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Untaxing Taxes: An Attempt to Compare Philippine and US Laws on Tax-Free Corporate Reorganizations

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"Untaxing Taxes: An Attempt to Compare Philippine and US Laws on Tax-Free Corporate Reorganizations"[1]

By

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I. INTRODUCTION

When the author started researching for this paper, he was thinking of a more general title (i.e. "A Comparative Study of Philippine and US law …) that would match the breadth of his purpose. He soon realized the presumptuousness thereof as US tax law is not easy to understand.

Hopefully, this paper is judged not so much on the limitations of its contents but more on the lasting significance of its goal. This work, after all, is not envisioned to be the final word on the subject but as a seminal work from which other future researches on the topic can take off from.

The significance is the benefit of comparison. In comparing tax-free corporate reorganizations between Philippine and US law, the author wishes to learn how the US legal system would approach similar tax situations in the Philippines so he could apply it in the practice of law. Labyrinthine as they may be, US tax rules are so well-developed that make them excellent subjects for a comparative study.

An obvious difference between the two legal systems is the length of the pertinent tax law provisions. Whereas the Philippines has a single provision of law for tax-free exchanges, Section 40 of the National Internal Revenue Code of 1997 (hereinafter

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referred to with its acronym "NIRC"[3]), the equivalent thereof in the United States' Internal Revenue Code of 1986 (hereinafter "IRC")[4] spans the entire gamut of provisions in Parts I, II, and III of Subchapter O[5], and the entire Part III of Subchapter C[6].

Aside from length, another obvious difference is the complexity of the IRC. It contains a lot of overlapping provisions and cross-references to its other provisions which in turn, are identified only by section, paragraph, and subparagraph number. A student of comparative law studying US tax law for the first time, like the author, would thus wonder whether the convoluted wordings of the IRC raises due process issues due to its seeming incomprehensibility to people not learned in tax law. In contrast to the IRC's being a masterpiece in prolixity, the NIRC's Section 40 is very typical of codes in civil law systems- short, concise, highly structured and organized.

This paper will attempt to compare the tax-free exchanges resulting to corporate reorganizations between the Philippines' NIRC and the United States' IRC. To achieve coherence in an otherwise complicated subject matter, this comparative study will proceed by discussing the corporate tax-free transactions allowed under Philippine law, namely – ordinary merger, de facto merger, and transfer to a controlled corporation. Each of them will then be compared to their closest counterparts among the various tax-free exchange provisions under the IRC in terms of their requisites, coverage and exclusions,

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[3] *National Internal Revenue Code of 1997* at http://www.bir.gov.ph/nirc/nir_tl02_ch07.html

[4] *See* I.R.C at FEDERAL INCOME TAX, CODE AND REGULATIONS (Martin B. Dickinson ed., 2003).

[5] *Id*
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[6] *Id*
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tax consequences[7], and where applicable, the rule relating to basis, exchanges not solely in kind, and assumption of liability. As such comparative method of study will leave out other tax-free exchange provisions in the IRC which may not have a direct statutory counterpart in the NIRC, this paper will, thereafter, try to discuss said other tax-free reorganization types under the IRC (i.e. the so-called Types E,F, and G reorganizations, as well as triangular reorganizations), and discuss their possible applicability or the lack thereof to Philippine tax practice.

The working hypothesis for this work is that there is so much similarity between the Philippine and the US tax laws on the matter of corporate tax-free exchanges, and that where such similarity ends, the differences may be applied in dealing with gray areas in Philippine tax practice. Phrased in another way, in the absence of any conflict with Philippine laws, US tax law principles in such a penumbra may be applied in resolving similar tax situations in the Philippines.

It should be obvious that this paper is written from a Philippine perspective. Thus, it does not include an extensive treatment of US tax rules except only when necessary in comparing it with similar Philippine rules.

As a word of caveat, the word "reorganization" is being used here to refer to both corporate "formation" contemplated by §. 351 of the IRC and §. 368 of the same code.[8]

II. PHILIPPINE LAW

[7] The author patterned his discussion in this paper on the tax consequences of the various types of reorganizations allowed under the IRC from CHERYL D. BLOCK, CORPORATE TAXATION: EXAMPLES AND EXPLANATIONS, (Aspen Law and Business, 1998).

[8] This qualification needs to be stressed as in US tax law, the term "reorganization" is a term of art. It refers only to the situations contemplated by §. 368(a)(1) of the IRC.

As earlier discussed, the pertinent primary law on the matter is Section 40 of the National Internal Revenue Code (NIRC) of 1997, as amended.[9] It provides:

"Sec. 40. Determination of Amount and Recognition of Gain or Loss. –

(A) Computation of Gain or Loss – The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis or adjusted basis for determining gain, and the loss shall be the excess of the basis or adjusted basis for determining loss over the amount realized. The amount realized from the sale or other disposition of property shall be the sum of money received plus the fair market value of the property (other than money) received;

(B) Basis for Determining Gain or Loss from Sale or Disposition of Property – The basis of property shall be –

1) The cost thereof in the case of property acquired on or after March 1, 1913, if such property was acquired by purchase; or
2) The fair market price or value as of the date of acquisition, if the same was acquired by inheritance; or
3) If the property was acquired by gift, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis is greater than the fair market value of the property at the time of the gift then, for the purpose of determining loss, the basis shall be such fair market value; or
4) If the property was acquired for less than an adequate consideration in money or money's worth, the basis of such property is the amount paid by transferee for the property; or
5) The basis as defined in paragraph (C)(5) of this Section, if the property was acquired in a transaction where gain or loss is not recognized under paragraph (C)(2) of this Section.

