[22]Cf. Article IV, Sec. 7 of the Philippine Constitution. The 1935 Charter contained an identical provision, found in its Article III, Sec. I, par. (6).

[23]Laski, Liberty in the Modern State 73 (1949).

[24]Ibid.

[25]Cox, The Role of the Supreme Court in American Government 37 (1976).

[26]Cf. Gonzales v. Commission on Elections, 27 SCRA 835 (1969). Where political matters are concerned, Justice Barredo is for absolutely free speech and press. Former Chief Justice Castro followed the balancing interests test as a standard of limitation. Justice Teehankee is of the same persuasion.

[27]Ibid, 856-857.

[28]Pope John XXIII, Pacem in Terris, The five Great Social Encyclicals, 180 (1969). The second paragraph reads thus: "And on this point Our Predecessor of immortal memory, Leo XIII, declared: 'This genuine, this honorable freedom of the sons of God, which most nobly protects the dignity of the human person, is greater than any violence or injustice; it has always been sought by the Church, and always most dear to her. This was the freedom which the Apostles claimed with intrepid constancy, which the apologists defended with their writings, and which the martyrs in such numbers consecrated with their blood.' "

[29]Flannery, The Documents of Vatican II, 800 (1975).

[30]Pope John XXIII, Pacem in Terris, The Five Great Social Encyclicals, 179 (1969).

[31]Ibid, 182.

[32]Ibid.

[33]Cf. Presidential Decree No. 191. It is headed by the President of the National Press Club as chairman with a recognized civil leader appointed by the President as co-chairman, and a representative each from the Manila Overseas Press Club, print, radio, and television groups.

[34]Cf. Presidential Decree no. 576. It was therein provided that both the Print Media and Broadcast Media may organize its own regulatory council responsible for formulating systems of self-regulation and internal discipline within its own ranks.

[35]Response on the FIDA Katuparan Award, December 19, 1979.

[36]Newsweek, October 15, 1979, 40.

[37]Newsweek, October 8, 1979, 12.

[38]Phil. Assn. of Free Labor Unions v. Salvador, L-29471, 25 SCRA 393, 403.

[39]United States v. United Mine Workers of America, 330 US 258, 308, Con. (1947).

SECTION 35(c)(2) OF THE TAX CODE: A TAX TRAP OR A TAX SHELTER?

by EXEQUIEL G. JAVIER, B.S., LL.B., L.I.M.

I. Introduction

Property may be transferred to a corporation in exhcnage for its stock without immediate tax consequences. However, tax authorities, because of statutory gaps or dearth in judicial precedents, have taken liberties in the existing tax rules which may contain a tax trap for the unwary investor.[1] Investors, for the same reasons, have used stock transaction as a tax shelter either to insulate income from the steep individual tax rates or to avoid income tax on gains.

A basic knowledge of the tax rules is a great help to the investor in planning a desired tax result. He can avoid the traps carved out by administrative interpretation. For example, if he desires to transfer property with a low acquisition cost (adjusted basis) but subject to a mortgage in excess of the adjusted basis, he may transfer the property and enough cash to prevent recognition of gain on the excess of the mortgage over the adjusted basis of the property.

The investor may likewise consider which type of incorporation – taxable or tax-free – will be more advantageous. If substantial amount of gain will be realized on incorporation, the investor will usually want to defer recognition of gain for as long as possible. Or if he owns an appreciated capital asset, he may transfer the asset to the corporation in a taxable incorporation, pay the tax at capital gains rate, and give the corporation a stepped-up basis to reduce the ordinary income tax at the corporate level. This would apply generally in a case where a corporation would be engaged in business as a real estate developer. A taxable corporation is likewise advantageous in the case of a property with an unrealized loss. In a tax-free transaction, however, the loss will go unrecognized.

To a high income tax bracket investor, a tax-free incorporation of his investment portfolio in stock gets generous tax results even if the corporation runs the risk of incurring the personal holding company tax. For long term investments, however, a taxable transaction may likewsie be preferable.

The tax benefits derived from a tax free or taxable incorporation ultimately depend on a case to case basis. No hard and fast rule may be formulated.

