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in connection with the construction of the WHO office building. The 3% contractor's tax would be within this category and should be viewed as a form of an "indirect tax" on the Organization, as the payment thereof or its inclusion in the bid price would have meant an increase in the construction cost of the building.

ACCORDINGLY, finding no reversible error committed by the respondent Court of Tax Appeals, the appealed decision is hereby affirmed.

SO ORDERED.

Narvasa, Melencio-Herrera, Cruz, Feliciano, Gancayco, and *Sarmiento, JJ.*, concur.

FIRST DIVISION

[G.R. Nos. L-33665-68. February 27, 1987]

COMMISSIONER OF INTERNAL REVENUE, *petitioner, vs.* **VICENTE A. RUFINO and REMEDIOS S. RUFINO, ERNESTO D. RUFINO and ELVIRA B. RUFINO, RAFAEL R. RUFINO and JULIETA A. RUFINO, MANUEL S. GALVEZ and ESTER R. GALVEZ, and COURT OF TAX APPEALS,** *respondents.*

SYLLABUS

1. TAXATION; NATIONAL INTERNAL REVENUE CODE; MERGER AIMED AT THE CONTINUATION AND EXPANSION OF BUSINESS; EXEMPT FROM PAYMENT OF CAPITAL GAINS TAX.— We hold that the Court of Tax Appeals did not err in finding that no taxable gain was derived by the private respondents from the questioned transaction. Contrary to the

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claim of the petitioner, there was a valid merger although the actual transfer of the properties subject of the Deed of Assignment was not made on the date of the merger. The Court finds no impediment to the exchange of property for stock between the two corporations being considered to have been effected on the date of the merger. That, in fact, was the intention, and the reason why the Deed of Assignment was made retroactive to January 1, 1959. Such retroaction provided in effect that all transactions set forth in the merger agreement shall be deemed to be taking place simultaneously on January 1, 1959, when the Deed of Assignment became operative. The certificates of stock subsequently delivered by the New Corporation to the private respondents were only evidence of the ownership of such stocks. Although these certificates could be issued to them only after the approval by the SEC of the increase in capitalization of the New Corporation, the title thereto, legally speaking, was transferred to them on the date the merger took effect, in accordance with the Deed of Assignment. Our ruling then is that the merger in question involved a pooling of resources aimed at the continuation and expansion of business and so came under the letter and intendment of the National Internal Revenue Code, as amended by the above-cited law, exempting from the capital gains tax exchanges of property effected under lawful corporate combinations.

2. ID; TAX EXEMPTION; BASIC CONSIDERATION FOR TAX EXEMPTION.— The basis consideration, of course, is the purpose of the merger, as this would determine whether the exchange of properties involved therein shall be subject or not to the capital gains tax. The criterion laid down by the law is that the merger "must be undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation."

3. COMMERCIAL LAW; CORPORATIONS; MERGER UNDER THE OLD LAW; TRANSACTION CONTEMPLATED THEREIN.— The procedure for such merger was prescribed in Section 28-1/2 of the old Corporation Law which, although not expressly authorizing a merger by name (as the new Corporation Code now does in its Section 77), provided that "a corporation may, by action taken at any meeting of its board of directors, sell, lease, exchange, or otherwise dispose of all or substantially

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all of its property and assets, including its goodwill, upon such terms and conditions and for such considerations, which may be money, stocks, bonds, or other instruments for the payment of money or other property or other considerations, as its board of directors deem expedient." The transaction contemplated in the old law covered the second type of merger defined by Section 35 of the Tax Code as "the acquisition by one corporation of all or substantially all of the properties of another corporation solely for stock," which is precisely what happened in the present case.

4. **TAXATION; NATIONAL INTERNAL REVENUE CODE; CAPITAL GAINS TAX; MERGER THAT MERELY DEFERRED COLLECTION THEREOF, TAXES MAY BE IMPOSED AT THE PROPER TIME WITHOUT PREJUDICE TO THE GOVERNMENT.**— The merger had merely deferred the claim for taxes, which may be asserted by the government later, when gains are realized and benefits are distributed among the stockholders as a result of the merger. In other words, the corresponding taxes are not forever foreclosed or forfeited but may at the proper time and without prejudice to the government still be imposed upon the private respondents, in accordance with Section 35(c) (4) of the Tax Code. Then, in assessing the tax, "the basis of the property transferred in the hands of the transferee shall be the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor on the transfer." The only inhibition now is that that time has not yet come.

