TAX-FREE EXCHANGES OF PROPERTY PURSUANT TO CORPORATE MERGERS AND CONSOLIDATIONS

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IN this jurisdiction, every exchange of one piece of property for another is a taxable event. The rule observed is that any property exchanged has its equivalent in money, in a sum equal to its fair market value at the time the exchange was made. The only qualification to this rule may be found in our income tax regulations which provide that the property received, in order to be deemed the equivalent of money, must be essentially different from the property transferred. As to what this essential difference should consist of, the law does not specify. Nevertheless, it is certain that if a taxpayer exchanges his stock in one corporation for the stock of another corporation, gain or loss in the transaction will be deemed realized to the extent of the difference in cost or other basis of the stock transferred and the market value of the stock received. This was the decision of our Supreme Court in *Ogan v. Meer*, (G.R. No. 49102, 1949),[1] the only case in this jurisdiction which dealt directly with the exchange of stock for stock.

When this mandate of the Supreme Court is applied to every exchange of property incident to corporate reorganization or recapitalization, its application will result in unfavorable tax consequences. There will be an imposition of tax or allowance of loss both on the corporate level and on the stockholders' level due entirely to "paper profits" or "losses" in the transaction. This disadvantageous treatment of corporate exchanges pursuant to a reorganization proved deleterious to the formation of bigger and cost-saving enterprises which are necessary for our industrial growth. It discouraged corporate shifts of property and made existing corporations loath to expand their activities through corporate combinations. It destroyed incentive to pool corporate resources for the purpose of increasing working capital by putting a high premium on purely "paper profits" and "losses."

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[1] In Ogan v. Meer, the Court reasoned that when stockholders of one corporation become the stockholders of the other corporation as a result of the transaction or exchange, they earned positive benefits and advantages, and therefore, the gain or loss should be included in the computation of the taxable income of the taxpayer.

Republic Act 1921,[2] which may be called our "reorganization statute," seeks to remedy this by amending Section 35 (c) of our Tax Code. Before this law took effect there was no specific provision of law governing the income tax status of corporate reorganizations, and while the Bureau of Internal Revenue, in rare instances, agreed to consider certain reorganizations to be tax-free, the broad conditions imposed by the Bureau in such cases made it desirable that legislation be enacted expressly governing corporate reorganizations.

As amended, Section 35, paragraph (c) (2) now provides that no gain or loss shall be recognized, if in pursuance of a plan of merger or consolidation,

a) a corporation which is a party to the merger or consolidation exchanges property solely for stock in a corporation which is a party to the merger or consolidation;

b) a shareholder exchanges stock in a corporation which is a party to the merger or consolidation solely for the stock of another corporation, also a party to the merger or consolidation; or

c) a security holder of a corporation which is a party to the merger or consolidation exchanges his securities in such corporation solely for stock or securities in another corporation.

The statute further provides new rules where, in the foregoing exchanges, money and/or other property is received by the transferor in addition to stocks and securities. It also contains definitions of terms and provides for the basis of property exchanged. These rules and definitions will be discussed in their logical order in this paper.

The recognized scheme and purpose of Republic Act 1921 is to omit from tax a mere change in form and to postpone the tax until there is a change in substance or a realization in money. In brief, it was enacted to free from the imposition of income tax, purely "paper profits" or "losses" wherein there is no realization of gain or loss in the business sense, but merely the recasting of the same interests in a different form.

At the outset, it is pointed out that the new law applies only to cases where two or more corporations are involved and is not applicable to cases where a going concern being carried on as a single proprietorship or a registered partnership is to be incorporated. Nevertheless, although only paragraph (c) of Section 35 of the Tax Code is amended, and although only corporations and their stock or security holders are affected, the change is so far-reaching as to make Section 35 (c) assume a new facade. It may be said that the change initiates the modernization of our Tax Code with respect to corporate taxation.