II. Statutory Scheme

As a rule, an investor recognizes gain or less when he transfers property to a corporation in exchange for its stock. The transaction is treated as a sale or exchange of property upon which he realizes gain or loss measured by the difference between the adjusted basis or acquisition cost of the property transferred and the value of the stock received. The entire gain or loss is recognized.[2] The taxable gain or deductible loss will depend on the status of the investor, whether corporate or individual, or the nature of the property, whether ordinary or capital asset, and in the latter case on the holding period whether long term or short term.

However, on the theory that certain transfers of property in exchange for stock merely work a change in the form of ownership,[3] the Tax Code excepts such transactions from immediate recognition of gain or loss. The Tax Code defers recognition of gain or loss to the time when the investor sells the stock or when the corporation sells the property.

The deferment of gain or loss on transfers of property for stock is found in Section 35(c)(2) of the Tax Code.[4] In general, the section defers recognition of gain or loss if a person exchanges his property for stock in a corporation as a result of such exchange such person, alone or together with others not exceeding four (4), gain control of the corporation.

Consistent with its purpose of deferring gain or loss, the section provides for a carryover adjusted basis. The adjusted basis of the stock in the hands of the investor is the same as his adjusted basis in the property transferred. The adjusted basis of the property in the hands of the corporation is the same as the investor's adjusted basis in the property.[5]

The only statutory exception to the non-recognition of gain or loss under the section is where the investor, if in addition to stock receives money or other property. In such case gain, but not loss, is recognized but not in excess of the amount of money and value of the property received.[6] However, the amount of the investor's liability assumed by the corporation or the amount of liability to which the property is subject taken by the corporation is not considered as money or other property.[7] Receipt of money or other property or assumption of liability,

however, does not cast out the exchange from the coverage of the section.

The section is not elective by mandatory. Thus, if the transfer of property to a corporation fits the mold of Section 35(c)(2) the investor may not repudiate the form adopted and elect to be taxed on the transfer.[8]

III. Problems in tax-free incorporations

(a) What constitutes property

Section 35(c)(2) requires that only stock be issued in exchange for property otherwise such stock will not be considered for purposes of meeting the 51 per cent control requirement. The section, therefore, poses the definitional problem of what constitutes "property". To prevent the avoidance of taxation on compensation income, the section is explicit as to services. They do not constitute property, hence, stock issued therefore is not considered as issued in exchange for property. However, trade secrets and know-how, have been held to be property under conditions.[9]

Based on the premise that a newly organized corporation always needs cash for working capital, money had likewise been ruled as property.[10]

The concept of property, however, presents an interesting issue when read into Section 210 of the Tax Code relating to the stock transaction tax. This issue will be discussed later.

(b) In exchange for stock

Presumably, in order to insure that the transfer of property in exchange for stock simply effects a change in the form of ownership with the investor merely continuing his interest in the property, Section 35(c)(2) requires that only stock be received in the exchange. Thus, securities, other than stock, albeit permitted to be received in reorganizations or mergers, are excluded on the theory that they partake more of a debt than an equity. Hence, a transfer of property solely for bonds by one investor is disqualified under the section and results in taxable gain for want of continuity of interest even if the other investors gain control of the corporation.[10a] However, a transfer of cash for bonds does not result in taxable gain, the transaction being merely a loan to the corporation.

(c) The control test

Section 35 (c)(2) applies if as a result of the exchange one or several persons, not exceeding five (5) gain control of the corporation to the extent of 51 per cent of the voting stock. The term control is defined to mean ownership of at least 51 per cent of all classes of stock entitled to vote.[11] If the requisite control is not met the entire gain realized by the investor or investors are recognized. The phrase "as a result of the exchange" seems to require that control must be acquired through the exchange itself. Thus, in case of several investors, they must, as a group, gain control of the corporation.

Loss of control after the exchange may prove fatal to the exchange. Thus, if according to a pre-arranged plan one of the transferors of the control group directs the corporation to issue the shares to his wife and children, the requisite control is not met.[12] However, where the investor himself after the exchange donated a portion of his stock to the members of his family, the control requirement is not broken.[13]

Section 35(c)(2), likewise, contemplates an additional transfer of property to a corporation already controlled by the investor.[14] Thus, if the investor already controls the corporation, a subsequent transfer of property which will increase his control still qualifies under the section.

For purpose of the 51 per cent control requirement, stock issued for services are not taken into account. A similar rule applies to bonds or securities other than stock.

