# REVENUE MEMORANDUM RULINGS 2001

Quezon City

November 29, 2001

**REVENUE MEMORANDUM RULING NO. 1-2001**

**SUBJECT : Tax Consequences of Tax-Free Exchange of Property for Shares of Stock of a Controlled Corporation Pursuant to Section 40(C)(2) of the National Internal Revenue Code of 1997**

**TO : All Internal Revenue Officers and Others Concerned**

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Pursuant to Section 4, in relation to Sections 40(C)(2), (4), (5), (6), 175, 176, and 196, and pertinent provisions of Titles II, IV and VII of the National Internal Revenue Code of 1997 (Tax Code of 1997), this Revenue Memorandum Ruling is issued to consolidate, provide, clarify and harmonize the existing guidelines on the tax consequences of a non-recognition transaction consisting of a tax-free exchange of property for shares of stock under Section 40(C)(2) of the Tax Code of 1997. This Revenue Memorandum Ruling shall apply solely and exclusively to, and may be relied upon only in situations in which the facts are substantially similar to the facts stated below, but subject to the principles of substance over form.

## I FACTS

1. A domestic corporation (the "Transferor") owns certain property, consisting, for example, of the following:

    1.1 Land encumbered by a real estate mortgage (REM);
    1.2 Buildings;
    1.3 100 shares of stock in G Corporation with a par value of P10 per share;
    1.4 50 shares of stock in D Corporation without par value;
    1.5 Unsecured receivables;
    1.6 Loans to Q ("Borrower/Mortgagor"), secured by a real estate mortgage;
    1.7 Cash.

2. X Corporation (the "Transferee") is a domestic corporation.

3. The Transferor transfers the property to the Transferee. In exchange, the Transferee issues shares to the Transferor out of the unissued portion of its existing authorized capital stock, or, if such existing authorized capital stock is insufficient, out of shares from an increase in the Transferee's authorized capital stock. The Transferor does not receive any money or property other than the aforementioned shares of the transferee.

4. The property transferred by the Transferor-corporation constitutes less than 80% of the Transferor's assets, including cash.

5. In addition to the transfer of the property, the Transferee assumes liabilities of the Transferor. However, the sum total of the amount of liabilities assumed, plus the amount of the encumbrance or REM on the Land (as stated in Section 40(C)(4) of the Tax Code of 1997 - "liabilities to which the property is subject") do not exceed the basis of the property transferred.

6. The shares are neither issued in payment for services, nor for settlement of an outstanding liability that arises from the performance of services rendered by the Transferor to the Transferee.

7. As a result of the above-mentioned transfer, the Transferor acquires at least 51% of the total outstanding capital stock of the Transferee entitled to vote.

**II TAX CONSEQUENCES**

1. **Income tax.** The Transferor shall not recognize any gain or loss on the transfer of the property to the Transferee. Consequently, the Transferor will not be subject to capital gains tax, income tax, or to creditable withholding tax on the transfer of such property to the Transferee. Neither may the transferor recognize a loss, if any, incurred on the transfer. The last paragraph of Section 40(C)(2) and (6)(c) of the Tax Code of 1997 state:

> "No gain or loss shall also be recognized if property is transferred to a corporation by a person in exchange for stock or unit of participation in such corporation of which as a result of such exchange said person, alone or together with others, not exceeding four (4) persons, gains control of said corporation: Provided, That stocks issued for services shall not be considered as issued in return for property."
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> "(c) The term 'control', when used in this Section, shall mean ownership of stocks in a corporation possessing at least fifty-one percent (51%) of the total voting power of all classes of stocks entitled to vote."

In addition, the assumption of liabilities or the transfer of property that is subject to a liability does not affect the non-recognition of gain or loss under Section 40(C)(2) of the Tax Code of 1997, since in this case, the total amount of such liabilities does not exceed the basis of the property transferred. Section 40(C)(4) of the Tax Code of 1997 states:

> "(4) **Assumption of liability.** -
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> (a) If the taxpayer, in connection with the exchanges described in the foregoing exceptions, receives stock or securities which would be permitted to be received without the recognition of the gain if it were the sole consideration, and as a part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property, subject to a liability, then **such assumption or acquisition shall not be treated as money and/or other property, and shall not prevent the exchange from being within the exceptions**.
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> (b) If the amount of the liabilities assumed plus the amount of the liabilities to which the property is subject **exceed** the total amount of the adjusted basis of the

> property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be."