To understand the scope of the new law, we must acquaint ourselves with the fundamental purposes and assumptions underlying tax-free

[2] Effective as of June 22, 1957.

exchanges in mergers or consolidations and thus avoid pitfalls which might result in the imposition of tax. In this respect, we must look to the rules and regulations established under the Federal Internal Revenue Code of the United States after whose reorganization provisions, Republic Act 1921 has been closely patterned. In the absence of our own jurisprudence on corporate reorganization, it is believed that said rules and regulations will be of authoritative weight until superseded or modified by our own tax authorities. The discussions following are premised on this assumption.

The cardinal rule in corporate reorganizations is that the transactions pertaining thereto must be undertaken for a "bona fide" business purpose and not solely for the purpose of escaping the burden of taxation. To determine this "bona fide" business purpose, every step of the transaction will be considered and the whole transaction or the whole series of transactions will be treated as a single unit. On this matter, the Supreme Court of the United States has consistently held[3] that the taxpayer may not rely solely on the literal compliance with the apparently clear language of the statute. The Supreme Court has, in effect, circumscribed the reorganization provisions with certain requirements, and failure to conform to them will frustrate even the most conscientious compliance with the law. Thus, a transfer of some assets of a corporation owned wholly by the taxpayer to a new corporation wholly owned by the same taxpayer and created solely for the purpose of receiving and transfering assets to the taxpayer as liquidating dividends, after which the new corporation was dissolved, is not a "reorganization" under the law exemption from tax, gain arising out of the transfer of assets. This is a mere device which put on the form of corporate reorganization as a disguise for concealing its real character to transfer a parcel of corporate shares to the taxpayer at capital gain rates.[4]

On the other hand, the business purpose is generally deemed complied with if the readjustments in the exchange effected in the consummation of the plan of reorganization are undertaken for reasons germane to the continuance of the business of a corporation, a party to the reorganization.[5] The immediate dissolution of the transferee corporation does not destroy a valid business purpose; but the continuance of the business in the hands of the transferee is sufficient indication of the required "business purpose." Furthermore, the immediate liquidation of the transferor is frequently a

[3] In Bazely v. Commissioner 34 AFTR 1319, (1947); and Adams v. Commissioner, 35 AFTR 1190, (1947) — a sole stockholder of a corporation with a large surplus had turned in a portion of his common stock, receiving in exchange, 10 year debentures callable at the option of the corporation. The court held that the net effect of the exchange was the same as if the stockholder had received the bonds as dividends, and taxed them as such. (The Supreme Court might have reached the same result because of the absence of a valid, business purpose, in which even the transaction would thus be considered a re-emption of stock essentially equivalent to a dividend.)

[4] Gregory v. Helvering 14 AFTR 1191; 293 U.S. 465, (1935).

[5] This is especially true in our jurisdiction which only recognizes mergers or consolidations.

part of the plan of reorganization and does not prevent the transaction from being within the statute.

Under the new law, the term "reorganization" refers only to an ordinary "merger" or "consolidation" and to the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock.[6] There is a merger when two or more corporations combine and one of the corporations retains its corporate existence and absorbs the other or others, which thereby lose their corporate existence; there is consolidation when a new corporation is created to take the place of the constituent corporations which are themselves dissolved in the process.[7] Other forms of reorganization do not fall within the purview of our statute. Hence, mere recapitalization of a single corporation or divisive reorganization will not derive any tax advantage from the law.

Every exchange pursuant to a merger or consolidation will have a two-fold effect. It will affect the corporation and it will affect the stock or security holder.