5. **ID.; ID.; ID.; ID.; RATIONALE.**— The reason for this conclusion is traceable to the purpose of the legislature in adopting the provision of law in question. The basic idea was to correct the Tax Code which, by imposing taxes on corporate combinations and expansions, discouraged the same to the detriment of economic progress, particularly the promotion of local industry. Speaking of this problem, H.B. No. 7233, which was subsequently enacted into R.A. No. 1921 embodying Section 35 as now worded, declared in the Explanatory Note: "The exemption from the tax of the gain derived from exchanges of stock solely for stock of another corporation resulting from corporate mergers or consolidations under the above provisions, as amended, was intended to encourage corporations in pooling, combining or expanding their resources conducive to the economic development of the country."

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APPEARANCES OF COUNSEL

Leonardo Abola for respondents.

D E C I S I O N

CRUZ, *J.*:

Petition for review on *certiorari* of the decision of the Court of Tax Appeals absolving the private respondents from liability for capital gains tax on the stocks received by them from the Eastern Theatrical, Inc. These were originally four cases involving appeals from the decision of the Commissioner of Internal Revenue dated July 11, 1966, holding the said respondents, Vicente A. Rufino and Remedios S. Rufino, Ernesto D. Rufino and Elvira B. Rufino, Rafael R. Rufino and Julieta A. Rufino, and Manuel S. Galvez and Ester R. Galvez, liable for deficiency income tax, surcharge and interest in the sums of ₱44,294.88, ₱27,229.44, ₱58,082.60 and ₱58,074.24, respectively, for the year 1959.

The facts, as narrated by the Court of Tax Appeals, are as follows:

The private respondents were the majority stockholders of the defunct Eastern Theatrical Co., Inc., a corporation organized in 1934, for a period of twenty-five years terminating on January 25, 1959. It had an original capital stock of ₱500,000.00, which was increased in 1949 to ₱2,000,000.00, divided into 200,000 shares at ₱10.00 per share, and was organized to engage in the business of operating theaters, opera houses, places of amusement and other related business enterprises, more particularly the Lyric and Capitol Theaters in Manila. The President of this corporation (hereinafter referred to as the Old Corporation) during the year in question was Ernesto D. Rufino.

The private respondents are also the majority and controlling stockholders of another corporation, the Eastern Theatrical, Inc., which was organized on December 8, 1958, for a term of

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50 years, with an authorized capital stock of ₱200,000.00, each share having a par value of ₱10.00. This corporation is engaged in the same kind of business as the Old Corporation. The General-Manager of this corporation (hereinafter referred to as the New Corporation) at the time was Vicente A. Rufino.

In a special meeting of stockholders of the Old Corporation on December 17, 1958, to provide for the continuation of its business after the end of its corporate life, and upon the recommendation of its board of directors, a resolution was passed authorizing the Old Corporation to merge with the New Corporation by transferring all its business, assets, goodwill, and liabilities to the latter, which in exchange would issue and distribute to the shareholders of the Old Corporation one share for each share held by them in the said Corporation.

It was expressly declared that the merger of the Old Corporation with the New Corporation was necessary to continue the exhibition of moving pictures at the Lyric and Capitol Theaters even after the expiration of the corporate existence of the former, in view of its pending booking contracts, not to mention its collective bargaining agreements with its employees.

Pursuant to the said resolution, the Old Corporation, represented by Ernesto D. Rufino as President, and the New Corporation, represented by Vicente A. Rufino as General Manager, signed on January 9, 1959, a Deed of Assignment providing for the conveyance and transfer of all the business, property, assets and goodwill of the Old Corporation to the New Corporation in exchange for the latter's shares of stock to be distributed among the shareholders on the basis of one stock for each stock held in the Old Corporation except that no new and unissued shares would be issued to the shareholders of the Old Corporation; the delivery by the New Corporation to the Old Corporation of 125,005-3/4 shares to be distributed to the shareholders of the Old Corporation as their corresponding shares of stock in the New Corporation; the assumption by the New Corporation of all obligations and liabilities of the Old Corporation under its bargaining agreement with the Cinema Stage & Radio Entertainment Free Workers (FFW) which

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included the retention of all personnel in the latter's employ; and the increase of the capitalization of the New Corporation in compliance with their agreement. This agreement was made retroactive to January 1, 1959.