In addition, the Transferee is not subject to income tax on its receipt of the property as contribution to its capital, even if the value of such property exceeds the par value or stated value of the shares issued to the Transferor. Section 55 of Revenue Regulations No. 2 ("Income Tax Regulations") states:

> "Section 55. *Acquisition or disposition by a corporation of its own capital stock.* - xxx xxx xxx. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than the par or stated value of such stock.
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> xxx xxx xxx"

However, stocks shall not be issued for a consideration less than par or issued price thereof. (Section 62, Corporation Code of the Philippines)

2. **Donor's tax.** The Transferor is not subject to donor's tax, regardless of whether the value of the property transferred exceeds the par/stated value of the Transferee shares issued to the Transferor, there being no intent to donate on the part of the Transferor.

3. **Value-added tax**. The Transferor is not subject to value-added tax ("VAT") on the transfer of the property if it is not engaged in a business that is subject to the VAT under Title IV of the Tax Code of 1997. Even if the Transferor is engaged in an activity that is subject to VAT, it is nonetheless not subject to VAT on the transfer of the property to the Transferee, since the Transferor gains control of the Transferee. Section 4.100-5(b)(1) of Revenue Regulations No. 7-95, as amended states:

> "(b) **Not subject to output tax**. - The VAT shall not apply to goods or properties existing as of the occurrence of the following:
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> > 1) Change of control of a corporation by the acquisition of the controlling interest of such corporation by another stockholder or group of stockholders, Example: transfer of property to a corporation in exchange for its shares of stock under Section 34(c)(2) and (6)(c) of the Code [*now 40(C)(2) and (6)(c) of the Tax Code of 1997*].

4. **Documentary stamp tax**. The documentary stamp tax consequences of the transfer are as follows:

> 4.1 Either the Transferor or the Transferee is subject to documentary stamp tax as

follows:

4.1.1 **On the transfer of real property (Section 196, Tax Code of 1997)** - P15 on each P1,000 or fractional part thereof, based on the higher of: (i) the consideration contracted to be paid for such real property, and (ii) the fair market value as determined in accordance with Section 6(E) of the Tax Code of 1997.

4.1.1.1 The "consideration contracted to be paid for such real property" shall be computed in accordance with the following rules. "Stock in a corporation is a valuable consideration for the transfer of real property." (Section 177, Revenue Regulations No. 26) Therefore, the consideration for the real property shall be computed as the par/stated value of the Transferee shares issued to the Transferor in exchange for such property plus the value of such property in excess of such par/stated value recognized in the books of the Transferee as premium, additional capital contribution, or donated surplus, or the like. For instance, if the value of the property is P1,000,000, but only shares with an aggregate par value of P250,000 are issued, there being a premium above par of P750,000, which the Transferee records as additional capital contribution, donated surplus, or the like, the consideration is P1,000,000 (that is, par value of P250,000 + premium of P750,000).

4.1.1.2 On the other hand, the fair market value of the property as determined in accordance with Section 6(E) of the Tax Code of 1997 whichever is higher between (1) the fair market value as determined by the Commissioner (that is, zonal value), and (2) the fair market value as shown in the schedule of values of the Provincial and City Assessors.

4.1.1.3 The value of the improvements thereon shall be based on the formula provided under Revenue Audit Memorandum Order (RAMO) No. 1-2001 but shall not be lower than the fair market value in the Tax Declaration in the year of exchange.

According to the said RAMO, the value of the improvement shall be determined by deducting the

zonal value of the land from the total selling price/consideration per Deed of Exchange. Thus, if the total selling price/consideration per Deed of Exchange is P1,000,000.00 and the zonal value of the land is P600,000.00, then the value of the improvement is P400,000.00.

The fair market value of the improvement shall be determined per latest tax declaration at the time of its sale or disposition (in this particular case, the exchange of such property). If the tax declaration was issued three (3) or more years prior to the date of sale or disposition, the Transferor shall be required to submit a certification from the city/municipal assessor as to the fact that such tax declaration is the latest tax declaration covering the real property. Absent such certification, the Transferor must secure a copy of the latest tax declaration duly certified by the assessor.

4.1.2 **On the transfer of shares of stock held by the Transferor (Section 176, Tax Code of 1997)** -

4.1.2.1 The transfer of the shares of G Corporation, which have a par value, is subject to documentary stamp tax of P1.50 on each P200 or fractional part thereof of the par value of such shares.

