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

June 10, 2002

REVENUE MEMORANDUM RULING NO. 2-2002

SUBJECT : Determination of Substituted Basis of Property Transferred and Shares Received, Pursuant to Section 40(C)(5) of the National Internal Revenue Code of 1997

TO : All Internal Revenue Officers and Others Concerned

I Scope

Pursuant to Section 4 in relation to Section 40(C)(5) and other pertinent provisions of Title II of the National Internal Revenue Code of 1997 (Tax Code of 1997), this Revenue Memorandum Ruling is issued to provide the guidelines provided by Section 40(C)(5) of the Tax Code of 1997 in determining the substituted basis of property transferred and shares received, pursuant to a tax-free exchange of property for shares of stock under Section 40(C)(2) of the Tax Code of 1997, which shall be annotated on the transfer certificate of title, condominium certificate of title, or certificate of stock of such property/shares, pursuant to the provisions of Revenue Regulations No. 18-2001 dated November 18, 2001. 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.

II Facts

A. Transfer Involving One Property

Situation No. 1

1. A corporation (the "Transferor") acquired a parcel of land in 1963 at a purchase price of P100,000.

2. On January 1, 2001, Transferor exchanges the said property for 1,000,000 shares with an aggregate par value of P1,000,000 of another corporation (the "Transferee") pursuant to Section 40(C)(2) of the Tax Code of 1997. At the time of such transfer, the property has a fair market value of P1,000,000,

which is higher than its zonal value as determined in accordance with Section 6(E) of the Tax Code of 1997.

3. The property transferred is not encumbered by any mortgage or any other lien.

4. Transferee does not assume any liability of Transferor.

5. The transaction complies with all the requisites of a tax-free exchange of property for shares of stocks of a controlled corporation under Section 40(C)(2) of the Tax Code of 1997 and Revenue Memorandum Ruling No. 1-2001 dated November 29, 2001, or a *de facto* merger under Revenue Memorandum Ruling No 1-2002 dated April 25, 2002, as the case may be.

Situation No. 2

Same facts as Situation No. 1, except that in this situation, instead of land, the property transferred is a building constructed on January 1, 1991 at a cost of P250,000. Assuming that the building has a useful life of 25 years and using the straight-line method of depreciation, the adjusted basis of the building at the time of the transfer on January 1, 2001 is P150,000 [P250,000 – (P250,000/25 years x 10 years].

Situation No. 3

Same facts as Situation No. 1, except that, in addition to the transfer of the land to Transferee, Transferee assumes the liabilities of Transferor in the amount of P30,000, and the fair market value of the land is P1,030,000, which is higher than its zonal value as determined in accordance with Section 6(E) of the Tax Code of 1997.

Situation No. 4

Same facts as Situation No. 1, except that the parcel of land transferred to Transferee in the exchange is mortgaged to secure Transferor's loan from Bank X in the amount of P25,000, and the fair market value of the land is P1,025,000, which is higher than its zonal value as determined in accordance with Section 6(E) of the Tax Code of 1997.

Situation No. 5

Same facts as Situation No. 1 except that, in addition to the transfer of the land to Transferee, Transferee assumes the liabilities of Transferor in the amount of P30,000. Moreover, the land transferred is mortgaged to secure Transferor's loan from Bank X in the amount of P25,000, and the fair market value of the land

is P1,055,000, which is higher than its zonal value as determined in accordance with Section 6(E) of the Tax Code of 1997.

B. Transfer Involving Two or More Properties

Situation No. 6

1. A corporation (the "Transferor") acquired two parcels of land in 1963 at a purchase price of P100,000 and P150,000, respectively ("Property 1" and "Property 2", respectively).

2. On January 1, 2001, Transferor exchanges the said properties for 1,000,000 shares with an aggregate par value of P1,000,000 of another corporation (the "Transferee") pursuant to Section 40(C)(2) of the Tax Code of 1997. At the time of such transfer, Property 1 has a fair market value of P430,000, while Property 2 has a fair market value of P600,000, both fair market values of which are higher than their respective zonal value as determined in accordance with Section 6(E) of the Tax Code of 1997.

3. The properties transferred are not encumbered by any mortgage or any other lien.

4. Transferee does not assume any liability of Transferor.

5. The transaction complies with all the requisites of a tax-free exchange of property for shares of stocks of a controlled corporation under Section 40(C)(2) of the Tax Code of 1997 and Revenue Memorandum Ruling No.1-2001 dated November 29, 2001.

