Headline	'De facto merger' - does it ring a bell?		
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'De facto merger' – does it ring a bell?

While sipping your favorite coffee early in the morning to jump start your day, you may have come across various headlines about corporate acquisitions while reading the newspaper or browsing news content online.

It seems that access to new developments, expansion of business, reduced costs and overhead, reduced competition and acquisition of a strong customer market base are just some of the benefits of such a business strategy.

An acquisition of a company can be effected through a merger or a consolidation. As defined by the Corporation Code of the Philippines, a merger occurs when two or more corporations merge into a single corporation which shall be one of the constituent corporations, while a consolidation occurs when two or more corporations consolidate into a new single corporation which shall be the consolidated corporation. Translating the definition into a basic formula, merger means A+B = A or B, while consolidation means A+B = C.

TOP OF MIND

FRYLEN Y. MANACIO

Merger or consolidation transactions are not uncommon. But the Tax Code also contemplates a "de facto merger," which may not be necessarily a term that would ring a bell for most readers.

Under the Tax Code, the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock is a de facto merger – for us accountants, a very good example of substance over form.

But where does taxation fit in the picture? As a famous cliché would say – "great power comes with great responsibility," allow me to modify it to "great benefits come with great tax consequences." Apparently in the point of view of the Bureau of Internal Revenue (BIR), no one should be enjoying the benefits from these business strategies without paying the corresponding tax liabilities, if any should be due.

As a general rule, the gain or loss on the sale or exchange of property shall be recognized and will be taxable. However, Section 40 (C)(2) of the Tax Code provides an exception such that no gain or loss shall be recognized if the sale or exchange of property is in pursuance of a plan of merger or consolidation, including a de facto merger transaction. But being a tax exempt transaction, the taxpayer must prove in a very clear manner that it is entitled to such exemption.

In the case of Premium Tobacco Redrying and Fluecuring Corp. vs. Commissioner of Internal Revenue (CTA Case No. 8897, July 18, 2017), the BIR assessed the taxpayer with deficiency taxes on its de facto merger transaction due to its failure to meet the requisites in order to be tax exempt, stressing that aside from the requisites that there must be a transfer of all or substantially all the properties of one corporation to another corporation solely for stock and that the transfer must be undertaken for a bona fide business purpose, "the element of permanence and not mere momentary holding" is also an essential requirement under Revenue Memorandum Ruling (RMR) No. 01-2002.

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The BIR argued that the assets of the subject de facto merger were subsequently transferred to another corporation (or a "third corporation" for this purpose) barely four months later after the de facto merger. Clearly, the subsequent transfer of the assets subject of the de facto merger was not for a bona fide business purpose, but rather a preliminary action on the part of the taxpayer to escape the burden of taxation.

Does the phrase "the element of permanence and not merely momentarily holding" prevent the subsequent transfer of the property by the transferee to another corporation? Should the subsequent disposal of the property be taken against the initial transfer of the assets?

The Court of Tax Appeals (CTA) agreed with the taxpayer, stating "the element of permanence and not merely momentarily holding" is not one of the requirements under the Tax Code. In order to constitute a de facto merger, only two requisites must be present. First, there must be a transfer of all or substantially all of the properties of transferor solely for stock of the transferee. Second, it must be undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation.

Under RMR No. 01-2002, the phrase "substantially all the properties of the corporation" means the acquisition by one corporation of at least 80 percent of the assets, including cash of another corporation, which has "the element of permanence and not momentarily holding." The phrase "the element of permanence and not merely momentary holding" pertains to the permanent transfer of the assets to the transferee corporation and not merely momentary or temporary holding. This means the transferred assets cannot be returned to the transferor corporation. The transfer of properties should not be merely temporary.

The subsequent transfer of the properties to another corporation (third corporation) is the discretion of the management and should not be taken against the initial transfer of the property. It should not prevent the entities in maximizing its full potential.

However, it must be noted that subsequent disposition of the properties involved in the exchange shall be subject to the corresponding income tax on the gain or income derived by the transferor or transferee.

The BIR also argued that the taxpayer should not assume that the exchange transaction was tax exempt without first securing a tax-free exchange ruling. The questions now arise – Do taxpayers need to first secure the tax-free exchange ruling before they can avail of the tax exemption? Should they initially treat the transaction as taxable, if a tax-free exchange ruling is not yet secured?

Fortunately, the CTA ruled in the negative. The ruling is not a precondition for the taxpayer to avail of the tax exemption. These rulings merely provide for the guidelines in monitoring tax-free exchanges of property so that in case of subsequent sale, these transactions can be taxed accordingly.

Nonetheless, it is axiomatic that tax exemptions, being in derogation of the sovereign power of the State, are strictly construed against the taxpayer. The burden of proving that it has complied with and satisfied all the requirements in order to be entitled to the exemption lies with the taxpayer. Thus, it is best to maintain proper documentation in case of a BIR inquiry in order to properly defend the availment of tax exemptions.

As one of the fastest growing economies in the Asia Pacific region, the Philippines is becoming more and more attractive to investors – foreign and local alike. Because of that, more corporate acquisitions are expected to transpire in the Philippines. It is important to be aware of the tax consequences of these transactions – to efficiently plan the resources, achieve the desired business purpose and ultimately help the Philippine economy.

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