4.1.2.2 The transfer of the shares of D Corporation, which are without par value, is subject to the documentary stamp tax of 25% of the documentary stamp tax that was paid when those shares were originally issued.

4.1.3 **Transfer of mortgage (Section 198, in relation to Section 195, Tax Code of 1997)** - The transfer of the real estate mortgage, as a consequence of the transfer of the loan to Q ("Borrower/Mortgagor"), is subject to documentary stamp tax at the following rate:

(a) When the amount secured does not exceed five thousand pesos (P5,000) - twenty pesos (P20);

(b) On each five thousand pesos (P5,000), or fractional part thereof in excess of five thousand pesos (P5,000), an additional tax of ten

pesos (P10).

4.2 The Transferee is subject to documentary stamp tax on the original issuance of its shares (Section 175, Tax Code of 1997), at the following rate, depending on whether such shares are par or no-par shares:

4.2.1 If the Transferee's shares are with par value, the documentary stamp tax is imposed at the rate of P2 on each P200 or fractional part thereof of the par value of such shares, regardless of whether the shares are issued at par value or for a premium (that is, for a consideration in excess of par value).

4.2.2 If the Transferee's shares are without par value, the documentary stamp tax is imposed at the rate of P2 on each P200 or fractional part thereof of the actual consideration paid for such shares.

5. **Time of payment of Taxes**. The time for the payment of the documentary stamp tax liabilities, whether the taxpayer is an e-filer or not, shall be as follows:

5.1 With respect to the transfer of property mentioned in 4.1, above, the documentary stamp tax shall be paid on or before the fifth (5th) day after the close of the month when the deed of assignment/transfer transferring such property was executed, made, signed, accepted, or transferred (Section 5, Revenue Regulations No. 6-2001).

5.2 With respect to the original issuance of shares mentioned in 4.2, above, the documentary stamp tax shall be paid on or before the fifth (5th) day after the close of the month of -

5.2.1 Approval of SEC registration, in case of original incorporation;

5.2.2 Approval of the increase in authorized capital stock, in case the shares issued to the Transferee come from the increase in authorized capital stock of the Transferee; or

5.2.3 Execution of the deed of assignment/transfer of the property for which the Transferee's shares are issued, in case the shares issued to the Transferor come from the unissued portion of the Transferee's existing authorized capital stock.

**III ADDITIONAL FACTS AND VARIATIONS NOT AFFECTING TAX CONSEQUENCES**

The following additional facts or variations will not affect the tax consequences of the transaction, as described

above:

1. In no. 1 of "I. Facts" stated above, if the total number of Transferors does not exceed five persons, whether such persons are natural persons or juridical persons.

2. In no. 7 of "I. Facts" stated above, the tax consequences are not affected by whether the Transferor is/was a shareholder prior to the transaction, or that, **prior to the transaction**, the Transferor already possessed control of the Transferee by owning 51% or more of the total outstanding capital stock of the Transferee entitled to vote. In such a case, the Transferor is deemed to have acquired "further control" of the Transferee, which places the transaction within the purview of Section 40(C)(2) of the Tax Code of 1997.

However, a Transferor who, prior to the transaction was an existing shareholder of the Transferee, but who owned less than 51% of the voting stocks of the Transferee (even if it, together with not more than four (4) persons, owned more than 51% of all classes of stocks entitled to vote of the Transferee) cannot be deemed to have gained control or further control of the Transferee if, after a transaction in which it is the sole transferor, it still owned by itself less than 51% of the voting stocks of the Transferee. For instance, assume in the above facts that, prior to the transfer, the Transferor, together with Stockholders E, B, M and R, owned 100% of the voting stocks of the Transferee. However, by itself the Transferor owned only 32% of the voting stocks of the Transferee (the balance of the 68% voting stocks being owned by Stockholders E, B, M and R). The Transferor transfers property to the Transferee in exchange for shares of stock. After this exchange, the Transferor owned, including the initial 32%, a total of 49% - or less than 51% - of the voting stocks of the Transferee. In this situation, the Transferor is not deemed to have gained control or further control of the Transferee.