On the corporate level, the non-recognition of gain or loss is prescribed for two specifically described types of exchanges, namely, that exchange in which stock or securities in a corporation, a party to the merger or consolidation, are in pursuance of a plan of reorganization, exchange for stock or securities in another corporation, a party to the same merger or consolidation; and that exchange in which a corporation, a party to a merger or consolidation exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation, also a party to the same merger or consolidation.[8]

In this area of the new law, care should be exercised lest the transaction or series of transactions result in what may very well be a taxable liquidation, or a mere sale of assets, or even an attempt to siphon off corporate earnings at capital gain rates. As already pointed out, literal compliance with the requirements of the statute is not always sufficient to bring the transaction under a tax-free reorganization. The underlying scheme and assumptions of the reorganization provisions must be fully satisfied before the tax may be postponed.

A safeguard against the happening of any of the mentioned events is to have the transaction or transactions satisfy the "continuity of interest" requirement of tax-free reorganization. Tax authorities, in scrutinizing the

[6] Henceforth, in this article, "reorganization" will only refer to these two forms of corporate combinations.

[7] Von Weise et al v. Commissioner 13 AFTR 708, (1934); Cortland Specialty Co. v. Commissioner, 11 AFTR 857 Affirming 22 BTA 808, 60 F. 2d. 937, (1933).

[8] The term "party to a merger or consolidation" includes a corporation resulting from a reorganization and both corporations in a transaction qualifying as a reorganization where one corporation acquires stock or properties of another corporation. A corporation remains a party to the reorganization although it transfers all or part of the assets acquired to a controlled subsidiary.

steps of a tax-free reorganizations, will require not only a continuity of the business enterprise under the modified corporate form but also a continuity of interest by the persons who were the owners of the enterprise before reorganization.

The "continuity of interest" requirement originated in *Pinellas Ice and Cold Storage Co. v. Commissioner.*[9] In this case, a corporation, contemplating dissolution, transferred 99% of its assets for cash, and secured notes of a new company organized to take title. The secured notes were short term notes which Pinellas claimed were securities exchanged for its assets. The Court did not see its way clear to recognize a tax-free reorganization[10] and held that the short term notes were not securities and hence were equivalent to cash to be taxed as gain. This was clearly a sale of assets clothed in the appearance of an exchange of property for cash and securities to escape taxation, and being an outright sale, there could be no continuity of interest from the old to the new corporation.

In subsequent cases, the crudeness in the Pinellas case was refined in the vain hope of qualifying the transfer of assets as a tax-free exchange. Thus, in another case, a sale of corporate assets through the exchange of the corporate stock for cash, and preferred stock of the purchasing corporation, was held to be a sale in fact rather than a reorganization exchange of stock for preferred stock and cash. The Court discovered in this case that the sellers were stepping out and the preferred stock which they received was to be held only temporarily until its sale was arranged by the purchasing group. Consequently, the profit on the sale was taxable as a capital gain.[11]

In still another case, another refinement of the sale transaction was disallowed. Here, one corporation exchanged its preferred stock for the first mortgage bonds of another corporation pursuant to a statutory merger. Again the Court held the transaction to be a taxable exchange because of the loss of proprietary interests in the assets.[12] Likewise, no tax-free reorganization was upheld where stock of a merged corporation was exchanged for common stock of small actual value, mortgage, bonds and cash.[13] Conversely, the acquisition of stock in exchange for debentures does not constitute the proprietary interest required.[14]

However, even in this fringe area of taxable exchanges which has been established by the "continuity of interest" requirement, many cases have

[9] 11 AFTR 1112, 287 U.S. 462, (1933).
[10] Rev. Act of 1926, Section 203 (h) (1) defines "reorganization as meaning x x x a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation.)
[11] Ralph M. Heintz, et al, 25 T.C. 132, (1947).
[12] F. W. Roebling, 143 F. 2d. 810; 32 AFTR 1083, (1944)
[13] Southwest Natural Gas Co. 14 TC 81, 189 F. 2d. 332, 40 AFTR 1180, (1936).
[14] Margaret S. Bullock, Parag. 44,406 P-H Memo TC, (1936).

