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FIRST DIVISION

[G.R. No. 108576. January 20, 1999]

COMMISIONER OF INTERNAL REVENUE, *petitioner, vs.* **THE COURT OF APPEALS, COURT OF TAX APPEALS and A. SORIANO CORP.,** *respondents.*

SYNOPSIS

Don Andres Soriano, a citizen and resident of the United States formed in the 1930's the corporation "A Soriano Y Cia," predecessor of ANSCOR. On December 30, 1964 Don Andres died. On June 30, 1968, pursuant to a Board Resolution, ANSCOR redeemed 28,000 common shares from Don Andres' estate. By November 1968, the Board further increased ANSCOR's capital stock to ₱75M divided into 150,000 preferred shares and 600,000 common shares. About a year later ANSCOR again redeemed 80,000 common shares from Don Andres' estate, further reducing the latter's common shareholdings. ANSCOR's business purpose for both redemptions of stock is to partially retire said stocks as treasury shares in order to reduce the company's foreign exchange remittances in case cash dividends are declared. In 1973, after examining ANSCOR'S books of account and records Revenue Examiners issued a report proposing that ANSCOR be assessed for deficiency withholding tax-at-source, pursuant to Sections 53 and 54 of the 1939 Revenue Code for the year 1968 and the second quarter of 1969 based on the transactions of exchange and redemption of stocks. Subsequently, ANSCOR filed a petition for review with the Court of Tax Appeals assailing the tax assessments on the redemptions and exchange of stocks. In its decision, the CTA reversed the BIR's ruling after finding sufficient evidence to overcome the *prima facie* correctness of the questioned assessments. In a petition for review, the Court of Appeals affirmed the ruling of the CTA. Hence, the present petition. The issue is whether ANSCOR's redemption of stocks from its stockholders as well as the exchange of common shares can be considered as equivalent to the distribution of taxable dividend making the proceeds thereof taxable under the provisions Section 83 (B) of the 1939 Revenue Act.

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The Supreme Court modified the decision of the Court of Appeals in that ANSCOR'S redemption of 82,752.5 stock dividends is herein considered as essentially equivalent to a distribution of taxable dividends for which it is liable for the withholding tax-at-source. While the Board Resolutions authorizing the redemptions state only one purpose — reduction of foreign exchange remittances in case cash dividends are declared. Said purpose was not given credence by the court in case at bar. Records show that despite the existence of enormous corporate profits no cash dividends were ever declared by ANSCOR from 1945 until the BIR started making assessments in the early 1970's. Although a corporation under certain exceptions, has the prerogative when to issue dividends, yet when no cash dividends are issued for about three decades, this circumstance negate the legitimacy of ANSCOR's alleged purposes. With regard to the exchange of shares, the Court ruled that that the exchange of common with preferred shares is not taxable because it produces no realized income to the subscriber but only a modification of the subscriber's rights and privileges which is not a flow of wealth for tax purposes.

SYLLABUS

1. TAXATION; PRESIDENTIAL DECREE NO. 67; NOT BEING A TAXPAYER, A WITHHOLDING AGENT LIKE THE PRIVATE RESPONDENT IS NOT PROTECTED BY THE AMNESTY UNDER THE DECREE.— An income taxpayer covers all persons who derive taxable income. ANSCOR was assessed by petitioner for deficiency withholding tax under Section 53 and 54 of the 1939 Code. As such, it is being held liable in its capacity as a withholding agent and not in its personality as a taxpayer. In the operation of the withholding tax system, the withholding agent is the payor, a separate entity acting no more than an agent of the government for the collection of the tax in order to ensure its payments; the payer is the taxpayer — he is the person subject to tax impose by law; and the payee is the taxing authority. In other words, the withholding agent is merely a tax collector, not a taxpayer. Under the withholding system, however, the agent-payor becomes a payee by fiction of law. His (agent) liability is direct and independent from the taxpayer, because the income tax is still impose on and due from the latter. The agent is not liable for the tax as no wealth flowed into him

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— he earned no income. The Tax Code only makes the agent personally liable for the tax arising from the breach of its legal duty to withhold as distinguish from its duty to pay tax since: "the government's cause of action against the withholding agent is not for the collection of income tax, but for the enforcement of the withholding provision of Section 53 of the Tax Code, compliance with which is imposed on the withholding agent and *not* upon the taxpayer." Not being a *taxpayer*, a withholding agent, like ANSCOR in this transaction is not protected by the amnesty under the decree. Codal provisions on withholding tax are mandatory and must be complied with by the withholding agent. The taxpayer should not answer for the non-performance by the withholding agent of its legal duty to withhold unless there is collusion or bad faith. The former could not be deemed to have evaded the tax had the withholding agent performed its duty. This could be the situation for which the amnesty decree was intended. Thus, to curtail tax evasion and give tax evaders a chance to reform, it was deemed administratively feasible to grant tax amnesty in certain instances. In addition, a "tax amnesty, much like a tax exemption, is never favored nor presumed in law and if granted by a statute, the terms of the amnesty like that of a tax exemption must be construed strictly against the taxpayer and liberally in favor of the taxing authority." The rule on *strictissimi juris* equally applies. So that, any doubt in the application of an amnesty law/decree should be resolved in favor of the taxing authority.

2. ID.; NATIONAL INTERNAL REVENUE CODE OF 1939; TAX ON STOCK DIVIDENDS; REDEMPTION AND CANCELLATION; PURPOSES INVOKED BY PRIVATE RESPONDENT CORPORATION, UNDER THE FACTS OF THE PRESENT CASE ARE NO EXCUSE FOR ITS TAX LIABILITY; REASON.— First, the alleged "filipinization" plan cannot be considered legitimate as it was not implemented until the BIR started making assessments on the proceeds of the redemption. Such corporate plan was not stated in nor supported by any Board Resolution but a mere afterthought interposed by the counsel of ANSCOR. Being a separate entity, the corporation can act only through its Board of Directors. The Board Resolutions authorizing the redemptions state only one purpose — reduction of foreign exchange remittances in case cash dividends are declared. Not even this purpose can be given

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credence. Records show that despite the existence of enormous corporate profits no cash dividend was ever declared by ANSCOR from 1945 until the BIR started making assessments in the early 1970's. Although a corporation under certain exceptions, has the prerogative when to issue dividends, yet when no cash dividends was issued for about three decades, this circumstances negates the legitimacy of ANSCOR's alleged purposes. Moreover, to issue stock dividends is to increase the shareholdings of ANSCOR's foreign stockholders contrary to its "filipinization" plan. This would also increase rather than reduce their need for foreign exchange remittances in case of cash dividend declaration, considering that ANSCOR is a family corporation where the majority shares at the time of redemptions were held by Don Andres' foreign heirs. Secondly, assuming *arguendo*, that those business purposes are legitimate, the same cannot be valid excuse for the imposition of tax. Otherwise, the taxpayer's liability to pay income tax would be made to depend upon a third person who did not earn the income being taxed. Furthermore, even if the said purposes support the redemption and justify the issuance of stock dividends, the same has no bearing whatsoever on the imposition of the tax herein assessed because the proceeds of the redemption are deemed taxable dividends since it was shown that income was generated therefrom. Thirdly, ANSCOR argued that to treat as 'taxable dividend' the proceeds of the redeemed stock dividends would be to impose on such stock an undisclosed lien and would be extremely unfair to intervening purchasers, i.e. those who buys the stock dividends after their issuance. Such argument, however, bears no relevance in this case as no intervening buyer is involved. And even if there is an intervening buyer, it is necessary to look into the factual milieu of the case if income was realized from the transaction. Again, we reiterate that the dividend equivalence test depends on such "time and manner" of the transaction and its net effect. The undisclosed lien may be unfair to a subsequent stock buyer who has no capital interest in the company. But the unfairness may not be true to an original subscriber like Don Andres, who holds stock dividends as gains from his investments. The subsequent buyer who buys stock dividends is investing capital. It just so happen that what he bought is stock dividends. The effect of its (stock dividends) redemption from that subsequent buyer is merely to return his capital subscription,

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which is income if redeemed from the original subscriber. After considering the manner and the circumstances by which the issuance and redemption of stock dividends were made, there is no other conclusion but that the proceeds thereof are essentially considered equivalent to a distribution of taxable dividends. As "taxable dividend" under Section 83(b), it is part of the "entire income" subject to tax under Section 22 in relation to Section 21of the 1939 Code. Moreover, under Section 29(a) of said Code, dividends are included in "gross income." As income, it is subject to income tax which is required to be withheld at source. The 1997 Tax Code may have altered the situation but it does not change this disposition.