**IV FURTHER CLARIFICATION OF FACTS AND TAX CONSEQUENCES**

1. No. 1 of "I. Facts" mentions "property". For purposes of Section 40(C)(2) of the Tax Code of 1997, this term excludes services, accounts receivable for services rendered by the Transferor for the Transferee, cash and the conversion of debt into equity.

2. No. 3 of "I. Facts" mentions the issuance of the Transferee's shares from the "unissued portion of its existing authorized capital stock, or, if such existing authorized capital stock is insufficient, out of shares from an increase in the Transferee's authorized capital stock". This statement of fact excludes the following, which if present, would give rise to a different tax consequence treated elsewhere other than in this Revenue Memorandum Ruling -

2.1 The issuance of treasury shares, which have previously been issued but were subsequently re-acquired by the Transferee and have not been retired.

2.2 Settlement of subscription receivables. Therefore, the tax consequences described above shall not apply to the extent that the property is transferred in payment for the unpaid balance of the subscription to shares.

3. No. 4 of "I. Facts" mentions the property transferred constituting "less than 80% of the

Transferor's assets, including cash". This requirement is necessary to distinguish this transaction from a de facto merger as described in Section 40(C)(6)(b) of the Tax Code of 1997 in relation to BIR Circular No. V-253 dated July 16, 1957, the tax consequences of which will be discussed in a different Revenue Memorandum Ruling.

4. No. 5 of "I. Facts" mentions the term "adjusted basis of the property", as well as the fact that such liabilities assumed and to which the property is subject "do(es) not exceed the adjusted basis of the property transferred". These terms are clarified as follows:

> 4.1 The basis or "original basis" of the property is its "historical cost". "Historical cost" is the value of the property as determined pursuant to Section 40(B) of the Tax Code of 1997. The term "adjusted basis" is the value of the property as determined pursuant to the said Section, modified by adjustments to the historical cost. For example, the "adjusted basis" of a property acquired by purchase is the historical cost (acquisition cost) of such property increased by, among others, the amount of improvements that materially add to the value of the property or appreciably prolong its life and decreased by accumulated depreciation. "Adjusted basis" excludes re-appraisal surplus, whether or not recorded in the books of the Transferor.
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> 4.2 "Property" does not include services or accounts receivable for services rendered by the Transferor to the Transferee, cash, or the conversion of debt into equity. Therefore, in determining whether liabilities assumed and to which the property is subject "do(es) not exceed the adjusted basis of the property transferred", the value of services rendered, cash and the conversion of debt into equity will be excluded from the computation of "adjusted basis of the property transferred".

5. The term "adjusted basis" should be distinguished from the term "substituted basis", since they are not necessarily synonymous. The terms "original basis" and "adjusted basis" are used in reference to the value of the property before it was transferred by the Transferor; whereas, the term "substituted basis" is used in reference to **both** the value of the property in the hands of the Transferee after its transfer **and** the shares received by the Transferor from the Transferee. The term "substituted basis" is significant in determining the tax basis of the aforementioned property or shares for purposes of computing the gain or loss on the subsequent disposition of such property or shares. The following rules will apply in determining substituted basis:

> 5.1 In general, the substituted basis of the Transferee's shares received by the Transferor for purposes of computing gain or loss on the subsequent disposition of such shares by the Transferor is equal to the Transferor's basis in the property at the time of the transfer (that is, "historical cost/original basis" or "adjusted basis", as the case may be) **decreased** by (1) the money received by the Transferor, and (2) the fair market value of the other property received by the Transferor, and **increased** by (a) the amount treated as dividend of the shareholder and (b) the amount of any gain that was recognized on the exchange. If, as in this case, the Transferee assumed liabilities of the Transferor and/or acquired property of the

Transferor that is subject to liabilities, the amount of liabilities shall be treated as money for purposes of determining the substituted basis. In the particular facts covered by this Revenue Memorandum Ruling, the substituted basis of the Transferee's shares acquired by the Transferor is the historical cost/original basis or adjusted basis of the properties mentioned in no. 1 of "I. Facts" (excluding cash), less the total of (a) the amount of liabilities assumed by the Transferee and (b) the amount of real estate mortgage on the Land.