Situation No. 7

7a. Same facts as Situation No. 6, except that, in addition to the transfer of Property 1 and Property 2 to Transferee, Transferee assumes the liabilities of Transferor in the amount of P30,000.

7b. Same facts as Situation No. 6, except that, in addition to the transfer of Property 1 and Property 2 to Transferee, the said properties are jointly mortgaged to secure Transferor's loan in the amount of P30,000.

Situation No. 8

Same facts as Situation No. 6, except that Property 1 transferred to Transferee in the exchange is mortgaged to secure Transferor's loan from Bank X in the amount of P25,000.

Situation No. 9

Same facts as Situation No. 6 except that, in addition to the transfer of Property 1 and Property 2 to Transferee, Transferee assumes the liabilities of Transferor in the amount of P30,000. Moreover, Property 1 is mortgaged to secure Transferor's loan from Bank X in the amount of P25,000.

Situation No. 10

1. Transferor transfers its assets, consisting of cash in the amount of P100,000, land acquired at a cost of P50,000 and a fair market value of P200,000, shares of stock in Corporation Z in the amount of P200,000, inventory of P200,000, raw material of P200,000, and trade receivables of P200,000, to Transferee for 1,000,000 shares of Transferee with an aggregate par value of P1,000,000. The respective original basis of the shares of stock in Corporation Z, inventory, raw material and trade receivables is equal to their respective fair market value at the time of transfer.

2. The properties transferred are not encumbered by any mortgage or any other lien.

3. Transferee does not assume any liability of Transferor.

4. The transaction complies with all the requisites of a tax-free exchange of property for shares of stocks of a controlled corporation under Section 40(C)(2) of the Tax Code of 1997 and Revenue Memorandum Ruling No. 1-2001 dated November 29, 2001, or a *de facto* merger under Revenue Memorandum Ruling No. 1-2002 dated April 25, 2002, as the case may be.

Situation No. 11

Same facts as Situation No. 10 except that, in addition to the transfer of the assets to Transferee, Transferee assumes the liabilities of Transferor in the amount of P100,000. Moreover, the land is mortgaged to secure Transferor's loan from Bank X in the amount of P25,000.

III Issues

1. Determination of the substituted basis of the shares issued by the Transferee to the Transferor in each of the above situations, for purposes of determining the gain or loss on the subsequent disposition of such shares by the Transferor.

2. Determination of the substituted basis of the property(ies) transferred in the hands of the Transferee in each of the above situations, for purposes of determining the gain or loss on the subsequent disposition of such property(ies) by the Transferee.

IV General Discussion

A. Applicable Rules in the Determination of Substituted Basis

1. Section 40(C)(5), Tax Code of 1997

1.1 With respect to the determination of the substituted basis of the shares received by the Transferor, 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."

1.2 With respect to the determination of the substituted basis of the property(ies) transferred by the Transferor to the Transferee, 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."

2. General Principles and Guidelines

2.1 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 [Sections 36(A)(2) and 34(F), Tax Code of 1997]. "Adjusted basis" excludes re-appraisal surplus, whether or not recorded in the books of the Transferor.

"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".

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" within the context of Section 40(C) of the Tax Code of 1997, 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 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.

2.2 Where only one property is transferred, the substituted basis of the shares received by the Transferor is equal to the adjusted basis of the aforementioned property at the time of transfer, as further adjusted by the liabilities transferred/assumed in accordance with Section 40(C)(5) of the Tax Code of 1997. To determine the substituted basis of each share, such aforementioned substituted basis shall be allocated pro rata among all the shares received by the Transferor in exchange for such property.

2.3 Where two or more properties are transferred, the proportionate number of shares issued for each property must first be determined. In the absence of express stipulation in the deed of assignment/exchange/transfer, the

proportionate number of shares deemed issued for each property shall be determined as follows (assuming two properties are transferred):

Property 1

$$\left[\frac{F_1}{F_1 + F_2}\right] \times X_t = X_1$$

Property 2

$$\left[\frac{F_2}{F_1 + F_2}\right] \times X_t = X_2$$

Where,

F_1 = fair market value of Property 1.

F_2 = fair market value of Property 2.

X_t = the total number of Transferee shares issued to Transferor

X_1 = the number of shares allocated to Property 1

X_2 = the number of shares allocated to Property 2

Fair market value is the total consideration or the fair market value per Section 6(E) of the Tax Code of 1997, whichever is higher.