been decided in favor of the taxpayer. The continuity of interest was satisfied, and gain was not recognized upon an exchange of notes of and an open account against a corporation, where the old stockholders' rights had passed to creditors in receivership proceedings before the plan of reorganization was filed.[15] Again, the continuity of interest requirement was held to have been satisfied despite the sale by a stockholder of the stock of the transferee corporation after distribution; the exchange of stock by the corporation and the subsequent sale (loss of proprietary interest) of the stockholder, not being interdependent transactions.[16]

Finally, the required "continuity of interest" was upheld where the evidence showed that a holding company, which was merged into an operating subsidiary, had exchanged their preferred stock for common stock and debentures of the subsidiary.[17]

The foregoing cases have been cited to illustrate the varying treatment accorded by the courts to every set of particular circumstances surrounding each transaction where doubtful compliance with the "business purpose" or "continuity of interest" requirements subjected the transactions to close scrutiny. To safely qualify the transaction as a tax-free reorganization, much will depend on the fulfillment by the corporate parties of the following conditions:

1. the transaction must be pursuant to a plan of merger or consolidation,
2. wherein one corporation acquires "substantially all" the properties of another corporation,
3. in exchange solely for all or a part of the voting stock of the acquiring corporation.

Although the first condition speaks of a plan of reorganization, the requirement of a formal written document evidencing the plan of reorganization is not essential where the circumstances of the transaction indicate that the several steps to be taken are pursuant to *a plan*. But it is always advisable that the taxpayer should also incorporate in his income tax return for the year in which the exchange takes place, a complete statement of all the facts pertinent to the non-recognition of gain or loss upon such exchange. In the case of corporations, the statements should include: (a) a certified copy of the plan of merger or consolidation with a statement under oath or affirmation showing in full the purpose thereof and in detail all transaction incident to or pursuant to the plan; (b) a complete statement of the cost or other basis of all property including all stock and securities transferred incident to the plan; (c) a statement of the amount of stock or securities and other property or money received from the exchange, including a statement of all distributions or other disposition

[15] Estell P. Erdman, et al. Parag. 46,038 P-H Memo TC, (1938).
[16] Rena B. Farr, 23 TC 266, (1941).
[17] H. Grady Manning Trust, et al, 15 TC 930, (1930).

made thereof; (d) a statement of the amount and nature of any liabilities assumed upon the exchange and the amount and nature of any liabilities to which any of the property acquired in the exchange is subject. In the case of a stock or security holder who receives stock, securities, money or other property in a tax-free exchange, the statement must include a statement of the cost or other basis of the stock or securities transferred in the exchange and a statement in full of the amount of stock or securities and other property or money received from the exchange, including any liabilities assumed upon the exchange, and any liabilities to which property received is subject. The amount of each kind of stock or securities and other property (other than liabilities assumed upon the exchange) received shall be set forth upon the basis of the fair market value thereof at the date of exchange.

The second condition makes the acquisition of all or "substantially all" the property of a merging corporation a prerequisite to a tax-free exchange. Under the present statute, "substantially all" has not been defined but left for future determination to the Collector of Internal Revenue. Even in the Federal Jurisdiction of the United States, the phrase has not been defined by law. However, many decisions on the matter have more or less defined the limits of the term "substantially all." Where a corporation transferred 75% of its assets, the exchange has been held not sufficient.[18] And where the transferor corporation transferred all of its assets but immediately received a "kick-back" of 32% thereof, the exchange was held not to be "substantially all" of its property.[19] Likewise a corporation which retained about one-fifth of its assets which it distributed to its stockholders, was held not to have transferred substantially all of its assets.[20]

Generally, where 86%[21] to 90%[22] of the assets were transferred, the exchange was considered to be "substantially all" the assets of the transferor. In this regard, the statute expressly provides that in determining whether the property transferred constitutes a substantial portion of the property of the transferor, "cash assets" of the transferor shall be deemed included in the term "property". However, there is authority to the view that "only cash as was needful for working capital" is part of the assets; but that "surplus cash distributed to the stockholders of the old corporation, was not a substantial part of the business properties."[23] Going further, there is also authority to the view that "substantially all of the assets" is not restricted to "operating properties but includes also accounts receivable."[24]