The section recognizes the fact that more often there will be several investors. It limits, however, the number to five (5). In case of more than five (5) investors, administrative interpretation in this area is not very enlightening. In BIR Ruling dated April 24, 1975, seven co-owners transferred property under co-ownership to a newly organized corporation in exchange for 35 per cent of the authorized capital stock to be divided equally among them. The ruling first laid down the premise that if it takes more than five (5) persons to gain control of the corporation, the exchange fails to qualify under Section 35(c)(2). The ruling then concluded that under the facts, the exchange qualifies as four (4) of the co-owners received more than 51 percent of the 35 percent of the stock issued. Hence, not only the four (4) co-owners, but also the other three co-owners are entitled to the benefits of the section.

It will be noted that both the premise and the conclusion are open to question. The premise seeks to disqualify the entire exchange under the section if more than five (5) investors gain control of the corporation. The better rule, however, would be to disqualify only those investors in excess of five (5) on the theory that the provisions of the section operate on the basis of each particular investor. Thus, if a particular investor fails to qualify, his failure should not taint the other investors who would otherwise qualify. That this is the approach adopted under Section (35(c)(2) is clear from Section 35(c)(3)(a) which taxes the gain of a particular shareholder who receives property or money in addition to stock.
property or money in addition to stock.

The conclusion reached by the ruling is likewise erroneous, insofar as it qualifies all the seven (7) co-owners under the section. It has no statutory basis as the law explicitly provides for not more than five (5) investors.

The limitation on the number of investors to not more than five (5) poses a problem in case of more than five (5) investors who want to avail of a tax-free transfer to a single corporation. The most convenient device is to create two corporations with some of the investors as controlling stockholders of one corporation and the other investors of the other corporation. The two corporations will subsequently be merged with the investors in the absorbed corporation receiving stock of the surviving corporation and eventually becoming stockholders therein. The receipt of stock from a surviving corporation is still a non-taxable transaction under the merger provisions of Section 35(c)(2). These series of transactions if not sufficiently "aged" or if not motivated by bona fide business reasons do not necessarily buy a tax-free insurance as the creation of the corporation which was subsequently absorbed may be treated under the step-transaction doctrine as a step to the transfer of property to a surviving corporation. Hence, the absorbed corporation may possibly be disregarded and the investors therein will be treated as if they originally transferred their property to the surviving corporation in which case they will recognize gain.

(d) Taxation of gain

Section 35(c)(2)(a)[15] provides that if in addition to stock, the investor receives money or other property, otherwise known as boot, the gain but not the loss shall be recognized to the extent of money and value of property received. Gain, however, will only be recognized if gain has been realized.[16]

Thus, if a taxpayer transfers property with an adjusted basis of ₱100 and a fair market value of ₱500 to a controlled corporation in exchange for stock worth ₱300, cash ot ₱100 and other property with a value of ₱100 his gain is computed as follows:

1. Amount Realized

a. Stock	–	₱	300
b. Cash	–		100
c. Other Property	–		100
d. TOTAL	–	₱	500

2. Less: adjusted basis of property transferred — 100

3. Gain Realized — 400

4. Gain Recognized — 200

It will be noted that of the gain realized in the amount of ₱400 only ₱200 which represents boot is recognized.

However, if the adjusted basis of the property is ₱450, only ₱50 will be recognized as it is the amount realized even if ₱200 which represent boot is received.

The character of the gain recognized will depend on the character of the property transferred, whether ordinary or capital, and in the latter case whether long term or short term.

The determination of gain, however, becomes more difficult in case several properties are transferred to the corporation. The section fails to provide for such a situation. The reasonable rule in this area is an asset by asset approach by allocating a proportionate amount of the boot received to each property on the basis of their relative fair market value.[17] Thus, if a land with an adjusted basis of ₱100 and a fair market value of ₱500 and a building with an adjusted basis of ₱600 and a fair market value of ₱500 are transferred in exchange for stock worth ₱600 and a cash of ₱400 only ₱200 would be recognized as gain attributable to the land as it constitutes 50% of the value of the assets transferred. The balance of ₱200 will not be recognized as gain since no gain was realized attributable to the building. The loss attributable to the building will go unrecognized.