3. ID.; ID.; ID.; **THE EXCHANGE OF COMMON WITH PREFERRED SHARES IN CASE AT BAR IS NOT TAXABLE; IT PRODUCES NO REALIZED INCOME TO THE SUBSCRIBER BUT ONLY A MODIFICATION OF THE SUBSCRIBER'S RIGHTS AND PRIVILEGES WHICH IS NOT A FLOW OF WEALTH FOR TAX PURPOSES.**— Both the Tax Court and the Court of Appeals found that ANSCOR *reclassified* its shares into common and preferred, and that parts of the common shares of the Don Andres estate and all of Doña Carmen's shares were *exchanged* for the whole 150,000 preferred shares. Thereafter, both the Don Andres estate and Doña Carmen remained as corporate subscribers except that their subscriptions now include preferred shares. There was no change in their proportional interest after the exchange. There was no cash flow. Both stocks had the same par value. Under the facts herein, any difference in their market value would be immaterial at the time of exchange because no income is yet realized — it was a mere corporate paper transaction. It would have been different, if the exchange transaction resulted into a flow of wealth, in which case income tax may be imposed. Reclassification of shares does not always bring any substantial alteration in the subscriber's proportional interest. But the exchange is different — there would be a shifting of the balance of stock features, like priority in dividend declarations or absence of voting rights. Yet neither the reclassification nor exchange *per se*, yields realize income for tax purposes. A common stock represents the residual ownership interest in the corporation. It is a basic class of stock ordinarily and usually issued without extraordinary rights or privileges and entitles the shareholder to a *pro rata* division of profits. Preferred stocks are those which entitle the shareholder to some

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priority on dividends and asset distribution. Both shares are part of the corporation's capital stock. Both stockholders are no different from ordinary investors who take on the same investment risks. Preferred and common shareholders participate in the same venture, willing to share in the profits and losses of the enterprise. Moreover, under the doctrine of equality of shares — all stocks issued by the corporation are presumed equal with the same privileges and liabilities, provided that the Articles of Incorporation is silent on such differences. In this case, the exchange of shares, without more, produces no realized income to the subscriber. There is only a modification of the subscriber's rights and privileges — which is not a flow of wealth for tax purposes. The issue of taxable dividend may arise only once a subscriber disposes of his entire interest and not when there is still maintenance of proprietary interest.

APPEARANCES OF COUNSEL

M. L. Gadioma Law Office for private respondent.
The Solicitor General for petitioner.

DECISION

MARTINEZ, *J.*:

Petitioner Commissioner of Internal Revenue (CIR) seeks the reversal of the decision of the Court of Appeals (CA)[1] which affirmed the ruling of the Court of Tax Appeals (CTA)[2] that private respondent A. Soriano Corporation's (hereinafter

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[1] Court of Appeals decision, promulgated on January 15, 1993, penned by Justice O. Herrera with Justices Montoya and Montenegro, concurring. The dispositive portion of which reads:

"WHEREFORE, finding no such abuse or improvident exercise of authority or discretion, the decision of the Court of Tax Appeals must be as it is hereby AFFIRMED" (*Rollo*, p. 121; CA Decision, p. 18).

[2] Decision in CTA Case No. 3710, dated July 4, 1991 penned by Associate Judge Roaquin with Judges A. Reyes and E. Acosta, concurring. (Annex "A"; *Rollo*, pp. 61-101, CTA Decision, p. 41). The dispositive portion of which reads:

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ANSCOR) redemption and exchange of the stocks of its foreign stockholders cannot be considered as "essentially equivalent to a distribution of taxable dividends" under Section 83(b) of the 1939 Internal Revenue Act.[3]

The undisputed facts are as follows:

Sometime in the 1930s, Don Andres Soriano, a citizen and resident of the United States, formed the corporation "A. Soriano Y Cia," predecessor of ANSCOR, with a ₱1,000,000.00 capitalization divided into 10,000 common shares at a par value of ₱100/share. ANSCOR is wholly owned and controlled by the family of Don Andres, who are all non-resident aliens.[4] In 1937, Don Andres subscribed to 4,963 shares of the 5,000 shares originally issued.[5]

On September 12, 1945, ANSCOR's authorized capital stock was increased to ₱2,500,000.00 divided into 25,000 common shares with the same par value. Of the additional 15,000 shares, only 10,000 was issued which were all subscribed by Don Andres, after the other stockholders waived in favor of the former their pre-emptive rights to subscribe to the new issues.[6] This increased

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"WHEREFORE, premises considered, the presumption of *prima facie* correctness of the assessments issued by the respondent having been overcome by sufficient and convincing evidence presented by petitioner, the decision appealed from is hereby reversed.

"Without pronouncement as to costs."

[3] Commonwealth Act 466. as amended, otherwise known as the Tax Code of 1939, Section 83(b) was renumbered to Sec. 66(b) by P.D. 1158, as amended, also known as the 1977 NIRC (took effect June 3, 1977) with further codification under the NIRC of 1986 (Sec. 42, P.D. 1994). Said provision was later renumbered to Sec. 73(b) by R.A. 8424 or the "Tax Reform Act of 1997" (took effect January 1, 1998) which provides exactly the same rule.

[4] CTA Decision, p. 2; *Rollo*, p. 62.

[5] The total original subscription of Don Andres was 4,971 shares including the 8 shares of his 4 nominees with 2 shares each. (*Rollo*, p. 63).

[6] *Ibid.*

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his subscription to 14,963 common shares.[7] A month later,[8] Don Andres transferred 1,250 shares each to his two sons, Jose and Andres, Jr., as their initial investments in ANSCOR.[9] Both sons are foreigners.[10]

By 1947, ANSCOR declared stock dividends. Other stock dividend declarations were made between 1949 and December 20, 1963.[11] On December 30, 1964 Don Andres died. As of that date, the records revealed that he has a total shareholdings of 185,154 shares[12] — 50,495 of which are original issues and the balance of 134,659 shares as stock dividend declarations.[13] Correspondingly, one-half of that shareholdings or 92,577[14] shares were transferred to his wife, Doña Carmen Soriano, as her conjugal share. The other half formed part of his estate.[15]

A day after Don Andres died, ANSCOR increased its capital stock to ₱20M[16] and in 1966 further increased it to ₱30M.[17] In the same year (December 1966), stock dividends worth 46,290 and 46,287 shares were respectively received by the Don Andres

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[7] According to the CA, the total shareholdings of Don Andres after the new shares were issued is 15,471 common shares. (*Rollo*, p. 105).

[8] Petitioner claims the transfer was made on October 27, 1947. (Memorandum of Petitioner, p. 3).

[9] *Rollo*, pp. 63-64.

[10] Petition, filed March 10, 1993, p. 5; *Rollo*, p. 13; Petitioner's Memorandum, p. 3.