The aforesaid transfer was eventually made by the Old Corporation to the New Corporation, which continued the operation of the Lyric and Capitol Theaters and assumed all the obligations and liabilities of the Old Corporation beginning January 1, 1959.

The resolution of the Old Corporation of December 17, 1958, and the Deed of Assignment of January 9, 1959, were approved in a resolution by the stockholders of the New Corporation in their special meeting on January 12, 1959. In the same meeting, the increased capitalization of the New Corporation to ₱2,000,000.00 was also divided into 200,000 shares at ₱100.00 par value each share, and the said increase was registered on March 5, 1959, with the Securities and Exchange Commission, which approved the same on August 20, 1959.

As agreed, and in exchange for the properties, and other assets of the Old Corporation, the New Corporation issued to the stockholders of the former stocks in the New Corporation equal to the stocks each one held in the Old Corporation, as follows:

Mr. & Mrs. Vicente A. Rufino ----------	17,083 shares
Mr. & Mrs. Rafael R. Rufino ----------	16,881 shares
Mr. & Mrs. Ernesto D. Rufino ----------	18,347 shares
Mr. & Mrs. Manuel S. Galvez ----------	16,882 shares

It was this above-narrated series of transactions that the Bureau of Internal Revenue examined later, resulting in the petitioner declaring that the merger of the aforesaid corporations was not undertaken for a *bona fide* business purpose but merely to avoid liability for the capital gains tax on the exchange of the old for the new shares of stock. Accordingly, he imposed the deficiency assessments against the private respondents for the amounts already mentioned. The private respondents' request for reconsideration having been denied, they elevated the matter to the Court of Tax Appeals, which reversed the petitioner.

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We have given due course to the instant petition questioning the decision of the said court in holding that there was a valid merger between the Old Corporation and the New Corporation and declaring that:

"It is well established that where stocks for stocks were exchanged, and distributed to the stockholders of the corporations, parties to the merger or consolidation, pursuant to a plan of reorganization, such exchange is exempt from capital gains tax . . . .

"In view of the foregoing, we are of the opinion and so hold that no taxable gain was derived by petitioners from the exchange of their old stocks solely for stocks of the New Corporation pursuant to Section 35 (c) (2), in relation to (c) (5), of the National Internal Revenue Code, as amended by Republic Act 1921."[1]

The above-cited Section 35 of the Tax Code, on the proper interpretation and application of which the resolution of this case depends, provides in material part as follows:

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

x x x x x x x x x

(c) Exchange of property —

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

(2) *Exceptions.* — No gain or loss shall be recognized if in pursuance of a plan 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

[1] *Rollo*, p. 45.

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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.

x x x x x x x x x

(5) Definitions. — (a) x 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: x x x."

In support of its position that the Deed of Assignment was concluded by the private respondents merely to evade the burden of taxation, the petitioner points to the fact that the New Corporation did not actually issue stocks in exchange for the properties of the Old Corporation at the time of the supposed merger on January 9, 1959. The exchange, he says, was only on paper. The increase in capitalization of the New Corporation was registered with the Securities and Exchange Commission only on March 5, 1959, or 37 days after the Old Corporation expired on January 25, 1959. Prior to such registration, it was not possible for the New Corporation to effect the exchange provided for in the said agreement because it was capitalized only at ₱200,000.00 as against the capitalization of the Old Corporation at ₱2,000,000.00. Consequently, as there was no merger, the automatic dissolution of the Old Corporation on its expiry date resulted in its liquidation, for which the respondents are now liable in taxes on their capital gains.

