development of the country. It discourages corporations from pooling their resources, thereby blocking one of the most important means thru which large concentrations of Philippine industries can be obtained. In other words, the present tax treatment of exchange of property under our laws is a disincentive to business to combine and expand. Actually its net effect is to place corporations in what may be termed 'a tax straight

jacket' from which they could escape only at prohibitive cost." (Explanatory Note of H. B. No. 6485.)

As afore-stated, the old Bachrach Motor Co. transferred all its assets and liabilities to two new corporations, the new Bachrach Motor Co. and the Bachrach Transportation Co., Inc. The stockholders surrendered their stocks in the transferor-company and received stocks in the transferee-corporations. The reorganization was a divisive type, a split-up. It was, therefore, neither a merger nor a consolidation. Obviously, this reorganization cannot qualify as a tax-free reorganization under Sec. 35(2) of the Revenue Code. Hence, the gains realized by Mary M. Bachrach in the exchange are taxable income.

In the computation of the taxable gain realized by Mary M. Bachrach, respondent Commissioner adopted the book value (₱2,043,436.02) of the shares in the old Bachrach Motor Co. This value is not disputed by petitioner. Consequently, we shall so consider it in computing the taxable gain. Similarly, in arriving at the taxable gain, he considered the original authorized capital of the old corporation (₱150,000.00) as the cost basis of the shares of stock. He deducted from the book value of ₱2,043,436.02 the original authorized capital of ₱150,000.00, thereby disregarding the subsequent increases in the capitalization. The certificates of increases of the capital stock of the old corporation (Exhibits "C," "D," and "E"), including the treasurer's certificates, establish the fact that said increases in the respective sums of ₱304,000.00, ₱290,000.00 and ₱175,000.00 were paid in cash. These increases, totalling ₱769,000.00, should be added to the original authorized capital of ₱150,000.00 (which, in the absence of evidence to the contrary, we consider as fully paid up) because they form part of the paid-in capital. Consequently, the increases of ₱769,-000.00 and the authorized capital of ₱150,000.00, which total 919,000.00, represent under the circumstances the cost basis of the shares of the old Bachrach Motor Co. and should be deducted from the book value. In fine, the resulting difference of ₱1,124,-436.02 is the taxable gain realized in the liquidation.

Finally, petitioner questions the income tax assessment in the amount of ₱107,848.26, which respondent considers as the excess over the valuation (₱731,442.19) of the usufruct received from Mary M. Bachrach's husband. He contends for the non-taxability as income of this excess on the ground that it is a part of the <u>corpus</u> of the estate of the husband. Respondent, however, suggests that this excess constitutes an income of the bequeathed usufruct, and, therefore, is taxable under Sec. 29(b) (3) of the Revenue Code.

The sum of ₱100,250.00, representing stock dividends corresponding to the shares of the estate of E. M. Bachrach in the old Bachrach Motor Co., is taxable as income in consequence of our resolution of the first issue. With respect to the balance of ₱7,598.26, it may be stated that petitioner admits said balance to be proceeds (of the usufruct) from the Consolidated Mines, Inc., People's Bank & Trust Co. and Meralco. Being proceeds of the usufruct they are taxable as income under Sec. 29(b)(3) of the Revenue Code.

But petitioner argues that the proceeds have already been taxed when the inheritance tax on the bequest was paid. The inheritance tax was assessed on the value of the right of usufruct (see Sec. 91 of the Revenue Code). What is now being taxed is income in pursuance of Sec. 29(b) (3) of the same Code.

WHEREFORE, the assessment appealed from is hereby modified and petitioner Modesto T. Flores, as co-administrator of the testate estate of the late Mary M. Bachrach, is ordered to pay to the Commissioner of Internal Revenue or his representative the sum of ₱316,541.00, with ½% monthly interest from April 18, 1961 to February 12, 1963. If the deficiency tax is not paid within thirty (30) days from the date this decision becomes final, petitioner is ordered to pay surcharge and interest as provided in Section 51(e) of the Revenue Code. Without costs.

SO ORDERED.

Quezon City, December 29, 1964.

AUGUSTO M. LUCIANO
Acting Presiding Judge

I CONCUR:

ROMAN M. UMALI
Associate Judge