[11] A 100% stock dividend was declared in 1947; 12,590 in 1949; 15,108 in 1950 (*Rollo*, p. 64).

[12] This figure includes the qualifying shares of the nominees of Don Andres.

[13] *Rollo*, p. 65.

[14] *Rollo*, pp. 15, 65.

[15] Special Proceedings for the settlement of the estate of Don Andres was filed before the then Court of First Instance (CFI) of Rizal and was terminated on November, 1974. (*Rollo*, pp. 66-67).

[16] *Rollo*, pp. 66, 105.

[17] *Rollo*, pp. 67, 105.

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estate[18] and Doña Carmen from ANSCOR. Hence, increasing their accumulated shareholdings to 138,867 and 138,864[19] common shares each.[20]

On December 28, 1967, Doña Carmen requested a ruling from the United States Internal Revenue Service (IRS), inquiring if an exchange of common with preferred shares may be considered as tax avoidance scheme[21] under Section 367 of the 1954 U.S. Revenue Act.[22] By January 2, 1968, ANSCOR reclassified its existing 300,000 common shares into 150,000 common and 150,000 preferred shares.[23]

In a letter-reply dated February 1968, the IRS opined that the exchange is only a recapitalization scheme and not tax avoidance.[24] Consequently,[25] on March 31, 1968 Doña Carmen exchanged her whole 138,864 common shares for 138,860 of the newly reclassified preferred shares. The estate of Don Andres in turn, exchanged 11,140 of its common shares, for remaining 11,140 preferred shares, thus reducing its (the estate) common shares to 127,727.[26]

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[18] Reference to the "Don Andres Estate" is only for the purpose of identity of the personalities involved.

[19] *Rollo*, pp. 68, 106.

[20] The CA ruled that the shareholdings of both the Don Andres estate and Doña Carmen each consisted of 22,756 *original common shares* and the rest as accumulated stock dividends (*Rollo*, p. 106). However, upon the death of Don Andres, his estate supposedly received 25,247.5 common shares which is one-half of the 50,495 original common shares.

[21] Tax avoidance as distinguish from tax evasion.

[22] *Rollo*, p. 68.

[23] Annex "G", Folder I, CTA Records, pp. 89-90; *Rollo*, pp. 69, 106.

[24] *Rollo*, pp. 68, 69.

[25] ANSCOR's Articles of Incorporation was amended by reclassifying a certain number of the common shares as preferred shares. (CTA Decision, p. 9; *Rollo*, p. 69).

[26] *Rollo*, pp. 69, 106.

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On June 30, 1968, pursuant to a Board Resolution, ANSCOR redeemed 28,000 common shares from the Don Andres' estate. By November 1968, the Board further increased ANSCOR's capital stock to ₱75M divided into 150,000 preferred shares and 600,000 common shares.[27] About a year later, ANSCOR again redeemed 80,000 common shares from the Don Andres' estate,[28] further reducing the latter's common shareholdings to 19,727. As stated in the Board Resolutions, ANSCOR's business purpose for both redemptions of stocks is to partially retire said stocks as treasury shares in order to reduce the company's foreign exchange remittances in case cash dividends are declared.[29]

In 1973, after examining ANSCOR's books of account and records, Revenue examiners issued a report proposing that ANSCOR be assessed for deficiency withholding tax-at-source, pursuant to Sections 53 and 54 of the 1939 Revenue Code,[30]

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[27] *Rollo*, p. 70.

[28] *Rollo*, pp. 70-71, 106.

[29] Rollo, p. 70.

[30] Sec. 53. *Withholding of tax at source.* – x x x (b) *Nonresident aliens.* — All persons, corporations and general copartnerships (*compañias colectivas*), in whatever capacity acting, including lessees or mortgagors of real or personal property, trustees acting in any trust capacity, executors, administrators, receivers, conservators, fiduciaries, employers, and all officers and employees of the Government of the Philippines having the control, receipt, custody, disposal, or payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensation, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income of any non-resident alien individual, not engaged in trade or business within the Philippines and not having any office or place of business therein, shall (except in the cases provided for in *subsection* (a) of this section) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to twenty *per centum* thereof: *Provided*, That no such deduction or withholding shall be required in the case of dividends paid by a foreign corporation unless (1) such corporation is engaged in trade or business within the Philippines and (2) more than eighty-five *per centum* of the gross income of such corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence)

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for the year 1968 and the second quarter of 1969 based on the transactions of exchange and redemption of stocks.[31] The Bureau of Internal Revenue (BIR) made the corresponding assessments despite the claim of ANSCOR that it availed of the tax amnesty

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was derived from sources within the Philippines as determined under the provisions of section thirty-seven: *Provided, further*, That the Commissioner of Internal Revenue may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent. (As amended by Sec. 9, Rep. Act No. 2343).

(c) *Return and payment,* — Every person required to deduct and withhold any tax under this section shall make return thereof, in duplicate, on or before the fifteenth day of April of each year, and, on or before the time fixed by law for the payment of the tax, shall pay the amount withheld to the officer of the Government of the Philippines authorized to receive it. Every such person is made personally liable for such tax, and is indemnified against the claims and demands of any persons for the amount of any payments made in accordance with the provision of this section. (As amended by Sec. 9, Rep. Act No. 2343).

(d) *Income of recipient.* — Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return and the amount, if any, by which the income tax collected at source exceeds the tax due on the return shall be refunded subject to the provisions of Section 309.

Sec. 54. *Payment of corporation income tax at source.* — In the case of foreign corporations subject to taxation under this Title not engaged in trade or business within the Philippines and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items as is provided in section fifty-three a tax equal to thirty *per centum* thereof, and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section. *Provided, however*, That no such deduction or withholding shall be required in the case of reinsurance premiums ceded to foreign insurance corporations not engaged in trade or business in the Philippines and having no office or place of business in the Philippines and having no office or place of business therein. (As amended by Sec. 10, R.A. No. 2343, and Sec. 2, R.A. No. 3825).

[31] For the 1968 and the 1969 deficiency withholding tax, private respondent was assessed P3,428,613.90 and ₱2,950,000.00, respectively or for a total of ₱6,378,613.50. Certain documents from the records shows that the 1969 assessments were reduced. (Folder I CTA records in case no. 3710, p. 289; *Rollo*, pp. 71-72, 106.)

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under Presiential Decree (P.D.) 23[32] which were amended by P.D.s 67 and 157.[33] However, petitioner ruled that the invoked decrees do not cover Sections 53 and 54 in relation to Article 83(b) of the 1939 Revenue Act under which ANSCOR was assessed.[34] ANSCOR's subsequent protest on the assessments was denied in 1983 by petitioner.[35]

Subsequently, ANSCOR filed a petition for review with the CTA assailing the tax assessments on the redemptions and exchange of stocks. In its decision, the Tax Court reversed petitioner's ruling, after finding sufficient evidence to overcome the *prima facie* correctness of the questioned assessments.[36] In a petition for review, the CA, as mentioned, affirmed the ruling of the CTA.[37] Hence, this petition.

The bone of contention is the interpretation and application of Section 83(b) of the 1939 Revenue Act[38] which provides:

"Sec. 83. Distribution of dividends or assets by corporations. —

(b) *Stock dividends* — 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 it represents a distribution of earnings or profits accumulated after March first, nineteen hundred and thirteen.*" (Italics supplied).

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[32] *Rollo*, pp. 72, 107.

[33] P.D. 23 dated October 16, 1972 is entitled "Proclaiming a Tax Amnesty Subject to Certain Exceptions."

[34] *Rollo*, p. 72.

[35] *Rollo*, p. 24.

[36] CTA Decision, p. 41; *Rollo*, p. 101.