2.4 Where a mortgage, pledge or other encumbrance exists on one of the properties transferred, such mortgage, pledge or other encumbrance shall have an effect on the determination of the substituted basis only of the property subject to such mortgage, pledge or other encumbrance. In other words, the amount of such mortgage, pledge or other encumbrance will not be allocated to the other properties which are not subject to said mortgage, pledge or other encumbrance. However, where two or more properties are mortgaged to secure a single loan or liability, and the Transferee assumes such liability, the amount of such liabilities shall be allocated among the properties transferred in determining the substituted basis of each such properties. The amount of such liabilities allocated among the properties shall be determined as follows:

Property 1

$$\left[\frac{F_1}{F_1 + F_2}\right] \times E_t = E_1$$

Property 2

$$\left[\frac{F_2}{F_1 + F_2}\right] \times E_t = E_2$$

Where,

F_1 = fair market value of Property 1.

F_2 = fair market value of Property 2.

E_t = the total amount of liabilities assumed by the Transferee other than liabilities to which the property(ies) is/are subject.

E_1 = the amount of liabilities allocated to Property 1.

E_2 = the amount of liabilities allocated to Property 2.

2.5 Where the Transferee assumes a liability or liabilities which does or do not constitute a mortgage, pledge or other encumbrance on any specific property, the amount of such liabilities shall be allocated among the properties transferred in determining the substituted basis of each such properties. The amount of such liabilities allocated among the properties shall be determined as follows:

Property 1

$$\left[\frac{F_1}{F_1 + F_2}\right] \times L_t = L_1$$

Property 2

$$\left[\frac{F_2}{F_1 + F_2}\right] \times L_t = L_2$$

Where,

F_1 = fair market value of Property 1.

F_2 = fair market value of Property 2.

L_t = the total amount of liabilities assumed by the Transferee other than liabilities to which the property(ies) is/are subject

L_1 = the amount of liabilities allocated to Property 1

L_2 = the amount of liabilities allocated to Property 2

3. Taking into account the foregoing, the substituted basis for the shares received by the Transferor shall be determined as follows:

Property 1	No. of Shares (X_1)
$B_{01} - (E_1 + L_1) = S_{s1}$	

Property 2	No. of Shares (X_2)
$B_{02} - (E_2 + L_2) = S_{s2}$	

Where,

B_{01} = the original or adjusted basis of Property 1 transferred at the time of transfer

B_{02} = the original or adjusted basis of Property 2 transferred at the time of transfer

E = the encumbrance on the specific property transferred at the time of transfer

L = the liabilities of the Transferor assumed by Transferee, allocated to that particular property (see 2.4 above)

S_{s1} = the substituted basis of the shares received by Transferor in exchange for Property 1

S_{s2} = the substituted basis of the shares received by Transferor in exchange for Property 2

V Application of Rules

A. Substituted Basis of Shares Received

Applying the foregoing rules, the substituted basis of the shares received by the Transferor is as follows:

Situation No. 1

Property 1	1,000,000 Shares
Step 1	$B_{01} – (E_1 + L_1) = S_{s1}$
	P100,000 – (0 + 0) = P100,000
Substituted Basis of 1,000,000 Transferee shares	P100,000

Situation No. 2

Property 1	1,000,000 Shares
Step 1	$B_{01} – (E_1 + L_1) = S_{s1}$
	P150,000 – (0 + 0) = P150,000
Substituted Basis of 1,000,000 Transferee shares	P150,000

Situation No. 3

Property 1	1,000,000 Shares
Step 1	$B_{01} – (E_1 + L_1) = S_{s1}$
	P100,000 – (0 + P30,000) = P70,000
Substituted Basis of 1,000,000 Transferee shares	P70,000

Situation No. 4

Property 1	1,000,000 Shares
Step 1	$B_{01} – (E_1 + L_1) = S_{s1}$
	P100,000 – (P25,000 + 0) = P75,000
Substituted Basis of 1,000,000 Transferee shares	P75,000

Situation No. 5

Property 1	1,000,000 Shares
Step 1	$B_{01} – (E_1 + L_1) = S_{s1}$
	P100,000 – (P25,000 + P30,000) = P45,000
Substituted Basis of 1,000,000 Transferee shares	P45,000

Situation No. 6

Property 1	
Step 1	
Allocation of shares	$\left[\frac{F_1}{F_1 + F_2}\right] \times X_t = X_1$
	$\left[\frac{P430,000}{P430,000 + P600,000}\right] \times 1,000,000 = 417,476$ shares*
Step 2	$B_{01} – (E_1 + L_1) = S_{s1}$
Determination of Substituted Basis	P100,000 – (P0 + 0) = P100,000