[18] I.T. 2373 CB Dec. 1927 p. 19.
[19] Arctic Ice Machine Co., 23 BTA 1223, (1934).
[20] Alice V. St. Onge, 31 BTA 295, (1947).
[21] Commissioner v. First Nat'l Bank of Altoona. Pa. 104 F 2d 865, (1939).
[22] Schuh Trading Co., 95 F 2d 404, 20 AFTR 1114, (1938).
[23] Gross v. Commissioner, 88 F 2d 567, 19 AFTR 158, (1937).
[24] Pillar Rock Packing Co. v. Commissioner. 90 F 2d 949, 19 AFTR 973, (1937).

In determining the percentage of property transferred and of property retained, the fair market value, rather than the cost to the transferor, should be used.[25]

The third condition of a tax-free exchange is that property must be acquired in an exchange "solely for voting stock." However, if at least 80% of the fair market value of all the property of the other corporation is acquired "solely for voting stock," the remainder of the property may be acquired for cash or other property. For the purpose of determining the percentage of assets acquired for cash or other property, a liability to be assumed by the acquiring corporation and the amount of any liability to which any property acquired by the acquiring corporation is subject, are treated as cash paid for the property. On the other hand, such assumption by the acquiring corporation of a liability of the other corporation, or the fact that property acquired is subject to a liability, shall be disregarded for the purpose of qualifying the exchange as one "solely for voting stock." But a word of warning; the assumption of a liability may be examined for its effect on the character of the reorganization.[26]

An example of an assumption of liability which would affect the nature of the transaction would be the issuance of bonds of a new company for bonds of the old company. Here, there is an assumption of liability. But if the bonds received by the new company is secured by a mortgage for a previously unsecured debt, there is apparently more than a mere assumption of liability. And if a new corporation acquired assets for voting stock, cash paid by the acquiring corporation to satisfy delinquent mortgage interest and taxes of assets, is considered as payment of an obligation of the predecessor and not as additional consideration for the assets.

A slight variation in the treatment of a tax-free exchange is applied when money and/or other property (other than stock or securities) is received in the transaction. If the exchange qualifies as non-taxable under the foregoing requirements, the receipt of other property or money does not result in the recognition of gain or loss provided the corporation distributes it in pursuance of the plan of merger or consolidation. If the transferor does not distribute the other property or money in pursuance to the plan of merger or consolidation, the gain is recognized, but only in the amount not in excess of the sum of the money and the fair market value of the other property so received, which is not distributed.[27]

The following transactions were held to be non-taxable exchanges pursuant to a plan of merger or consolidation:

1. Where, pursuant to a plan of reorganization, T corporation merged with R corporation, and stockholders of T delivered practically its entire stock and received stock of R in exchange, the non-recognition of gain or loss was

[25] American Foundation Co., Parag. 62, 822, P-H Fed., (1941).
[26] Federal Regulations (TD 6152) Section 1. 368-2.
[27] *Id.* note 26.

upheld under all the circumstances, notwithstanding the temporary lodging of T company stock in R company's subsidiary.[28]

2. Where a holding company was merged into an operating subsidiary and stockholders exchanged common and preferred stock of the Holding company for the common stock and debenture bonds of the subsidiary, there was a business purpose in the merger and the transaction was a statutory reorganization and no gain or loss was recognized to the stockholders.[29]
3. A tax-free reorganization occurred where an operating company was merged into a holding company. The holding company acquired all the stock of the operating company by issuing its voting stock (common and preferred) to stockholders of the operating company.[30]
4. A statutory merger of subsidiary and parent corporations was carried out by the cancellation of subsidiary's stock but without the surrender of the parent corporation's stock nor issuance of new shares. This resulted in a non-taxable exchange under the law rather than a taxable liquidation. The merger agreement had the effect of changing the stock of the parent corporation into stock of the consolidation and an actual exchange of certificates would have been an idle gesture.[31]