[37] CA Decision, p. 18; *Rollo*, p. 121.

[38] The original provision was retained in R.A. 8424 except that the reference to the year was deleted.

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Specifically, the issue is whether ANSCOR's *redemption* of stocks from its stockholder as well as the exchange of common with preferred shares can be considered as "essentially equivalent to the distribution of taxable dividend," making the proceeds thereof taxable under the provisions of the above-quoted law.

Petitioner contends that the exchange transaction is tantamount to "cancellation" under Section 83(b) making the proceeds thereof taxable. It also argues that the said Section applies to *stock dividends* which is the bulk of stocks that ANSCOR redeemed. Further, petitioner claims that under the "net effect test," the estate of Don Andres gained from the redemption. Accordingly, it was duty of ANSCOR to withhold the tax-at-source arising from the two transactions, pursuant to Section 53 and 54 of the 1939 Revenue Act.[39]

ANSCOR, however, avers that it has no duty to withhold any tax either from the Don Andres estate or from Doña Carmen based on the two transactions, because the same were done for legitimate business purposes which are (a) to reduce its foreign exchange remittances in the event the company would declare cash dividends,[40] and to (b) subsequently "filipinized" ownership of ANSCOR, as allegedly envisioned by Don Andres.[41] It likewise invoked the amnesty provisions of P.D. 67.

We must emphasize that the application of Sec. 83(b) depends on the special factual circumstances of each case.[42] The findings of facts of a special court (CTA) exercising particular expertise on the subject of tax, generally binds this Court,[43] considering

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[39] Petitioner's Reply, pp. 2, 10.

[40] Board of Directors Resolutions dated June 15, 1968 and October 30, 1969 (BIR Records, Folder III, pp. 12-13; 7-8).

[41] Comment, pp. 13-14; Rejoinder, pp. 4-5.

[42] *Gloninger v. Commissioner*, 339 F2d 211; *Blotch v. US* 261 F Supp 597, 386 F2d 839; *John P Elton v. Commissioner*, 47 B.T.A. 111.

[43] *Philippine Refining Company v. CA*, 326 Phil. 680, (1996); *Commissioner of Internal Revenue v. CA*, 312 Phil 337; *Commissioner of Internal Revenue v. Philippine American Life Insurance Co.* 244 SCRA 446 (1995); *CIR v. Administratrix of the Estate of Echarri*, 67 Phil. 502.

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that it is substantially similar to the findings of the CA which is the final arbiter of questions of facts.[44] The issue in this case does not only deal with facts but whether the law applies to a particular set of facts. Moreover, this Court is not necessarily bound by the lower courts' conclusions of law drawn from such facts.[45]

AMNESTY:

We will deal first with the issue of tax amnesty. Section 1 of P.D. 67[46] provides:

"I. In all cases of *voluntary disclosure of previously untaxed income and/or wealth* such as earnings receipts, gifts, bequests or any other acquisitions from any source whatsoever which are taxable under the National Internal Revenue Code, as amended, realized here or abroad by any *taxpayer*, natural or juridical; the collection of all internal revenue taxes including the increments or penalties or account of non-payment as well as all civil, criminal or administrative liabilities arising from or incident to such disclosures under the National Internal Revenue Code, the Revised Penal Code, the Anti-Graft and Corrupt Practices Act, the Revised Administrative Code, the Civil Service laws and regulations, laws and regulations on Immigration and Deportation, or any other applicable law or proclamation, are hereby condoned and, in lieu thereof, *a tax of ten (10%) per centum on such previously untaxed income or wealth* is hereby imposed, subject to the following conditions: (conditions omitted) [Italics supplied].

The decree condones "the collection of all internal revenue taxes including the increments or penalties or account of non-payment as well as all civil, criminal or administrative liabilities arising from or incident to" (voluntary) disclosures under the NIRC of previously untaxed income and/or wealth "realized here or abroad by any taxpayer, natural or juridical."

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[44] *Binalay v. Manalo*, 195 SCRA 374, 380 citing *Sese v. IAC*, 152 SCRA 585.

[45] See *Manila Bay Club Corp. v. CA*, 62 SCAD 435; 315 Phil. 807 (1995); *Pilar Development Corporation v.* IAC, 146 SCRA 215 (1986).

[46] Promulgated November 24, 1972.

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May the withholding agent, in such capacity, be deemed a *taxpayer* for it to avail of the amnesty? An income taxpayer covers all persons who derive taxable income.[47] ANSCOR was assessed by petitioner for deficiency withholding tax under Section 53 and 54 of the 1939 Code. As such, it is being held liable in its capacity as a withholding agent and not in its personality as a taxpayer.

In the operation of the withholding tax system, the withholding agent is the payor, a separate entity acting no more than an agent of the government for the collection of the tax[48] in order to ensure its payments;[49] the payer is the taxpayer – he is the person subject to tax impose by law;[50] and the payee is the taxing authority.[51] In other words, the withholding agent is merely a tax collector, not a taxpayer. Under the withholding system, however, the agent-payor becomes a payee by fiction of law. His (agent) liability is direct and independent from the taxpayer,[52] because the income tax is still impose on and due from the latter. The agent is not liable for the tax as no wealth flowed into him – he earned no income. The Tax Code only makes the agent personally liable for the tax[53] arising from the breach of its legal duty to withhold as distinguish from its duty to pay tax since:

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[47] *Tan v. Del Rosario*, 55 SCAD 831 (1994).

[48] *Phil Guaranty Co., Inc v. CIR*, 15 SCRA 1 (1965).

[49] *Bank of America v. CA*, 53 SCAD 406, 413 (1994).

[50] Sec. 20(n), 1986 Tax Code.

[51] The pronouncement of the Court in the case of *Bank of America, supra*, that the *payee* is the taxpayer should not be confused with the payee in the case at bar. Therein, the payee referred to is the foreign entity recipient of profit remitted by a local company. Herein, the payee referred to is the party who received money as tax.

[52] *Commissioner of Internal Revenue v. Procter and Gamble*, 204 SCRA 377 (1991).

[53] *Phil. Guaranty v. CIR, supra* See also Sec. 53(c) 1939 Tax Code, as amended by R.A. No. 2343 which provides in part that "xxx Every such person is made personally liable for such tax xxx."

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"the government's cause of action against the withholding agent is not for the collection of income tax, but for the enforcement of the withholding provision of Section 53 of the Tax Code, compliance with which is imposed on the withholding agent and *not* upon the taxpayer."[54]

Not being a *taxpayer*, a withholding agent, like ANSCOR in this transaction, is not protected by the amnesty under the decree.

Codal provisions on withholding tax are mandatory and must be complied with by the withholding agent.[55] The taxpayer should not answer for the non-performance by the withholding agent of its legal duty to withhold unless there is collusion or bad faith. The former could not be deemed to have evaded the tax had the withholding agent performed its duty. This could be the situation for which the amnesty decree was intended. Thus, to curtail tax evasion and give tax evaders a chance to reform,[56] it was deemed administratively feasible to grant tax amnesty in certain instances. In addition, a "tax amnesty, much like a tax exemption, is never favored nor presumed in law and if granted by a statute, the terms of the amnesty like that of a tax exemption must be construed strictly against the taxpayer and liberally in favor of the taxing authority."[57] The rule on

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[54] See *Commissioner of Internal Revenue v. Malayan Insurance*, 129 Phil. 165, 170 (1967) citing *Jai Alai v. Republic*, L-17462, May 29, 1967; 1967B PHILD 460.