Substituted Basis of 417,476 Transferee shares	P100,000

Property 2	
Step 1	
Allocation of shares	$\left[\frac{F_2}{F_1 + F_2}\right] \times X_t = X_2$
	$\left[\frac{P600{,}000}{P430{,}000 + P600{,}000}\right] \times 1{,}000{,}000 = 582{,}524$ shares*
Step 2	$B_{02} - (E_2 + L_2) = S_{s2}$
Determination of Substituted Basis	P150,000 – (0 + 0) = P150,000
Substituted Basis of 582,524 Transferee shares	P150,000

***** Computation of the number of shares has been rounded off to the nearest whole number.

Situation No. 7

7a.

Property 1	
Step 1	
Allocation of shares	$\left[\frac{F_1}{F_1 + F_2}\right] \times X_t = X_1$

	$\left[\frac{P430{,}000}{P430{,}000 + P600{,}000}\right] \times 1{,}000{,}000$ = 417,476 shares*
Step 2	
Allocation of liability	$\left[\frac{F_1}{F_1 + F_2}\right] \times L_t$ = L_1
	$\left[\frac{P430{,}000}{P430{,}000 + P600{,}000}\right] \times P30{,}000$ = P12,524**
Step 3	$B_{01} - (E_1 + L_1) = S_{s1}$
Determination of Substituted Basis	P100,000 – (0 + 12,524) = P87,476
Substituted Basis of 417,476 Transferee shares	P87,476

Property 2	
Step 1	
Allocation of shares	$\left[\frac{F_2}{F_1 + F_2}\right] \times X_t$ = X_2
	$\left[\frac{P600{,}000}{P430{,}000 + P600{,}000}\right] \times 1{,}000{,}000$ = 582,524 shares*
Step 2	
Allocation of liability	$\left[\frac{F_2}{F_1 + F_2}\right] \times L_t$ = L_2

	$\left[\frac{P600{,}000}{P430{,}000 + P600{,}000}\right] \times P30{,}000$ = P17,476**
Step 3	$B_{02} - (E_2 + L_2) = S_{s2}$
Determination of Substituted Basis	P150,000 – (0 + 17,476) = P132,524
Substituted Basis of 582,524 Transferee shares	P132,524

***** Computation of the number of shares has been rounded off to the nearest whole number.

** Allocation of the liability has been computed to the nearest peso.

7b.

Property 1	
Step 1	
Allocation of shares	$\left[\frac{F_1}{F_1 + F_2}\right] \times X_t = X_1$
	$\left[\frac{P430{,}000}{P430{,}000 + P600{,}000}\right] \times 1{,}000{,}000$ = 417,476 shares*
Step 2	
Allocation of liability	$\left[\frac{F_1}{F_1 + F_2}\right] \times E_t = E_1$
	$\left[\frac{P430{,}000}{P430{,}000 + P600{,}000}\right] \times P30{,}000$ = P12,524**
Step 3	$B_{01} - (E_1 + L_1) = S_{s1}$

Determination of Substituted Basis	P100,000 – (12,524 + 0) = P87,476
Substituted Basis of 417,476 Transferee shares	P87,476

Property 2	
Step 1	
Allocation of shares	$\left[\frac{F_2}{F_1 + F_2}\right] \times X_t$ = X_2
	$\left[\frac{P600,000}{P430,000 + P600,000}\right] \times 1,000,000$ = 582,524 shares*
Step 2	
Allocation of liability	$\left[\frac{F_2}{F_1 + F_2}\right] \times E_t$ = E_2
	$\left[\frac{P600,000}{P430,000 + P600,000}\right] \times P30,000$ = P17,476**
Step 3	$B_{02} – (E_2 + L_2) = S_{s2}$
Determination of Substituted Basis	P150,000 – (17,476 + 0) = P132,524
Substituted Basis of 582,524 Transferee shares	P132,524

***** Computation of the number of shares has been rounded off to the nearest whole number.

** Allocation of the liability has been computed to the nearest peso.

Situation No. 8

Property 1	
Step 1	
Allocation of shares	$\left[\frac{F_1}{F_1 + F_2}\right] \times X_t = X_1$
	$\left[\frac{P430{,}000}{P430{,}000 + P600{,}000}\right] \times 1{,}000{,}000 = 417{,}476$ shares*
Step 2	$B_{01} - (E_1 + L_1) = S_{s1}$
Determination of Substituted Basis	P100,000 – (P25,000 + 0) = P75,000
Substituted Basis of 417,476 Transferee shares	P75,000