For their part, the private respondents insist that there was a genuine merger between the Old Corporation and the New Corporation pursuant to a plan aimed at enabling the latter to continue the business of the former in the operation of places

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of amusement, specifically the Capitol and Lyric Theaters. The plan was evolved through the series of transactions above narrated, all of which could be treated as a single unit in accordance with the requirements of Section 35. Obviously, all these steps did not have to be completed at the time of the merger, as there were some of them, such as the increase and distribution of the stock of the New Corporation, which necessarily had to come afterwards. Moreover, the Old Corporation was dissolved on January 1, 1959, pursuant to the Deed of Assignment, and not on January 25, 1959, its original expiry date. As the properties of the Old Corporation were transferred to the New Corporation before that expiry date, there could not have been any distribution of liquidating dividends by the Old Corporation for which the private respondents should be held liable in taxes.

We sustain the Court of Tax Appeals. We hold that it did not err in finding that no taxable gain was derived by the private respondents from the questioned transaction.

Contrary to the claim of the petitioner, there was a valid merger although the actual transfer of the properties subject of the Deed of Assignment was not made on the date of the merger. In the nature of things, this was not possible. Obviously, it was necessary for the Old Corporation to surrender its net assets first to the New Corporation before the latter could issue its own stock to the shareholders of the Old Corporation because the New Corporation had to increase its capitalization for this purpose. This required the adoption of the resolution to this effect at the special stockholders meeting of the New Corporation on January 12, 1959, the registration of such issuance with the SEC on March 5, 1959, and its approval by that body on August 20, 1959. All these took place after the date of the merger but they were deemed part and parcel of, and indispensable to the validity and inforceability of, the Deed of Assignment.

The Court finds no impediment to the exchange of property for stock between the two corporations being considered to have been effected on the date of the merger. That, in fact, was the intention, and the reason why the Deed of Assignment was made retroactive to January 1, 1959. Such retroaction

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provided in effect that all transactions set forth in the merger agreement shall be deemed to be taking place simultaneously on January 1, 1959, when the Deed of Assignment became operative.

The certificates of stock subsequently delivered by the New Corporation to the private respondents were only evidence of the ownership of such stocks. Although these certificates could be issued to them only after the approval by the SEC of the increase in capitalization of the New Corporation, the title thereto, legally speaking, was transferred to them on the date the merger took effect, in accordance with the Deed of Assignment.

The basic consideration, of course, is the purpose of the merger, as this would determine whether the exchange of properties involved therein shall be subject or not to the capital gains tax. The criterion laid down by the law is that the merger "must be undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation." We must therefore seek and ascertain the intention of the parties in the light of their conduct contemporaneously with, and especially after, the questioned merger pursuant to the Deed of Assignment of January 9, 1959.

It has been suggested that one certain indication of a scheme to evade the capital gains tax is the subsequent dissolution of the new corporation after the transfer to it of the properties of the old corporation and the liquidation of the former soon thereafter. This highly suspect development is likely to be a mere subterfuge aimed at circumventing the requirements of Section 35 of the Tax Code while seeming to be a valid corporate combination. Speaking of such a device, Justice Sutherland declared for the *United States Supreme Court in Helvering v. Gregory*:

"When subdivision (b) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' (Section 112[g]) of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is

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the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose — a mere devise which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

"In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (b), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[2]

We see no such furtive intention in the instant case. It is clear, in fact, that the purpose of the merger was to continue the business of the Old Corporation, whose corporate life was about to expire, through the New Corporation to which all the assets and obligations of the former had been transferred. What argues strongly, indeed, for the New Corporation is that it was not dissolved after the merger agreement in 1959. On the contrary, it continued to operate the places of amusement originally owned by the Old Corporation and transferred to the New Corporation, particularly the Capitol and Lyric Theaters, in accordance with the Deed of Assignment. The New Corporation, in fact, continues to do so today after taking over the business of the Old Corporation twenty-seven years ago.

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[2] 293 U.S. 465, 79 L. ed. 596.

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It may be recalled at this point that under the original provisions of the old Corporation Law, which was in effect when the merger agreement was concluded in 1959, it was not possible for a corporation, by mere amendment of its charter, to extend its life beyond the time fixed in the original articles; in fact, this was specifically prohibited by Section 18, which provided that "any corporation may amend its articles of incorporation by a majority vote of its board of directors or trustees and the vote or written assent of two-thirds of its members, if it be a non-stock corporation, or if it be a stock corporation, by the vote or written assent of the stockholders representing at least two-thirds of the subscribed capital stock of the corporation x x x: *Provided, however*, That the life of said corporation shall not be extended by said amendment beyond the time fixed in the original articles x x x."