[55] *Ibid.*

[56] The Whereas clauses of P.D. No. 23 provides in part:

"x x x x x x x x x

"WHEREAS, it is the policy of the Government to give tax evaders a chance to reform and be a part of the New Society with a clean slate,

"WHEREAS, tax evaders who wish to relent and are willing to reform may be reluctant to disclose their liability for income taxes because of the criminal and civil penalties attendant to tax evasion;

"x x x x x x x x x"

[57] *People v. Castañeda, Jr.* 165 SCRA 327, 341 (1988) citing *E. Rodriguez, Inc v. The Collector of Internal Revenue*, 139 Phil. 354 (1969) and *Commissioner of Internal Revenue v. A.D. Guerrero*, 128 Phil. 197 (1967).

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strictissimi juris equally applies.[58] So that, any doubt in the application of an amnesty law/decree should be resolved in favor of the taxing authority.

Furthermore, ANSCOR's claim of amnesty cannot prosper. The implementing rules of P.D. 370 which expanded amnesty on previously untaxed income under P.D. 23 is very explicit, to wit:

"Section 4. *Cases not covered by amnesty. – The following cases are not covered by the amnesty subject of these regulations*:

x x x x x x x x x

(2) Tax liabilities with or without assessments, on withholding tax at source provided under Sections 53 and 54 of the National Internal Revenue Code, as amended;[59]

ANSCOR was assessed under Sections 53 and 54 of the 1939 Tax Code. Thus, by specific provision of law, it is not covered by the amnesty.

TAX ON STOCK DIVIDENDS

General Rule

Section 83(b) of the 1939 NIRC was taken from Section 115(g)(1) of the U.S. Revenue Code of 1928.[60] It laid down the general rule known as the 'proportionate test'[61] wherein stock dividends once issued form part of the capital and, thus, subject to income tax.[62] Specifically, the general rule states that:

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[58] *E Rodriguez Inc. v. Collector of Internal Revenue, supra.*; *Province of Tarlac v. Alcantara*, 216 SCRA 790. See also *La Carlota Sugar Central v. Jiminez*, 112 Phil. 232 (1961) cited in *Phil. Guaranty v. CIR, supra.*

[59] Section 4 of Revenue Regulations No. 2-74, dated January 14, 1974, (70 O.G. 1472, February 25, 1974).

[60] Later known as the U.S. Revenue Code of 1939.

[61] Michie's Federal Tax Handbook, 1967 ed., p. 196.

[62] Under Section 21(c)(2) of the 1986 NIRC, as amended, dividends are subject to a tax of either 0% as of January 1, 1989 or to the schedule

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"A stock dividend representing the transfer of surplus to capital account shall not be subject to tax."

Having been derived from a foreign law, resort to the jurisprudence of its origin may shed light. Under the US Revenue Code, this provision originally referred to "stock dividends" only, without any exception. Stock dividends, strictly speaking, represent capital and do not constitute income to its recipient.[63] So that the mere issuance thereof is not yet subject to income tax[64] as they are nothing but an "enrichment through increase in value of capital investment."[65] As capital, the stock dividends postpone the realization of profits because the "fund represented by the new stock has been transferred from surplus to capital and no longer available for actual distribution."[66] Income in tax law is "an amount of money coming to a person within a specified time, whether as payment for services, interest, or profit from investment."[67] It means cash or its equivalent.[68] It is gain derived and severed from capital,[69] from labor or from

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under Section 22(a)(2) or not subject to tax under Section 24(e)(4) and 24(a)(6)D. Under the Tax Reform Act of 1997, dividends are subject to a final tax.

[63] *Posados v. Warner*, 279 US 340, 73 L ed 729 (1929); See also *Eisner v. Macomber*, 64 L ed 521 at 525, and *Towne v. Eisner*, 245 US 418; *Gibbons v. Mahon*, 136 U.S. 549, 560, 34 L ed 525, 527.

[64] Fisher v Trinidad, 43 Phil. 973, 974.

[65] *Towne v. Eisner.*

[66] *Fisher v. Trinidad, supra., Eisner v. Macomber, supra* at 530.

[67] *Conwi v. CTA*, 213 SCRA 83 (1992); *Fisher v. Trinidad, supra.*

[68] *Ibid.*

[69] The "gain derived from capital" is "not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed or drawn by the claimant for separate use, benefit and disposal." *U.S. v. Phellis*, 257 US 156, 42 S Ct 63, 65, 66 L ed 180; *Taft v. Bowers*, 278 US 470, 49 S Ct 199 cited in Matic, Jr., *Income Taxation in the Philippines*, 1979 ed. p. 93.

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both combined[70] — so that to tax a stock dividend would be to tax a capital increase rather than the income.[71] In a loose sense, stock dividends issued by the corporation, are considered unrealized gain, and cannot be subjected to income tax until that gain has been realized. Before the realization, stock dividends are nothing but a representation of an interest in the corporate properties.[72] As capital, it is not yet subject to income tax. It should be noted that capital and income are different. Capital is wealth or fund; whereas income is profit or gain or the flow of wealth.[73] The determining factor for the imposition of income tax is whether any gain or profit was derived from a transaction.[74]

The Exception

"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 it represents a distribution of earnings or profits* accumulated after March first, nineteen hundred and thirteen." (Italics supplied).

In a response to the ruling of the American Supreme Court in the case of *Eisner v. Macomber*[75] (that *pro rata* stock dividends are not taxable income), the exempting clause above quoted was added because corporations found a loophole in

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[70] *Doyle v. Mitchell Brothers Co.*, 247 US 179, 38 S. Ct. 467 citing *Stratton's Independence v. Howbert*, 231 U.S. 399, 415, 34 S. Ct. 136, 58 L ed 385.

[71] *Towne v. Eisner, supra.*

[72] *Eisner v. Macomber*, 252 US 189 cited in *Fisher v. Trinidad, supra.*

[73] See Fisher, "The Nature and Capital of Income", cited in Cesar Rey. *The Tax Code Annotated*, 1958 ed., p. 32 and 1964 ed P. 42; *Madrigal, et. al. v. Rafferty, et al.*, 38 Phil. 414. See also Section 36, Old Income tax Regulations.

[74] *CIR v. Administratrix of the Estate of Echerri*, 67 Phil. 502.

[75] 252 U.S. 189, 64 L ed 521, 40 S Ct 189 9 ALR 1570 (1920).

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the original provision. They resorted to devious means to circumvent the law and evade the tax. Corporate earnings would be distributed under the guise of its initial capitalization by declaring the stock dividends previously issued and later redeem said dividends by paying cash to the stockholder. This process of issuance-redemption amounts to a distribution of taxable cash dividends which was just delayed so as to escape the tax. It becomes a convenient technical strategy to avoid the effects of taxation.

Thus, to plug the loophole — the exempting clause was added. It provides that the redemption or cancellation of stock dividends, depending on the "time" and "manner" it was made, is "essentially equivalent to a distribution of taxable dividends," making the proceeds thereof "taxable income" "to the extent it represents profits." The exception was designed to prevent the issuance and cancellation or redemption of stock dividends, which is fundamentally not taxable, from being made use of as a device for the actual distribution of cash dividends, which is taxable.[76] Thus,

> "the provision had the obvious purpose of preventing a corporation from avoiding dividend tax treatment by distributing earnings to its shareholders in two transactions – a pro rata stock dividend followed by a pro rata redemption – that would have the same economic consequences as a simple dividend."[77]

Although redemption and cancellation are generally considered capital transactions, as such, they are not subject to tax. However, it does not necessarily mean that a shareholder may not realize a taxable gain from such transactions.[78] Simply put, depending on the circumstances, the proceeds of redemption of stock dividends are essentially distribution of cash dividends, which when paid becomes the absolute property of the stockholder. Thereafter, the latter becomes the exclusive owner thereof

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[76] *CIR v. Brown*, 293 U.S. 570.