Finally, with regard to tax-free exchanges on the corporate level, it must be remembered that every step of the transaction will be closely scrutinized. And whether a series of steps should be treated separately or as a single transaction, depends upon whether there was a previously binding legal obligation to carry through the entire plan. If such an obligation exists, and the steps of the plan are mutually interdependent, the entire plan is treated as one transaction. Recognition or non-recognition of gain or loss will depend on the last step. But where no such legal obligation exists, the taxability of the transaction is usually determined after an intermediate step, or rather, the last step that is considered by the court to be mutually interdependent. The binding obligation can be an oral agreement.[32]

The second effect of tax-free exchanges is reflected in the subsequent distribution of stock and/or securities to stock or security holders of the combining corporations. The statute provides that no gain or loss is recognized if stock or securities in a corporation, a party to the merger or consolidation, are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in another corporation, a party to the merger or consolidation. Under the statute, "securities" refer only to bonds and debentures and not notes of whatever class or duration.

Two types of reorganization are contemplated by this provision of the statute: first, an ordinary merger or consolidation, and second, the acquisition of substantially all of the property of another corporation through an

[28] G. B. Chase, 44 BTA 39, (1944); Margaret Kahn, 133 F. 2d 199, 30 AFTR 748, (1943).
[29] H. Grady Manning Trust, et al., 15 TC 930, (1934).
[30] Forest Hotel Corp. v. Fly, 112 F. Supp. 782, 43 AFTR 1073, (1948).
[31] Guthro Holding Co., v. Commissioner, 138 F 2d 16, 31 AFTR 618, (1943).
[32] But an oral agreement unexecuted for six years was held insufficient in Schmieg, Hungate and Kotjian, Inc., 27 BTA 337, (1927).

exchange of all or part of the voting stock of the acquiring corporation. The statute provides that under the foregoing conditions, no gain or loss is recognized to a shareholder who surrenders his stock in exchange for other stock, or to a security holder who surrenders his securities in exchange for stock or securities.

However, in the case of a security holder, certain limitations are imposed. A security holder may surrender his securities and receive securities only in the same principal amount, or in a lesser principal amount, without the recognition of gain or loss to him. If securities in any greater amount are received, the fair market value of the excess amount is treated as "other property." Secondly, if securities are received and no securities are surrendered, such securities are also treated as "other property."

If an exchange were attempted of common stock alone for securities alone, it would apparently fail as not being in pursuance of a plan of reorganization. The distribution might then be taxable as a dividend to the extent of the earnings and profits of the corporation, or, should the distribution be non-pro-rata, as a redemption of stock by the corporation. But the fact that properties retained by the transferor corporation or received in exchange for the properties exchanged in the merger or consolidation, are used to satisfy existing liabilities not represented by securities, and which were incurred in the ordinary course of business before the reorganization does not prevent the non-recognition of gain or loss in the transaction.

Mention has already been made of money and/or "other property" received as additional consideration in tax-free exchanges. The statute also provides for the treatment of this additional consideration in transactions that would otherwise qualify as tax-free exchanges. If the rules for non-recognition of gain or loss would apply to an exchange, but for the fact that in addition to the property (stock and securities) permitted to be received, there is received also "other property" or money, then the gain, if any, is recognized but not in excess of the sum of money and the fair market value of the other property so received. In the event of a loss, however, no loss is recognized.[33]