(e) Assumption of liabilities

Section 35(c)(3)(c)[18] provides that if in addition to stock, the corporation assumes the liability of the investor or acquires from the investor property subject to liability, such assumption of liability shall be considered as boot.

However, administrative rulings have carved out an exception to the above rule. Where the total liabilities assumed by the corporation exceed the total adjusted basis all the assets transferred, the excess will give rise to a taxable gain in an otherwise tax-free incorporation.[19] The rulings enunciate a sound rule. It prevents the investor from borrowing against the property just before its tax-fee transfer to a corporation and retaining the proceeds while leaving the corporation to repay the loan.[20] It likewise forestalls any attempt on the part of the investor to foist upon the corporation purely personal obligations.[21]

Sound as it may be, the rule, however, lacks statutory basis. Section 35(c)(3)(c) specifically provides that assumption of liability by the corporation shall not be treated as boot to the investor regardless of whether the liability assumed is in excess of the adjusted basis of the property transferred. Hence, any attempt to tax as boot liability assumed in excess of the adjusted basis is vulnerable for lack statutory support.

(f) Basis

(i) The investor's basis

Section 35(c)(4)(a) provides that if the investor recognizes no gain or loss, he takes as his adiusted basis for the stock the same adjusted basis he had in the property transferred.[21a] In case the investor recognizes gain in the form of boot, he takes as his adjusted basis for the stock the same adjusted basis he had in the property decreased by the amount of money and value of property recieved and increased by the amount of gain recognized. Thus, if property with an adjusted basis of ₱500 and a fair market value of ₱1,000 is transferred in exchange for stock worth ₱600 and cash of ₱400. The adjusted basis of the stock in the hands of the investor is ₱500 (₱500 [adjusted basis] – ₱400 [cash] + ₱400 [gain recognized].)

If the corporation in addition to stock assumes the liability of the investor or takes his property subject to liability, Section 35(c)(4)(a) fails to include such liability as an adjustment to the adjusted basis. Presumably, the omission is based on the premise that under Section 35(c)(3)(c), liability assumed is not considered as boot.

However, what the statute omits, administrative legislation provides. In BIR Ruling dated February 27, 1976, it was held that the assumption of liability in excess of the adjusted basis of the property transferred has the effect of reducing the adjusted basis of the stock in the hands of the investor. Thus, the adjusted basis for the stock issued in exchange for property with an adjusted basis of ₱50,000 but subject to a mortgage of ₱60,000 is zero, computed as follows:

Adjusted basis of the Property	–	₱50,000
Plus: Gain Recognized	–	10,000
Less: Mortgage	–	60,000
AB of the Stock	–	0

The above computation as illustrated in the ruling reflects the economic reality of the transaction. The investor's net investment in the property is zero (adjusted basis of ₱50,000 plus the tax cost of ₱10,000 less mortgage of ₱60,000). By transferring the property subject to a mortgage, the investor has fully recovered his net investment, hence, it is but logical that his adjusted basis in the stock should be zero. If the investor later sells the stock, the entire selling price will be taxable gain to him.

Again the ruling, though it makes sense, cannot supply a statutory omission.

(ii) The corporation's basis

The corporation's adjusted basis for the property is the same as the investor's adjusted basis in the property. However, if the investor recognizes gain, the corporation's adjusted basis for the property is carried over from the investor plus gain recognized to the investor.[22] As pointed out earlier, liability assumed is not boot, hence, it does not enter into the computation of the corporation's adjusted basis for the property transferred except when the assumption of liability results in gain to the investor.[22a]

IV. The personal holding company tax connection

Section 63 of the Tax Code imposes a penalty tax of 45 per cent on the undisturbed net income of so-called personal holding companies-corporations controlled by a few stockholders deriving a bulk of their income from passive types of investments such as dividends, interest, rents, etc.

Section 64 of the Tax Code defines a personal holding company in terms of the nature of gross income and the number of stockholders. Thus, a corporation qualifies as a personal holding company if

1) initially at least 80 percent (thereafter 70 percent) of its gross income is personal holding company income which under Section 65 consists of a) dividends, interests, rents, royalties; b) gains from the sale of stock or securities; c) gains from future transactions in commodities; d) amount received under personal service contracts; and e) compensation for use of corporate property by shareholders, and

2) at any time during the last half of the taxable year, more than 50 percent in value of its outstanding stock is owned directly or indirectly by or for not more than five (5) individuals.