Property 2	
Step 1	
Allocation of shares	$\left[\frac{F_2}{F_1 + F_2}\right] \times X_t = X_2$
	$\left[\frac{P600{,}000}{P430{,}000 + P600{,}000}\right] \times 1{,}000{,}000 = 582{,}524$ shares*
Step 2	$B_{02} - (E_2 + L_2) = S_{s2}$

Determination of Substituted Basis	P150,000 – (0 + 0) = P150,000
Substituted Basis of 582,524 Transferee shares	P150,000

***** Computation of the number of shares has been rounded off to the nearest whole number.

Situation No. 9

Property 1	
Step 1	
Allocation of shares	$\left[\frac{F_1}{F_1 + F_2}\right] \times X_t = X_1$
	$\left[\frac{P430{,}000}{P430{,}000 + P600{,}000}\right] \times 1{,}000{,}000 = 417{,}476$ shares*
Step 2	
Allocation of liability	$\left[\frac{F_1}{F_1 + F_2}\right] \times L_t = L_1$
	$\left[\frac{P430{,}000}{P430{,}000 + P600{,}000}\right] \times P30{,}000 =$ P12,524**
Step 3	$B_{01} – (E_1 + L_1) = S_{s1}$
Determination of Substituted Basis	P100,000 – (P25,000 + 12,524) = P62,476
Substituted Basis of 417,476 Transferee shares	P62,476

Property 2	
Step 1	
Allocation of shares	$\left[\frac{F_2}{F_1 + F_2}\right] \times X_t = X_2$
	$\left[\frac{P600,000}{P430,000 + P600,000}\right] \times 1,000,000 = 582,524$ shares*
Step 2	
Allocation of liability	$\left[\frac{F_2}{F_1 + F_2}\right] \times L_t = L_2$
	$\left[\frac{P600,000}{P430,000 + P600,000}\right] \times P30,000 =$ P17,476**
Step 3	$B_{02} – (E_2 + L_2) = S_{s2}$
Determination of Substituted Basis	P150,000 – (0 +17,476) = P132,524
Substituted Basis of 582,524 Transferee shares	P132,524

***** Computation of the number of shares has been rounded off to the nearest whole number.

** Allocation of the liability has been computed to the nearest whole peso.

Situation No. 10

The first step is to allocate the P1,000,000 Transferee shares among cash (in the amount of P100,000) and property (with an aggregate fair market value of P1,000,000). Following the formula for determining such allocation,

$$\left[\frac{F_1}{F_1 + F_2 + F_3 + F_4 + F_5 + F_6}\right] \times X_t = X_1 \text{, or}$$

$$\left[\frac{P200{,}000}{P100{,}000 + P200{,}000 + P200{,}000 + P200{,}000 + P200{,}000 + P200{,}000}\right] \text{ x P1,000,000} =$$

90,909 shares

will be allocated to cash. The balance of 909, 091 shares will be allocated to the land, shares of stock in Corporation Z, inventory, raw materials, and trade receivables, and the number of shares allocated to each, as well as the respective substituted basis of such shares shall be computed in the same manner as illustrated in Situations 1 to 9, above, as the case may be. For this purpose, a single substituted basis shall be allocated to inventory as if it were a single asset, and regardless of the number of items existing in the inventory. The same treatment shall be accorded to raw materials and trade receivables.

Situation No. 11

Same as in Situation No. 10, except that the mortgage in the amount of P25,000 allocable to the land shall be considered in determining the substituted basis of the land, and the liabilities in the amount of P100,000 shall be pro-rated among the properties (but not cash).

B. Substituted Basis of Property Transferred

On the other hand, the substituted basis of the property(ies) received by the Transferee shall be the original or adjusted basis of such property in the hands of the Transferor at the time of the transfer (second paragraph, Section 40(C)(5)(b), Tax Code of 1997), since in all of the above situations, the Transferor does not recognize any gain.

VI Variations

1. If there are two or more Transferors, the above-mentioned procedures shall be separately followed for each Transferor to determine the substituted basis of the shares received by each.

2. The above rules shall apply for each particular property, so long as the amount of liabilities to which such property is subject, plus the pro rata portion of the other liabilities allocated to such property does not exceed the original or adjusted basis of such property at the time of its transfer to the Transferee.

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.

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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