And if an exchange (in which gain is to be recognized because of the receipt of other property or money) has the effect of a distribution of a dividend, then there is taxed as a dividend to each distributee such an amount of the gain as is not in excess of his ratable share of the undistributed earnings and profits of the corporation, and the remainder of the gain, if any, is treated as gain from the exchange of property. Thus, in a statutory merger, stockholders of the absorbed corporation received in exchange for their stock, stock of the surviving corporation, plus cash in lieu of fractional shares. The cash was paid by the surviving corporation. The gain was recognized on the exchange to the extent of the cash and

[33] Federal Regulations, Section 1. 356-1.

was taxable as a dividend to the extent of the earnings and profits of the absorbed corporation.[34] And in a statutory consolidation of two corporations into a new corporation, the taxpayer, a shareholder in one of the corporations, received a lesser number of shares in the new corporation than she otherwise would have been entitled to, the difference in the amount of the new shares went to the stockholders of the other corporation as the result of the cancellation of a debt owed by the taxpayer to her corporation, and for other considerations. The court held that the cancellation of the taxpayer's debt was equivalent to the receipt of other property or money, having the effect of a distribution taxable as a dividend.[35]

In this particular area of the law, difficulty is most likely to be encountered when part of the assets of a corporation are transferred to a new corporation for all of the latter's stock, and the old corporation makes a distribution in liquidation to its shareholders of the new stock with cash and other assets not transferred. In such a case, the question will arise as to whether the shareholders have received a liquidating dividend, (to be reported as capital gain or loss), or a distribution in connection with a reorganization, and because of the receipt of cash and other property, subject to the rules, that no loss is recognized but part of the gain may be taxed as a dividend. Should there be a finding that there was in fact a reorganization, the result would be adverse to the taxpayer as the distribution would be taxed as dividends. The fact that the transaction may also be viewed as a contraction of the business and therefore a partial liquidation will not alter the character of the transaction.[36]

But this adverse effect may be offset if it can be shown that the new corporation which acquired part of the assets of the liquidating corporation did so for the purpose of continuing the orderly liquidation of such property, as distinguished from continuation or operation of a business with the transferred assets.[37]

Another area of doubt is whether an exchange where both stock and cash is involved, is an exchange of stock for stock and cash, or an exchange of stock for stock and a subsequent sale of part of the stock for cash. The answer will inevitably depend on the nature of the particular transaction. In a decided case[38] it appeared that after the taxpayer had agreed to sell 200 shares of stock in a corporation for cash, the purchaser agreed to exchange shares of its own stock for her remaining 500 shares. The court held that under the circumstances, the sale and the exchange were two separate transactions, and that the determination of the Commissioner and

[34] Rev. Ruling 56-220, BIR 1956-22.
[35] Hawkinson v. Commissioner, 23 TC 933, (1931).
[36] Lewis et al., Trustees v. Commissioner, 176 F 2d 646, 38 AFTR 377, (1942). (This situation would most probably not be covered by our statute, it being a transfer of only part of the assets.)
[37] George D. Graham, 37 BTA 623, (1939).
[38] Bruce v. Helvering, 76 F 2d 442, 15 AFTR 1137, (1935).

the Board that there was an exchange of 700 shares of stock for stock and cash, was unwarranted. But where a purchasing corporation agrees to buy back part of its stock given in a tax-free exchange, the court held that there was an exchange of stock for stock and cash.[39]

When "other property" or money is received in an otherwise non-taxable exchange, the computation of the amount of gain, if any, recognized upon the exchange, depends first on the computation of the amount of gain *realized* on the exchange. Consequently, when as part of the consideration to the taxpayer, another party to the exchange assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, the liability plays a dual role: 1) with respect to its treatment in computing the *gain realized;* and 2) with respect to its treatment in computing *gain recognized.* In computing the gain realized, the amount of the liabilities is treated as cash received by the taxpayer. However, in computing the amount of gain recognized, the statute provides that such assumption or acquisition of liability will not be treated as money and/or other property (with respect to the rules for partial recognition of gain and non-recognition of loss), and if the only type of consideration received by the taxpayer in addition to that permitted to be received under the statute, consists of such assumption or acquisition, and the transaction otherwise qualifies, it is deemed to be non-taxable.[40]

If the principal purpose of the taxpayer with respect to the assumption or acquisition by another of the liability was a purpose to avoid tax on the exchange, or if it was not for a "bona fide" business purpose, then liabilities will be treated as money received on the exchange.