[77] *United States v. Davis*, 397 U.S. 301, 25 L ed 2d 323, 328, 90 S Ct 1041 (1970).

[78] 105 A.L.R. 774-775.

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and can exercise the freedom of choice[79] Having realized gain from that redemption, the income earner cannot escape income tax.[80]

As qualified by the phrase "such time and in such manner," the exception was not intended to characterize as taxable dividend every distribution of earnings arising from the redemption of stock dividends.[81] So that, whether the amount distributed in the redemption should be treated as the equivalent of a "taxable dividend" is *a question of fact*,[82] which is determinable on "the basis of the particular facts of the transaction in question."[83] No decisive test can be used to determine the application of the exemption under Section 83(b) The use of the words "such manner" and "essentially equivalent" negative any idea that a weighted formula can resolve a crucial issue — Should the distribution be treated as taxable dividend.[84] On this aspect, American courts developed certain recognized criteria, which includes the following:[85]

1) the presence or absence of real business purpose,

2) the amount of earnings and profits available for the declaration of a regular dividend and the corporation's past record with respect to the declaration of dividends,

3) the effect of the distribution as compared with the declaration of regular dividend,

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[79] *Eisner v. Macombe, supra.*, 524 citing *Davis v. Jackson*, 25 N.E. 21.

[80] *Wise v. Meer*, 78 Phil. 655; *Ogan v. Meer*, 83 Phil. 844.

[81] *Helvering v. Griffiths*, 318 U.S. 371.

[82] *Hirsch v. CIR*, 124 F2d 24, *Commissioner v. Bobson*, 70 F2d 304; *Randolph v. Commissioner*; 76 F2d 472, *Commissioner v. Champion*, 78 F2d 513; *Brown v. Commissioner*, 79 F2d 73; *Mc Guire v. Commissioner*, 84 F2d 432.

[83] *Bains v. United States*, 289 F2d 644, 646 (1961); See also *Ferro v. Comm.*, 242 F2d 838; *Callan Court Co v. Cobb*, 274 F2d 532.

[84] *Flanagan v. Helvering*, 116 F2d 937.

[85] *Himmel v. Comm., 338 F2d 815; Blount* v. Comm., 425 F2d 921; *Comm. v. Berenbaum*, 369 F2d 337.

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4) the lapse of time between issuance and redemption,[86]

5) the presence of a substantial surplus[87] and a generous supply of cash which invites suspicion as does a meager policy in relation both to current earnings and accumulated surplus.[88]

REDEMPTION AND CANCELLATION

For the exempting clause of Section 83(b) to apply, it is indispensable that: (a) there is redemption or cancellation; (b) the transaction involves stock dividends and (c) the "time and manner" of the transaction makes it "essentially equivalent to a distribution of taxable dividends." Of these, the most important is the third.

Redemption is repurchase, a reacquisition of stock by a corporation which issued the stock[89] in exchange for property, whether or not the acquired stock is cancelled, retired or held in the treasury.[90] Essentially, the corporation gets back some of its stock, distributes cash or property to the shareholder in payment for the stock, and continues in business as before. The redemption of stock dividends previously issued is used as a veil for the constructive distribution of cash dividends. In the instant case, there is no dispute that ANSCOR *redeemed* shares of stocks from a stockholder (Don Andres) twice (28,000 and 80,000 common shares). But where did the shares redeemed come from? If its source is the original capital subscriptions upon establishment of the corporation or from initial capital investment in an existing enterprise, its redemption to the concurrent value of acquisition may not invite the application of Sec. 83(b) under the 1939 Tax Code, as it is not income but a mere return of capital. On the contrary, if the redeemed

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[86] *Adler v. Comm.*, 77 F2d 733; *Robinson v. Comm.*, 69 F2d 972.

[87] *Brown v. Comm.*, 79 F2d 73, *Hyman v. Helvering*, 71 F2d 342.

[88] *Levin v. Comm.*, 385 F2d 521.

[89] West Tax Law Dictionary, 1993 ed., p. 691; *Seda v. CIR*, 82 T.C. 484 (1984).

[90] 33A Am Jur 2d, Federal Taxation (1995) Par. 4852; *Income Tax Techniques*, J.K.Lasser Institute, vol. IV, Chapter 11, 11.02.

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shares are from stock dividend declarations other than as initial capital investment, the proceeds of the redemption is additional wealth, for it is not merely a return of capital but a gain thereon.

It is not the stock dividends but the proceeds of its redemption that may be deemed as taxable dividends. Here, it is undisputed that at the time of the last redemption, the *original common* shares owned by the estate were only 25,247.5.[91] This means that from the total of 108,000 shares redeemed from the estate, the balance of 82,752.5 (108,000 less 25,247.5) must have come from *stock dividends*. Besides, in the absence of evidence to the contrary, the Tax Code presumes that every distribution of corporate property, in whole or in part, is made out of corporate profits,[92] such as stock dividends. The capital cannot be distributed in the form of redemption of stock dividends without violating the trust fund doctrine – wherein the capital stock, property and other assets of the corporation are regarded as equity in trust for the payment of the corporate creditors.[93] Once capital, it is always capital.[94] That doctrine was intended for the protection of corporate creditors.[95]

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[91] This figure represents Don Andres' conjugal share. (Memorandum for private respondent, p.19).

[92] Sec. 83 (c) [1939 NIRC] later Sec. 66 (c) [1977 NIRC, as amended] and now Sec. 73 (c) [1997 Tax Code] provides that: "*Dividends distributed are deemed made from most recently accumulated profits.* – Any distribution made to the shareholders or members of a corporation in the year nineteen hundred and thirty-nine or subsequent tax years, shall be deemed to have been made from the most recently accumulated profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received: x x x."; See also *Hyman v. Helvering*, 71 F2d 342, 344.

[93] *Boman Environmental Development Corporation v. CA*, 167 SCRA 540 (1985); Under Section 43 of the New Corporation Code (B.P. 68), corporations can declare dividends out of the "unrestricted retained earnings" and under Section 122 thereof, it cannot distribute any of its assets or property except upon lawful distribution and after all debts and liabilities settled.

[94] *Hyman v. Helvering, supra.*

[95] *Steinberg v. Velasco*, 52 Phil 953 (1925); *Phil Trust Co. v. Rivera*, 44 Phil. 469 (1923).

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With respect to the third requisite, ANSCOR redeemed stock dividends issued just 2 to 3 years earlier. The time alone that lapsed from the issuance to the redemption is not a sufficient indicator to determine taxability. It is a must to consider the factual circumstances as to the manner of both the issuance and the redemption. The "time" element is a factor to show a device to evade tax and the scheme of cancelling or redeeming the same shares is a method usually adopted to accomplish the end sought.[96] Was this transaction used as a "continuing plan," "device" or "artifice" to evade payment of tax? It is necessary to determine the "net effect" of the transaction between the shareholder-income taxpayer and the acquring (redeeming) corporation.[97] The "net effect" test is not evidence or testimony to be considered; it is rather an inference to be drawn or a conclusion to be reached.[98] It is also important to know whether the *issuance* of stock dividends was dictated by legitimate business reasons, the presence of which might negate a tax evasion plan.[99]

The issuance of stock dividends and its subsequent redemption must be separate, distinct, and not related, for the redemption to be considered a legitimate tax scheme.[100] Redemption cannot be used as a cloak to distribute corporate earnings.[101] Otherwise, the apparent intention to avoid tax becomes doubtful as the intention to evade becomes manifest. It has been ruled that:

"[A]n operation with no business or corporate purpose – is 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

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[96] *Ibid.*

[97] See *Phelps v. Commissioner*, 247 F 2d 156, 158-159.

[98] *Bradbury v. Comm.*, 298 F2d 111; *Bloch v. U.S.*, 386 F2d 839.

