REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE
Quezon City

April 25, 2002

REVENUE MEMORANDUM RULING NO. 1-2002

SUBJECT : Tax Consequences of *De Facto* Merger Pursuant to Section 40(C)(2) and (6)(b) of the National Internal Revenue Code of 1997

TO : All Internal Revenue Officers and Others Concerned

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 *de facto* merger under Section 40(C)(2) and (6)(b) 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 principle that for such transaction to be considered a *de facto* merger within the purview of Section 40(C)(2) in relation to 40(6)(b) of the Tax Code of 1997, the same must be undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation.

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. The property transferred by the Transferor constitutes at least 80% of the Transferor's assets, including cash.

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. 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.

II GENERAL PRINCIPLES

1. A *de facto* merger involves the acquisition by one corporation of all or substantially all the properties of another solely for stock. Section 40(C)(6)(b) of the Tax Code of 1997 states:

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

The phrase "substantially all the properties of another corporation" is defined in BIR General Circular No. V-253 dated July 16, 1957 to mean "the acquisition by one corporation of at least 80% of the assets, including cash, of another corporation," which 'has the element of permanence and not merely momentary holding'.

To constitute a *de facto* merger, the following elements must concur: (1) there must be a transfer of all or substantially all of the properties of the transferor corporation solely for stock, and (2) it must be undertaken for a *bona fide* business purpose and not solely for the purpose of escaping the burden of taxation.

One basic difference between a *de facto* merger and a statutory merger is that the Transferor is not automatically dissolved in the case of the former. Likewise, there is no automatic transfer to the Transferee of all the rights, privileges, and liabilities of the Transferor. It is, in fact, in procedure, similar to a transfer to a controlled corporation under the same Section 40(C)(2) of the Tax Code of 1997, except that at least 80% of the Transferor's assets, including cash, are transferred to the Transferee, with the element of permanence and not merely momentary holding. However, a *de facto* merger and a transfer to a controlled corporation are different in that, (1) the Transferor in a *de facto* merger is a corporation, while in a transfer to a controlled corporation, the

Transferors may either be a corporation or an individual, and (2) in a *de facto* merger, there is no requirement that the transferor gains control (that is, 51% of the total voting powers of all classes of stocks of the Transferee entitled to vote) of the Transferee as a prerequisite to enjoying the benefit of non-recognition of gain or loss. What is essential in a *de facto* merger is that the Transferee acquires all or substantially all of the properties of the Transferor.

III 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, nor 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.

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. –
>
> (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."

Moreover, 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.

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. Section 4.100-5(b)(1) & (3) 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].*
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> xxx
>
> 3) Merger or consolidation of corporations. The unused input tax of the dissolved corporation as of the date of merger or consolidation shall be absorbed by the surviving or new corporation."

Thus, since a *de facto* merger is considered within the definition of a merger under Section 40(C)(6) of the Tax Code of 1997, the transfer of the property by the Transferor to the Transferee shall not be subject to VAT. However, the second sentence of Section 4.100-5(b)(3), *supra,* is inapplicable in *de facto* mergers, and therefore, the Transferor's unused input tax cannot be absorbed by or transferred to the Transferee. The above sentence contemplates only a statutory merger or consolidation that, by operation of law, results in a "dissolved corporation" and a "surviving or new corporation". Furthermore, pursuant to Section 80 of the Corporation Code of the Philippines, the unused input tax, being an asset, is transferred in statutory merger by operation of law.

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 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:

4.1.4 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).

4.1.5 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 Documentary Stamp 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 Transferor 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.

IV 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, the total number of Transferors in a *de facto* merger is not relevant in determining whether it qualifies for non-recognition of gain or loss. However, non-recognition of gain or loss will apply to the Transferors that meet the requirements for a *de facto* merger described in "II. General Principles"

2. In no. 3 of "I. Facts" stated above, the shares issued by the Transferee may either be voting or non-voting stocks since the voting requirement applies only to a transfer to a controlled corporation, pursuant to Section 40(C)(2) in relation to 40(C)(6)(c) of the Tax Code of 1997.

3. The tax consequences are not affected by whether the Transferor is/was a shareholder prior to the transaction.

4. Paragraph IV(4) & (5) of Revenue Memorandum Ruling 1-2001 dated November 29, 2001, which discuss the tax basis of property and shares involved in a merger, consolidation or transfer to a controlled corporation, are hereby reproduced and adopted by reference in this Revenue Memorandum Ruling.

V 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. 2 of "I. Facts" mentions the property transferred constituting "at least 80% of the Transferor's assets, including cash". This distinguishes this transaction from a transfer to a controlled corporation as described in Section 40(C)(2) of the Tax Code of 1997 and Revenue Memorandum Ruling No. 1-2001 dated November 29, 2001.

3. 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 –

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

3.2 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.

VI 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 18, 2001 and Revenue Memorandum Order No. 32-2001 dated November 28, 2001.

VII Repealing Clause

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

VI Effectivity

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

(Original Signed)
RENÉ G. BAÑEZ
Commissioner of Internal Revenue

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