This prohibition, which incidentally has since been deleted, made it necessary for the Old and New Corporations to enter into the questioned merger, to enable the former to continue its unfinished business through the latter.

The procedure for such merger was prescribed in Section 28-1/2 of the old Corporation Law which, although not expressly authorizing a merger by name (as the new Corporation Code now does in its Section 77), provided that "a corporation may, by action taken at any meeting of its board of directors, sell, lease, exchange, or otherwise dispose of all or substantially all of its property and assets, including its goodwill, upon such terms and conditions and for such considerations, which may be money, stocks, bonds, or other instruments for the payment of money or other property or other considerations, as its board of directors deem expedient." The transaction contemplated in the old law covered the second type of merger defined by Section 35 of the Tax Code as "the acquisition by one corporation of all or substantially all of the properties of another corporation solely for stock," which is precisely what happened in the present case.

What is also worth noting is that, as in the case of the Old Corporation when it was dissolved on December 31, 1958, there has been no distribution of the assets of the New Corporation

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since then and up to now, as far as the record discloses. To date, the private respondents have not derived any benefit from the merger of the Old Corporation and the New Corporation almost three decades earlier that will make them subject to the capital gains tax under Section 35. They are no more liable now than they were when the merger took effect in 1959, as the merger, being genuine, exempted them under the law from such tax.

By this decision, the government is, of course, not left entirely without recourse, at least in the future. The fact is that the merger had merely deferred the claim for taxes, which may be asserted by the government later, when gains are realized and benefits are distributed among the stockholders as a result of the merger. In other words, the corresponding taxes are not forever foreclosed or forfeited but may at the proper time and without prejudice to the government still be imposed upon the private respondents, in accordance with Section 35(c) (4) of the Tax Code. Then, in assessing the tax, "the basis of the property transferred in the hands of the transferee shall be the same as it would be in the hands of the transferor, increased by the amount of gain recognized to the transferor on the transfer." The only inhibition now is that that time has not yet come.

The reason for this conclusion is traceable to the purpose of the legislature in adopting the provision of law in question. The basic idea was to correct the Tax Code which, by imposing taxes on corporate combinations and expansions, discouraged the same to the detriment of economic progress, particularly the promotion of local industry. Speaking of this problem, H.B. No. 7233, which was subsequently enacted into R.A. No. 1921 embodying Section 35 as now worded, declared in the Explanatory Note:

"The exemption from the tax of the gain derived from exchanges of stock solely for stock of another corporation resulting from corporate mergers or consolidations under the above provisions, as amended, was intended to encourage corporations in pooling, combining or expanding their resources conducive to the economic development of the country."[3]

[3] *Rollo*, p. 44.

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Our ruling then is that the merger in question involved a pooling of resources aimed at the continuation and expansion of business and so came under the letter and intendment of the National Internal Revenue Code, as amended by the above-cited law, exempting from the capital gains tax exchanges of property effected under lawful corporate combinations.

WHEREFORE, the decision of the Court of Tax Appeals is affirmed in full, without any pronouncement as to costs.

SO ORDERED.

Yap (Chairman), Narvasa, Melencio-Herrera, Feliciano, Gancayco, and *Sarmiento, JJ.*, concur.

EN BANC

[G.R. No. L-35648. February 27, 1987]

PERSHING TAN QUETO, *petitioner, vs.* **COURT OF APPEALS, JUAN POMBUENA and RESTITUTA TACALINAR GUANGCO DE POMBUENA,** *respondents.*

SYLLABUS

1. **REMEDIAL LAW; EVIDENCE; FINDINGS OF FACT OF THE TRIAL AND APPELLATE COURTS; NOT BINDING WHEN BASED ON ERRONEOUS INFERENCES.**— The finding by both the Court of First Instance and the Court of Appeals, that the disputed lot is paraphernal and that TAN QUETO is a builder in bad faith were regarded by Us in Our assailed decision as findings of facts and thus ordinarily conclusive on Us. Assuming they are factual findings, still if they are erroneous inferences from certain facts, they cannot bind this Court.