The exception provided for by the statute does not affect the general rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized. But as previously mentioned in the earlier part of this paper, the assumption of liabilities will be disregarded in determining whether the exchange is solely for voting stock.

The foregoing rules have been expounded to indicate under what conditions gain or loss will not be recognized in corporate reorganizations. However, it cannot be inferred that the described transactions which qualify under the statute are altogether exempt from tax. A so-called non-taxable exchange is in reality merely a postponement of the recognition of gain or loss because property received tax-free must take a substituted or

[39] First Seattle Dexter Horton National Bank et al, executors, 27 BTA 1242, (1935).
[40] Example: An individual transfers to a controlled corporation property with an adjusted basis of ₱10,000 and subject to a liability of ₱4,000. He received in exchange stock of the corporation worth ₱8,000 and ₱3,000 cash. The realized gain of the individual is ₱5,000 (8,000 + 3,000 + 4,000 minus 10,000). However, gain is recognized only to the extent of ₱3,000 cash received since the statute provides that for such purpose the liability is not to be treated as other property or money.

carry-over basis which is the same as the basis of the property given in the exchange, or in certain cases, the same as the basis of the property in the hands of the transferor. Different rules apply in determining basis as to corporations and basis as to distributees.

The basis of property acquired by a corporation in connection with a reorganization under the statute, is the same as it would be in the hands of the transferor increased in the amount of gain recognized to the transferor on the transfer. This rule does not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as all or part of the consideration for the transfer. And if the basis of the property received has the same basis, in whole or in part, as it would have in the hands of the transferor, then the holding period includes the period during which the property was held by the transferor. This will be advantageous to the taxpayer as it allows him to tack on to his holding period that of his predecessor, thus accelerating the required holding period to qualify the property's taxability at long term capital gain rates.

The basis to distributees of non-recognition property (stock and securities permitted to be received in tax-free exchanges), is the same as the basis of the property transferred, (adjusted to the date of exchange) —
decreased by —

1. the fair market value of any other property (except money) received by the taxpayer, and
2. the amount of any money received by the taxpayer, and,

increased by —

1. the amount that was treated as a dividend, and,
2. the amount of gain to the taxpayer recognized on the exchange, (except any part of the gain that was treated as a dividend).

For the purpose of determining the basis of the property received in a wholly or partly tax-free exchange, the amount of any liability to which the property transferred by the taxpayer is subject, or the amount of any liabilities of the taxpayer assumed by another party to the exchange, is treated as money received by the taxpayer on the exchange, whether or not the assumption of liabilities resulted in a recognition of gain or loss to the taxpayer. And when more than one class of non-recognition property is received in a wholly or partly tax-free exchange, the substituted basis is to be allocated among the properties received tax-free, pursuant to such rules and regulations that the Collector of Internal Revenue might promulgate.

The basis of any "other property" (except money) received by the taxpayer in any of the foregoing exchanges is the fair market value as of the date of exchange.

The foregoing discussion of rules and regulations governing tax-free exchanges of property makes no pretense of embodying a complete and detailed coverage of the law. The broadness of the subject matter makes this impossible. Rather, its sole purpose is to expound general principles which may serve as starting points in the pursuit of a more detailed understanding of the law. To indicate the way towards this understanding has been the task of this paper.

In closing, it must be remembered that the new statute has not yet found its clear delineations within this jurisdiction. Only the passage of time and the authoritative interpretations by our tax authorities and our courts will establish its clear-cut applicability to some given situations. And even in these defined areas, the complexities of corporate reorganization will be forever testing the scope and limits of the statute.