[99] *Asmussen v. CIR*, 36 B.T.A. (F) 878; See also *.Neff v. U.S.*, 301 F2d 330; *Cohen v. U.S.*, 192 F Supp 216; *Herman v. Comm.*, 283 F2d 227; *Kessner v. Comm.*, 248 F2d 943; *Comm v. Pope*, 239 F2d 881; *US v. Fewel*, 255 F2d 496.

[100] *Bryan v. CIR*, 20 B.T.A (F) 73.

[101] *CIR v. Cordingley*, 78 F2d 118.

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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 a stockholder."[102]

Depending on each case, the exempting provision of Sec. 83(b) of the 1939 Code may not be applicable if the redeemed shares were issued with *bona fide* business purpose,[103] which is judged after each and every step of the transaction have been considered and the whole transaction does not amount to a tax evasion scheme.

ANSCOR invoked two reasons to justiy the *redemptions* – (1) the alleged "filipinization" program and (2) the reduction of foreign exchange remittances in case cash dividends are declared. The Court is not concerned with the wisdom of these purposes but on their relevance to the whole transaction which can be inferred from the outcome thereof. Again, it is the "*net effect* rather than the motives and plans of the taxpayer or his corporation"[104] that is the fundamental guide in administering Sec. 83(b). This tax provision is aimed at the result.[105] It also applies even if at the time of the issuance of the stock dividend, there was no intention to redeem it as a means of distributing profit or avoiding tax on dividends.[106] The existence of legitimate business purposes in support of the *redemption* of stock dividends is immaterial in income taxation. It has no relevance in determining "dividend equivalence."[107] Such purposes may be material only upon the *issuance* of the stock dividends. The test of taxability

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[102] *Helvering v. Gregory*, 293 U.S. 465 cited in *Commissioner of Internal Revenue v. Rufino*, 148 SCRA 42, 50 (1987).

[103] *Patty v. Helvering*, 98 F2d 717.

[104] *Bloch v. U.S.*, 261 F Supp 597, 386 F2d 839; *Boyle v. Comm.*, 187 F2d 557; *Commissioner v. Estate of Beaford*, 325 U.S. 283, 89 L ed 1611, 65 S Ct 1157; See also the cases of Hirsch, Flanagan and Davis, *supra*.

[105] *Hirsch v. Commissioner, supra*, , *Hill v. Commissioner supra*.

[106] *McGuire v. Commissioner*, 84 F2d 431; *Brown, Jr. v. Commissioner*, 79 F2d 73, *Hill v. Commissioner*, 66 F2d 45.

[107] *Northup v. U S* 240 F 2d 304, 307; See also *McGinty v. Commissioner*, 325 F 2d 820, 821-822; *U S v. Davis*, 397 U.S. 301 (1990).

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under the exempting clause, when it provides "such time and manner" as would make the redemption "essentially equivalent to the distribution of a taxable dividend," is whether the redemption *resulted* into a flow of wealth. If no wealth is realized from the redemption, there may not be a dividend equivalence treatment. In the metaphor of *Eisner v. Macomber*, income is not deemed "realize" until the fruit has fallen or been plucked from the tree.

The three elements in the imposition of income tax are: (1) there must be gain or profit, (2) that the gain or profit is realized or received, actually or constructively,[108] and (3) it is not exempted by law or treaty from income tax. Any business purpose as to why or how the income was earned by the taxpayer is not a requirement. Income tax is assessed on income received from any property, activity or service that produces the income because the Tax Code stands as an indifferent neutral party on the matter of where income comes from.[109]

As stated above, the test of taxability under the exempting clause of Section 83(b) is, whether income was realized through the redemption of stock dividends. The redemption converts into money the stock dividends which become a realized profit or gain and consequently, the stockholder's separate property.[110] Profits derived from the capital invested cannot escape income tax. As realized income, the proceeds of the redeemed stock dividends can be reached by income taxation regardless of the existence of any business purpose for the redemption. Otherwise, to rule that the said proceeds are exempt from income tax when the redemption is supported by legitimate business reasons would defeat the very purpose of imposing tax on income. Such argument would open the door for income earners not to pay tax so long as the person from whom the income was derived has legitimate business reasons. In other words, the payment

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[108] Some authorities add that the gain or profit must not only be realized but must also be recognized. (33A Am Jur 2d, Federal Taxation [1995] par. 10000)

[109] *Commissioner of Internal Revenue v. Manning*, 66 SCRA 14.

[110] *Eisner v. Macomber*, *supra* at 529.

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of tax under the exempting clause of Section 83(b) would be made to depend not on the income of the taxpayer but on the business purposes of a third party (the corporation herein) from whom the income was earned. This is absurd, illogical and impractical considering that the Bureau of Internal Revenue (BIR) would be pestered with instances in determining the legitimacy of business reasons that every income earner may interposed It is not administratively feasible and cannot therefore be allowed.

The ruling in the American cases cited and relied upon by ANSCOR that "the redeemed shares are the equivalent of dividend only if the shares were not *issued* for genuine business purposes"[111] or the "redeemed shares have been *issued* by a corporation *bona fide*"[112] bears no relevance in determining the non-taxability of the proceeds of redemption. ANSCOR, relying heavily and applying said cases, argued that so long as the *redemption* is supported by valid corporate purposes the proceeds are not subject to tax.[113] The adoption by the courts below [114] of such argument is misleading if not misplaced. A review of the cited American cases shows that the presence or absence of "genuine business purposes" may be material with respect to the *issuance* or declaration of stock dividends but not on its subsequent *redemption*. The issuance and the redemption of stocks are two different transactions. Although the existence of legitimate corporate purposes may justify a corporation's acquisition of its own shares under Section 41 of the Corporation Code,[115] such purposes cannot excuse the

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[111] *De Nobili Cigar Co v. Commissioner*, 143 F 2d 436.

[112] *Patty v. Helvering*, 98 F 2d 717.

[113] Comment, pp. 14-16; *Rollo*, pp. 127-129; Rejoinder, p. 4; *Rollo*, p. 195.

[114] CTA Decision, pp 31-32, *Rollo*, pp. 91-92; CA Decision, pp. 11-13; Rollo, pp 114-116.

[115] *Batas Pambansa Blg.* 8. Section 41 provides: "*Power to acquire own shares* — A stock corporation shall have the power to purchase or acquire its own shares for a legitimate corporate purpose or purposes, including but not limited to the following: Provided that the corporation

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stockholder from the effects of taxation arising from the redemption. If the issuance of stock dividends is part of a tax evasion plan and thus, without legitimate business reasons the redemption becomes suspicious which may call for the application of the exempting clause. The substance of the whole transaction, not its form, usually controls the tax consequences.[116]

The two purposes invoked by ANSCOR, under the facts of this case are no excuse for its tax liability. First, the alleged "filipinization" plan cannot be considered legitimate as it was not implemented until the BIR started making assessments on the proceeds of the redemption. Such corporate plan was not stated in nor supported by any Board Resolution but a mere afterthought interposed by the counsel of ANSCOR. Being a separate entity, the corporation can act only through its Board of Directors.[117] The Board Resolutions authorizing the redemptions state only one purpose – reduction of foreign exchange remittances in case cash dividends are declared. Not even this purpose can be given credence. Records show that despite the existence of enormous corporate profits no cash dividend was ever declared by ANSCOR from 1945 until the BIR started making assessments in the early 1970's. Although a corporation under certain exceptions, has the prerogative when to issue dividends, yet when no cash dividends was issued for about three decades, this circumstances negates the legitimacy of ANSCOR's alleged purposes. Moreover, to issue stock dividends is to increase the shareholdings of ANSCOR's foreign stockholders contrary to

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has unrestricted retained earnings in its books to cover the shares to be purchased or acquired:

1.) To eliminate fractional shares arising out of stock dividends;

2.) To collect or compromise an indebtedness to the corporation, arising out of unpaid subscription, in a delinquency sale, and to purchase delinquent shares sold during said sale; and

3.) To pay dissenting or withdrawing stockholders entitled to payment for their shares under the provisions of this Code."