Section 40(C)(5)(a) of the Tax Code of 1997 states:

> "(5) **Basis**. -
>
> (a) The basis of the stock or securities received by the transferor upon the exchange specified in the above exception shall be the same as the basis of the property, stock or securities exchanged, decreased by (1) the money received, and (2) the fair market value of the other property received, and increased by (a) the amount treated as dividend of the shareholder and (b) the amount of any gain that was recognized on the exchange; Provided, That the property received as "boot" shall have as basis its fair market value; provided, further, that if as part of the consideration to the transferor, the transferee of property assumes a liability of the transferor or acquires from the latter property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this paragraph, be treated as money received by the transferor on the exchange; provided, finally, that if the transferor receives several kinds of stock or securities, the Commissioner is hereby authorized to allocate the basis among the several classes of stocks or securities."

5.2 On the other hand, the substituted basis of the property in the hands of the Transferee for purposes of computing gain or loss on the subsequent disposition of such property by the Transferee is the Transferor's original or adjusted basis in such property at the time of transfer plus the gain recognized to the transferor on the exchange. Section 40(C)(5)(b) of the Tax Code of 1997 states:

> "The basis of the property transferred in the hands of the transferee shall be same as it would be in the hands of the transferor increased by the amount of the gain recognized to the transferor on the transfer."

In the particular facts of this Revenue Memorandum Ruling, there are no circumstances under which the Transferor recognizes gain. Thus, in this case, the substituted basis of the property in the hands of the Transferee is equal to the Transferor's original or adjusted basis in such property at the time of the transfer.

6. No. 7 of "I. Facts" mentions that the Transferor acquires "at least 51% of the **total outstanding capital stock** of the Transferee **entitled to vote"**. Shares of stock "entitled to vote" excludes those shares that have been denied voting rights in the Transferee's Articles of Incorporation, in accordance with the provisions of Batas Pambansa Blg. 68 ("The Corporation Code of the Philippines" or the "Corporation Code") (although the Corporation Code may retain the right of holders of preferred shares to vote in certain instances specified in the Code).

For instance, assume in the above Facts, that the Transferee has an authorized capital stock of P32,550,000.00 divided into 265,000 common shares and 2,990,000 preferred **non-voting** shares with a par value of P10.00 per share. Only common shares have voting rights. The stockholders of the Transferee **before** the transfer are the following:

| Stockholders | Common | | Preferred |
|---|---|---|---|
| Transferor | 135,490 | | 9 |
| B | 10 | | 8 |
| C | 64,000 | | 651,244 |
| D | 64,000 | | 651,246 |
| E | 1,497 | | 530,340 |
| F | 1 | | 1 |
| G | 1 | | 1 |
| H | 1 | | 1 |
| | ---------- | | ---------- |
| TOTAL | 265,000 | | 1,832,850 |
| | ====== | | ====== |

The Transferee increases its authorized capital stock by increasing only the number of its common shares. Out of this increase, the Transferor subscribes to 298,450 common shares for a total subscription price of P2,984,500.00, which subscription is paid in property.

As a result of the subscription, the Transferor gains control of the Transferee by owning 77.01% (433,940/563,450 common shares) of the latter's outstanding shares of stock that are entitled to vote, to wit:

| | | | |
|---|---|---|---|
| G | 1 | | 1 |
| H | 1 | | 1 |
| | --- | | --- |
| TOTAL | 563,450 | | 1,832,850 |
| | ====== | | ====== |

7. If the Transferor is a Philippine branch of a foreign corporation, and the branch is incorporated into the Transferee corporation (such that the branch will no longer exist after the incorporation of the Transferee) directly owned by the head office, in addition to the tax consequences described above, the branch will be subject to the 15% branch profits remittance tax to the extent that there are unremitted branch profits at the time of transfer (Section 28(A)(5), Tax Code of 1997), since the transaction will be considered a constructive remittance of branch profits to the head office which is converted into equity of the Transferee corporation. The 15% rate may be reduced under applicable provisions of the various tax treaties to which the Philippines is a signatory.

**V COMPLIANCE**

In addition to the foregoing, the Transferor/s and Transferee should comply with their obligations as provided in Revenue Regulations No. 18-2001 dated November 13, 2001 and Revenue Memorandum Order No. dated November , 2001.

**VI REPEALING CLAUSE**

All Rulings that are inconsistent with this Revenue Memorandum Ruling are hereby repealed accordingly.

**VII EFFECTIVITY**

Subject to the provisions of Section 246 of the Tax Code of 1997, this Revenue Memorandum Ruling shall take effect immediately.

**RENÉ G. BAÑEZ**
Commissioner of Internal Revenue