Prior to Presidential Decree No. 1457 which amended Section 65 of the Tax Code, Section 35(c)(2) was the most convenient tax shield for investors. Prior to its amendment, Section 65 excluded from personal holding company income dividends received by corporations from domestic or resident foreign corporation (intercorporate dividends) on which a final tax of 10 percent was paid.[23]

Thus, an investor would organize a corporation under Section 35 (c)(2) to hold his portfolio investments in stock so that the intercorporate dividends received by the corporation would be taxed at a relatively low rate of 10 percent rather than at a steep graduated individual tax rate if the dividends were received directly by the investor himself. And if the corporation derives all or substantial part of its income from intercorporate dividends it could accumulate with impunity rather than distribute its earnings to the investor without incurring the 45 percent penalty tax. Although such accumulation would in all probability incur the 25 percent accumulated earnings tax [see Section 25 of the Tax Code], an investor who is in the high income tax bracket still gets substantial tax benefits as the effective tax on such dividends would only be about 32.50 percent.

With the amendment of Section 65, the tax cost of incorporating portfolio investments in stock through a Section 35 (c)(2) exchange has somewhat become

prohibitive. Under the amendment intercorporate dividends are now treated as personal holding company income. Thus, if a corporation holding such investments derives all or substantial part of its income from intercorporate dividends, it is well-nigh probable that it would qualify as a personal holding company.

The amendment however has not effectively deterred investors from using Section 35(c)(2) in the incorporation of their stock investments. If the investor is in the 60 percent income tax bracket, tax planning in this area still reaps generous tax results. The effective tax on intercorporate dividends received by a personal holding company is about 50.5 percent which is much lower than the individual tax if the dividends were directly paid to such investor.

Another factor which contributes to the incorporation of portfolio investments in stock is the uncertainty on what constitutes the tax base for the imposition of the 45 percent penalty tax. It is possible for a corporation to qualify as a personal holding company. However, it is equally possible that such corporation may escape the 45 percent penalty tax.

The penalty tax is imposed on the "undistributed net income" of the corporation which qualifies as a personal holding company [Section 63, Tax Code]. However, the phrase "undistributed net income" is neither defined by the Tax Code nor by the regulations thereunder. Is it a tax concept or an economic concept?

If it is a tax concept, the starting point for purposes of computing "undistributed net income" is gross income. This may be inferred from the definition of "net income" which is gross income less deductions allowed."[24] Hence, income which is not gross income for tax purposes is excluded in the computation of "net income".

Thus, under this concept, intercorporate dividends, albeit considered as personal holding company income, are not gross income for pusposes of computing net income. This is clear from Section 24 (c)(2) of the Tax Code which provides that such dividends "are not included in the determination of gross income of the recipient corporation." Gains from sale of stock acquired and sold after November 5, 1970 although they are likewise personal holding company income are

likewise not gross income. Since the sale of such stock is subject to the stock transaction tax, Section 210 of the Tax Code specifically provides that "any capital gain arising from a stock transaction . . . shall not be taken into account in computing net capital gains." Accordingly, if the tax concept of "net income" is read into the personal holding company tax provisions for purposes of computing "undistributed net income", a personal holding company which derives all of its income from intercorporate dividends and gains from sales of stock, may possibly have no "undistributed net income" on which the 45 percent penalty tax may be imposed.

However, the phrase "undistributed net income" may be construed as an economic concept which looks to the net profits or earnings of the corporation for the taxable year as reflected in its financial statements. This concept may be deduced from the purpose underlying the penalty tax which seeks to tax net profits or earnings of the corporation which are available for distribution as dividends to the stockholders[25]

Under this concept, therefore, intercorporate dividends and gains from sales of stock, albeit not gross income, may be added back as part of the earnings and profits of the corporation for purposes of computing the "undistributed net income".

The absence of tax rules, whether judicial or administrative, as to what constitutes "undistributed net income" has emboldened some investors in taking the risks in incorporating their portfolio investments in stock.

