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BDB Law's "Tax Law for Business" *appears in the opinion section of* ***Business Mirror*** *every Thursday.*

Tax-free transfers of property during merger, consolidation

MERGERS and consolidations had been the popular modes of undertaking reorganization of businesses, not only because these are allowed but also because of the lesser tax consequences. A merger takes place when two or more corporations merge into a single corporation that shall be one of the constituent corporations. Meanwhile, corporations may also consolidate into a new single corporation, which shall be the consolidated corporation.

And what are the tax implications of a merger or consolidation?

Subject to certain conditions, the present Tax Code (specifically Section 40[C][2] of the 1997 Tax Code) recognizes that no gain or loss shall be recognized if, in pursuance of a merger or consolidation, a corporation that is a party to a merger or consolidation, exchanges property solely for stock in a corporation, which is a party to a merger or consolidation; or if a shareholder exchanges stock in a corporation that is a party to the merger or consolidation solely for the stock of another corporation, which is also a party to the merger or consolidation, among other things. Although the tax is merely deferred because the tax impact is recognized in subsequent transfers of the shares and pieces of property, merger transactions are usually considered free from income tax since no tax is paid at the time of the transaction.

Also, through administrative issuances, the exemption from value-added tax (VAT) has become the accepted practice. Revenue Regulations 16-2005 specifically recognizes that the VAT shall not apply to goods or property existing at the time of the occurrence of the merger or consolidation. Thus, transfer of assets and property as a result of merger is exempt from VAT.

Likewise, no documentary-stamp tax is due, even if the transaction would have been subject to DST in an ordinary transfer. The Bureau of Internal Revenue (BIR) had also consistently ruled that no donor's tax is due in a merger or consolidation on the ground that no donative intent is intended in undertaking merger or consolidation.

Essentially therefore, undergoing merger or consolidation does not give rise to the taxes usually involved in transfers. In addition to the tax-free character of mergers and consolidations, the surviving corporation absorbs the unutilized input taxes of the absorbed corporation. Likewise, Revenue Regulations 14-2001 allowed the net operating losses (Nolco) of the absorbed corporation to be carried to the surviving corporation, subject only to the requirement that there has been no substantial change in the ownership of the business or enterprise. This must be so because one of the legal effects of a merger or consolidation is the transfer of all the rights, property and assets of the absorbed corporation to the surviving or new corporation. And the Nolco and the deductibility of the Nolco is just one of assets and rights transferred by the absorbed corporation.

These are just some of the tax consequences of merger or consolidation, which makes this mode of reorganization attractive. Recently, however, there were issuances made by the BIR that changed or modified these rules.

In recent rulings (e.g., BIR Ruling 214-2012), the BIR denied the transfer of the Nolco of the absorbed corporation to the surviving corporation. The reason is that the Nolco is not one of the assets of the absorbed company that can be transferred and absorbed by the surviving company; only the absorbed corporation can avail itself of this privilege.

In a more recent ruling, the BIR said the merger of a subsidiary to a parent company where the parent company would not be issuing shares to the subsidiary in exchange for the assets is an upstream merger. The BIR said this is in the nature of a donation made by the subsidiary to the parent company. While the pervious BIR administrations had consistently ruled that similar transactions fall within the ambit of Section 40(C)(2) of the Tax Code, this new administration is saying otherwise.

Another issuance affecting this area is Revenue Memorandum Circular 40-2012, which requires that the rulings issued under Section 40(C)(2) of the Tax Code shall be valid only for 90 days from the receipt of the ruling by the parties. Also within the same period, a photocopy of the TCT or CCT or Certificate of Shares of Stock that bears the annotation of substituted basis of the real property or shares of stock transferred and received, should be submitted to the Law Division of the BIR. Otherwise, any transaction in connection with tax-free exchange transaction confirmed by a ruling shall be void and without effect.

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