[116] Michie, Federal Tax Handbook, p. 101.

[117] Section 23 of B.P. 68 also known as the Corporation Code of the Philippines.

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its "filipinization" plan. This would also increase rather than reduce their need for foreign exchange remittances in case of cash dividend declaration, considering that ANSCOR is a family corporation where the majority shares at the time of redemptions were held by Don Andres' foreign heirs.

Secondly, assuming *arguendo*, that those business purposes are legitimate, the same cannot be valid excuse for the imposition of tax. Otherwise, the taxpayer's liability to pay income tax would be made to depend upon a third person who did not earn the income being taxed. Furthermore, even if the said purposes support the redemption and justify the issuance of stock dividends, the same has no bearing whatsoever on the imposition of the tax herein assessed because the proceeds of the redemption are deemed taxable dividends since it was shown that income was generated therefrom.

Thirdly, ANSCOR argued that to treat as 'taxable dividend' the proceeds of the redeemed stock dividends would be to impose on such stock an undisclosed lien and would be extremely unfair to intervening purchasers, *i.e.* those who buys the stock dividends after their issuance.[118] Such argument, however, bears no relevance in this case as no intervening buyer is involved. And even if there is an intervening buyer, it is necessary to look into the factual milieu of the case if income was realized from the transaction. Again, we reiterate that the dividend equivalence test depends on such "time and manner" of the transaction and its net effect. The undisclosed lien[119] may be unfair to a subsequent stock buyer who has no capital interest in the company. But the unfairness may not be true to an original subscriber like Don Andres, who holds stock dividends as gains from his investments. The subsequent buyer who buys stock dividends is investing capital. It just so happen that what he bought is stock dividends. The effect of its (stock dividends)

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[118] *Rollo*, p 113.

[119] "To make the stock dividend taxable is to impose an undisclosed lien and would be unfair to intervening purchasers." *(Commissioner v. Cordingley*, 78 F2d 118).

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redemption from that subsequent buyer is merely to return his capital subscription, which is income if redeemed from the original subscriber.

After considering the manner and the circumstances by which the issuance and redemption of stock dividends were made, there is no other conclusion but that the proceeds thereof are essentially considered equivalent to a distribution of taxable dividends. As "taxable dividend" under Section 83(b), it is part of the "entire income" subject to tax under Section 22 in relation to Section 21[120] of the 1939 Code. Moreover, under Section 29(a) of said Code, dividends are included in "gross income." As income, it is subject to income tax which is required to be withheld at source. The 1997 Tax Code may have altered the situation but it does not change this disposition.

EXCHANGE OF COMMON WITH PREFERRED SHARES[121]

Exchange is an act of taking or giving one thing for another[122] involving reciprocal transfer[123] and is generally considered as a taxable transaction. The exchange of common stocks with preferred stocks, or preferred for common or a combination of either for both, may not produce a recognized gain or loss, so long as the provisions of Section 83(b) is not applicable. This

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[120] Sec. 22. *Tax on nonresident alien individual.* — (a) *Nonresident alien engaged in trade or business within the Philippines.* — There shall be levied, collected and paid for each taxable year upon the entire income received from all sources within the Philippines by every nonresident alien individual engaged in trade or business within the Philippines the tax imposed by Section 21. (as amended by R.As. 2343 & 3841).

Sec. 21. *Rates of tax on citizens or residents.* — There shall be levied, collected and paid annually upon the entire income received in the preceding taxable year from all sources by every individual, a citizen or resident of the Philippines, a tax equal to the sum of the following x x x. (as amended by R.A. 2343)

[121] See 1986 and 1997 Tax Code where exchange of stocks is subject to a capital gains tax

[122] *US v. Paire*, 31 F. Supp 898, 900, *Kessler v. US.* 124 F2d 152, 154.

[123] *Horwick v. CIR*, 133 F2d 732, 737.

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is true in a trade between two (2) persons as well as a trade between a stockholder and a corporation. In general, this trade must be parts of merger, transfer to controlled corporation, corporate acquisitions or corporate reorganizations. No taxable gain or loss may be recognized on exchange of property, stock or securities related to reorganizations.[124]

Both the Tax Court and the Court of Appeals found that ANSCOR *reclassified* its shares into common and preferred, and that parts of the common shares of the Don Andres estate and all of Doña Carmen's shares were *exchanged* for the whole 150,000 preferred shares. Thereafter, both the Don Andres estate and Doña Carmen remained as corporate subscribers except that their subscriptions now include preferred shares. There was no change in their proportional interest after the exchange. There was no cash flow. Both stocks had the same par value. Under the facts herein, any difference in their market value would be immaterial at the time of exchange because no income is yet realized – it was a mere corporate paper transaction. It would have been different, if the exchange transaction resulted into a flow of wealth, in which case income tax may be imposed.[125]

Reclassification of shares does not always bring any substantial alteration in the subscriber's proportional interest. But the exchange is different – there would be a shifting of the balance of stock features, like priority in dividend declarations or absence of voting rights. Yet neither the reclassification nor exchange *per se*, yields realize income for tax purposes. A common stock represents the residual ownership interest in the corporation. It is a basic class of stock ordinarily and usually issued without extraordinary rights or privileges and entitles the shareholder to a *pro rata* division of profits.[126] Preferred stocks are those

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[124] *McDonald Restaurant v. CIR*, 688 F2d 520, (1982); West Tax Law Dictionary, 1993 ed Minn, West Publishing Co., pp. 676, 780.

[125] Under the 1997 Tax Code, exchange of stocks is subject to capital gains tax.

[126] 13 Am. Jur. 318, Fletcher cited in Agbayani, Commercial Law, Vol. 3 (1979 ed), p. 89

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which entitle the shareholder to some priority on dividends and asset distribution.[127]

Both shares are part of the corporation's capital stock. Both stockholders are no different from ordinary investors who take on the same investment risks. Preferred and common shareholders participate in the same venture, willing to share in the profits and losses of the enterprise.[128] Moreover, under the doctrine of equality of shares — all stocks issued by the corporation are presumed equal with the same privileges and liabilities, provided that the Articles of Incorporation is silent on such differences.[129]

In this case, the exchange of shares, without more, produces no realized income to the subscriber. There is only a modification of the subscriber's rights and privileges — which is not a flow of wealth for tax purposes. The issue of taxable dividend may arise only once a subscriber disposes of his entire interest and not when there is still maintenance of proprietary interest.[130]

WHEREFORE, premises considered, the decision of the Court of Appeals is MODIFIED in that ANSCOR's redemption of 82,752.5 stock dividends is herein considered as essentially equivalent to a distribution of taxable dividends for which it is LIABLE for the withholding tax-at-source. The decision is AFFIRMED in all other respects.

SO ORDERED.

Davide, Jr., C.J. (Chairman), Melo, Kapunan, and *Pardo, JJ.,* concur.

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[127] *In re: Silberkraus*, 229 NY Supp., 735.

[128] 2 Fletcher Cyc. Corp., p. 831 citing *Best v. Oklahoma Mill Co.*, 14 Okla 135 Par 1005.

[129] Sec. 5 par 1, last sentence of Act 1459 [Old Corporation Law] now Sec. 6 of B.P. 68 requires that the distinguishing features be stated also in the Certificate of Stock.

[130] *McDonald v. CIR, supra.*