V. The stock transaction tax connection

The classic form of tax avoidance, if not necessarily tax evasion, is the use of Section 35(c)(2) in conjunction with Section 210.[26] An investor, who owns a property with an adjusted basis of ₱100 and a fair market value of ₱1,000, instead of selling the property and be taxed at capital gains rate on the potential gain of ₱900, incorporates the property in a non-taxable transaction under Section 35 (c) (2). He receives stock in the exchange worth ₱1,000 and sells the same at ₱1,000 paying only ¼ of 1 percent under Section 210.

Many investors have used this scheme probably on the mistaken assumption that under the Tax Code, the scheme has no income tax consequences.

Since the enactment of Republic Act No. 6141 (now Section 210) gain derived from the sale of shares acquired under a non-taxable transaction pursuant to Section 35 (c) (2) is subject to income tax.

This is clear from the proviso contained in Section 210 which originally read:

> "Provided, that in case of gain not arising from but realized out of the said transaction, the pertinent provision of this Code shall apply."

The Congressional debate on the import of this proviso is illustrated in the example given above.[27] Thus, on the sale of the shares, the stock transaction tax does not apply, but the gain of ₱900 is recaptured as income subject to income tax.

The proviso, however, because of its ambiguity was amended by P.D. 1457. The amended proviso now reads:

> "Provided, that gains from the sale or exchange of shares of stock acquired by a person in exchange for property where no gain or loss was recognized under the provisions of paragraph (c)(2) of Section 35 of this Code or under any other law, shall be subject to the income tax imposed under Title II of this Code."

The amendment, instead of removing the ambiguity of the old proviso, has introduced more confusion.

As previously discussed, money is considered property in the Section 35(c)(2) exchange. Is it likewise considered as property under the Section 210 proviso? If it is, the sale of shares acquired in exchange for money under Section 35(c)(2) is not subject to the stock transaction tax. The gain derived from such sale is, therefore, subject to income tax.

The better interpretation, however, is that the property contemplated by the proviso does not include money. This is evident from the legislative intent in enacting the old proviso. During the deliberations on Republic Act No. 6141, the legislators were quite wary of possible tax avoidance in a situation where property with a high market value but a low adjusted basis is transferred to a corporation in a non-taxable exchange and the investor subsequently sells the shares only paying the stock transaction tax.[28] The proviso therefore was inserted to close the possible escape hatch for potential gain attributable to the transfer of appreciated property. Based, therefore, on legislative intent it may be safely assumed that the proviso refers only to transfer of appreciated property a non-taxable transaction. Hence, a tax-free incorporation where money is transferred in exchange for shares is not covered by the proviso.

Another confusion added by the amendment is the impact of Section (35(c)(2) transfers where gain is recognized. The proviso contemplates a Section 35(c)(2) exchange where no gain or loss was recognized. Thus, if the investor, in addition to stock, receives boot or the corporation assumes a liability in excess of the adjusted basis of the property transferred, does the receipt of boot or the assumption of liability cast out the exchange from the proviso since gain was recognized? If it does, the amendment has introduced a bigger tax loophole than the original proviso. To take out the exchange from the clutches of the proviso, all the investor has to do is transfer appreciated property in exchange for stock and a nominal amount of cash and subsequently sell the stock paying the stock transaction tax.

For the sophisticated investors, tax avoidance in the area comes in various forms. In order to break the non-taxable requirement of the proviso, appreciated property, instead of being transferred under a Section 35(c)(2) transaction, is sold either at cost or at a price lower than its market value to a corporation. The investor pays either a minimal tax or no tax at all on the sale. He then uses the proceeds of the sale to acquire the stock of the corporation and turns around and sells the stock paying the stock transaction tax on theory that he acquired the stock for cash and not for property.

Tax avoidance may also come by way of donation. The investor instead of selling appreciated property, incorporates the property under Section 35(c)(2). He donates the stock received in the exchange to the members of his family paying only a much lower donor's tax. He then causes the member of his family to sell the shares paying only the transaction tax again on the premise that the shares were acquired not through a non-taxable exchange but by way of a donation.

A more subtle type of tax avoidance comes in the guise of stock dividends. This device is usually used by an investor of a controlled corporation which through the years has grown in terms of assets and earnings. Thus, the investor who originally transferred property to the corporation under Section 35(c)(2) exchange now wants to sell the stock. However, he could not immediately sell the stock received in the exchange because the appreciation in value may generate prohibitive tax cost because of the **proviso**. Instead he causes the corporation to declare stock dividends (to the extent of earnings). He then sells the stock received in the exchange and the stock received by way of dividends at a split price. While he pays income tax at capital gains rate on the sale of stock received in the exchange, he only pays the stock transaction tax on the sale of stock dividends on the theory that they were acquired not in exchange for property. The investor, therefore, by causing the corporation to declare stock dividends and by splitting the price has likewise split the potential gain which would have been recaptured as income if only the stock received in the exchange was sold.

All these forms of tax avoidance, though not technically covered by the **proviso** are fraught with tax hazards. The intervening transactions, e.g. sale of appreciated property to the corporation, donation or declaration of stock dividends may be collapsed by the tax authorities as lacking in substance or unnecessary steps to the subsequent sale of the stock.[29]

A transfer of property to a corporation under Section 35(c)(2) exchange with a view to a long term investment is a veritable tax trap for the unwary investor. As presently worded, the proviso does not make a distinction between gain attributable to the transfer of appreciated property and gain attributable to the subsequent sale of stock. Under the old proviso only gain attributable to the transfer of appreciated property, i.e., potential gain ~~realzied~~ when property is transferred to a corporation under a Section 35(c)(2) exchange, is recaptured as income when the stock is subsequently sold. Under the present proviso, however, the entire gain realized from the sale of stock is recognized and taxed as income irrespective of whether part of the gain was realized after the property was transferred to the corporation.

Because of the possible tax risks posed by the proviso, a taxable transfer of property to a corporation is preferable to a tax-free exchange under Section 35(c)(2) if the investor desires a long term investment. A taxable transaction removes the subsequent sale of the stock from the clutches of the proviso and the investor has to pay only the stock transaction tax whether or not the stock has appreciated in value after the taxable transfer of property. However, if the investor prefers a taxable transfer of property to a corporation, care should be taken that the transaction does not fit the mold of Section 35(c)(2).

VI. Conclusion

The lack of definite tax rules, statutory, or judicial, has honed Section 35(c)(2) into a two-edged sword. The tax authorities thorugh administrative legislation have formulated their own rules which contain hidden tax traps to the unsophisticated investors. The investors because of the flexibility arising from the vagueness of tax rules, have equally used Section 35(c)(2) as a vehicle of tax avoidance, if not necessarily tax evasion. Indeed, Section 35(c)(2) depending on the sophistication may be a tax trap or a tax shelter.

FOOTNOTES

[1]Bongiovanni v. Commissioner, 73-1 USTC 9133.

[2]Section 35(c)(1), NIRC.

[3]Portland Oil Co. V. Commissioner, 109 F2d 479.

[4]Section 35(c)(2) of the Tax Code provides in part: "x x x No gain or loss shall be recognized if a person exchanges his property for stock in a corporation which as a result of such exchange said person, alone or together with others, not exceeding four persons, gains control of said corporation. *Provided,* That stock issued for services shall not be considered as issued in return for property.

[5]Section 35(c)(4)(a)

[6]Section 35(c)(3)(a)

[7]Section 35 (c)(3)(c), NIRC.

[8]Houck v. Hinds, 215 F2d 673; Pocatello Coca-cola Bottling Co. vs. U.S., 131 F2d 912.

[9]Rev. Ruling 64-56; Du Pont de Nemours & Co. v. U.S., 61-1 USTC 9359.

[10]Halliburton vs. Commissioner, 35-2 USTC par. 9431; George M. Holstein, 23 T.C. 923.

[10a]Revenue Ruling 73-473

[11]Section 35(c)(5)(c).

[12]Fahs vs. Florida Machines & Foundry Co., 168 F2d 957.

[13]Wilgard Realty Co., Inc. v. Commissioner, 127 F2d 514.

[14]BIR Ruling, February 27, 1976.

[15]Section 35(c) (2)(a) provides: "If, in connection with an exchange described in the above exceptions, a shareholder or security holder receives not only stocks or securities permitted to be received without recognition of gain or loss, but also money and/or other property, the gain, if any, but not the loss shall be recognized but in an amount not in excess of the sum of money and the fair market value of such other property received: Provided, That as to the shareholder, if the money and/or other property received has the effect of a distribution of a taxable dividend, there shall be taxed as a dividend to the shareholder an amount of the gain recognized not in excess of his ratable share of the undistributed earnings and profits of the corporation; the remainder, if any, of the gain recognized shall be treated as a capital gain.

[16]BIR General Circular No. V-253.

[17]Revenue Ruling 68-55.

[18]Section 35(c) (3)(c) provides: "If the taxpayer, in connection with the exchanges described in the foregoing exception, 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 a 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.

[19]BIR Ruling, February 17, 1976; BIR Ruling, April 26, 1976; BIR Ruling, May 25, 1977.

[20]Drybrough v. Commissioner, 42 T.C. 1029.

[21]Campbel v. Wheeler, 342 F2d 837 (1965).

[21a]See Note 16, *supra*

[22]Section 35(c) (4)(b) provides: "The bais of the property transferred in the hands of the transferee shall be the same as it would be in the hands of the transferor, increased by the amount of the gain recognized to the transferor on the transfer.

[22a]BIR ruling, February 27, 1976.

[23]See Section 24(c)(1). NIRC.

[24]Section 28, NIRC.

[25]See Section 255, Income Tax Regulations, for sources of distribution of dividends.

[26]Sec. 210.*Percentage tax on certain transactions. – (a) Tax on stock sale or exchange.* – There shall be levied, assessed, collected, and paid on every sale, exchange, transfer or similar transaction intended to convert ownership, of, or title to, any share or shares of a stock, a tax equivalent to one-fourth of one per centum of the gross selling price of the share or shares of stock sold or of the gross value in money of the shares of stock, exchanged or transferred, which shall be paid by the seller or transferor.

x x x

Pending the suspension of the effectivity of Section 34 paragraph (g) of this Code by Presidential Decree No. 1116, any capital gain arising from a stock transaction on which the tax herein imposed has been paid shall not be taken into account in computing net capital gain or loss under Section thirty-four of this Code if (1) both the acquisition and the disposition of said stock by the taxpayer are effected after the effectivity of this Code and (2) the sale, exchange, and transfer in bona fide and the consideration for the transaction represents the substantial fair market value of the stock; Provided, That gains from the sale or exchange of shares of stock acquired by a person in exchange for property where no gain or loss was recongized under the provisions of paragraph (c)(2) of Section 35 of this Code or under any other law, shall be subject to income tax imposed under Title II of this Code. However, any capital loss arising from such transaction shall be taken into account in computing net capital gain in accordance with the provisions of this Code: Provided, That there shall be no capital loss carry-over.

x x x

[27]Senate Congressional Record, September 17, 1970.

[28]Senate Congressional Record, *supra.*

[29]See Gregory v. Holvering, 293 U.S. 465; Hazeltine Corporation v. Commissioner, 89 F2d 513.

"BLOWING THE WHISTLE": THE NEW RESPONSIBILITIES AND LIABILITIES OF THE LAWYER IN SECURITIES TRANSACTIONS

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I. INTRODUCTION

What standards must a lawyer apply when he deals with securities transactions? More particularly, what is the liability of the lawyer for failure to comply with the disclosure requirements that are contained in the registration statement required by Section 11 of the Federal Securities Act of 1933? A spate of recent developments and cases have made these issues very important. In the words of Securities and Exchange Commissioner A.A. Sommer, Jr.:[1]

> For many years the sponsors of securities institutes and programs have been blessed with innumerable occasions to promote their wares; attorneys have flocked to programs on Rule 10b-5, than the Texas Gulf Sulphur complaint (at this point we all ceased to wait for the decisions and spent endless hours and days discussing simply the charges) was the focus, then Bar Chris, accountants liabilities, and innumerable subtopics and variations of these. All these and others have now been subordinated in interest to a single topic: the legal exposure of lawyers under the securities laws administered by the Securities and Exchange Commission. Anyone organizing a program to which he expects to entice lawyers in substantial numbers cannot safely omit this topic. The topic is, in the vernacular, hot, a best seller.

This development is particularly interesting to this writer who comes from a country whose entire law on securities transactions is based on the Federal Securities Act of 1933, the Federal Securities Act of 1934, and the Uniform Sales of Securities Act.[2] Because of this umbilical cord, it is not surprising that Philippine courts often refer to American precedents when they are presented with issues on how the law should be interpreted and construed. It is of particular interest to this writer whether the whistle being blown in Mahattan will eventually be heard in Manila.