(C) Exchange of Property-

(1) General Rule- Except as herein provided, upon the sale or exchange of property, the entire amount of the gain or loss, as the case may be shall be recognized.

(2) Exception – No gain or loss shall be recognized if in pursuance of a plan of merger or consolidation –

[9] Presidential Decree (PD) No. 1158, the basic law has been amended several times, most notably, by PD 1994, Executive Order (EO) No. 273, and more recently by Republic Act (RA) No. 8424, otherwise known as the "Tax Reform Act of 1997".

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

(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 such corporation, a party to the merger or consolidation.

No gain or loss shall also be recognized if property is transferred to a corporation by a person in exchange for stock or unit of participation in such a corporation of which as a result of such exchange said person, alone or together with others, not exceeding four (4) persons, gains control of said corporation. Provided, that stocks issued for services shall not be considered as issued in return for property.

(3) Exchange Not Solely In Kind –

(a) If in connection with an exchange described in the above exceptions, an individual, a shareholder, a security holder or a corporation receives not only stock or securities permitted to be received without the recognition of gain or loss, but also money and/or property, the gain, if any, but not the loss, shall be recognized, but in an amount not in excess of the sum of the 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 dividend to the shareholder an amount of the gain recognized not in excess of his proportionate 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.

(b) If, in connection with the exchange described in the above exceptions, the transferor corporation receives not only stock permitted to be received without the recognition of gain or loss but also money and/or other property, then (i) if the corporation receiving such money and/or other property distributes it in pursuance of the plan of merger or consolidation, no gain to the corporation shall be recognized

from the exchange, but ii) if the corporation receiving such other property and/or money does not distribute it in pursuance of the plan of merger or consolidation, the gain, if any, but not the loss to the corporation shall be recognized but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not distributed.

(4) Assumption of Liability-

(a) If the taxpayer, in connection with the exchanges by described in the foregoing exceptions, 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 part of the 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.

(c) If the amount of the liabilities assumed plus the amount of the liabilities to which the property is subject exceed the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(5) Basis –The basis of the stock or securities received by the transferor upon the exchange specified in the above exception shall be the same as the basis of the property, stock or securities exchanged, decreased (1)the money received, and (2) the fair market value of the other property received, and increased by (a) the amount treated as dividend of the shareholder and (b) the amount of any gain, that was recognized on the exchange: Provided, That the property received as "boot" shall have as basis its fair market value: Provided further, That if as part of the consideration to the transferor, the transferee of property assumes a liability of the transferor or acquires from the latter property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this paragraph, be treated as money received by the transferor on the exchange: Provided, finally, That if the transferor receives several kinds of stock or securities, the Commissioner is hereby authorized to allocate the basis among the several classes of stocks or (b) The

basis 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.

(6) Definitions –

(a) The term "securities" means bonds and debentures but not "notes" of whatever class or duration.

(b) The term "merger" or "consolidation" when used in this Section shall be understood to mean : (i) the ordinary merger or consolidation, or ii) the acquisition by one corporation of all or substantially all the properties of another corporation solely for stock; Provided, That for a transaction to be regarded as a merger or consolidation within the purview of this Section, it must be undertaken for a bona fide business purpose and not solely for the purpose of escaping the burden of taxation: Provided, further, That in determining whether a business purpose exists, each and every step of the transaction shall be considered and the whole transaction or series of transaction shall be treated as a single unit: Provided, finally, That in determining whether the property transferred constitutes a substantial portion of the property of the transferor, the term "property" shall be taken to include the cash assets of the transferor.

(c) The term "control", when used in this Section, shall mean ownership of stocks in a corporation possessing at least fifty-one percent (51%) of the total voting power of all classes of stocks entitled to vote.

(d) The Secretary of Finance, upon recommendation of the Commissioner, is hereby authorized to issue rules and regulations for the purpose and for the proper implementation of this Section".

Notably, the NIRC does not define what it refers to as "plan of merger or consolidation" in Section 40(C)(2) or "ordinary merger or consolidation" set forth in the above-mentioned Section 40(C)(6)(b). Resort is thus made to the pertinent Philippine

law on mergers and consolidations, Batas Pambansa Blg. 68, otherwise known as the "Corporation Code of the Philippines"[10]. The following provisions of said law applies:

"TITLE IX
MERGER AND CONSOLIDATION

"Sec.76. Plan of Merger or Consolidation – Two or more corporations may merge into a single corporation which shall be one of the constituent corporations or may consolidate into a new single corporation which shall be the consolidated corporation.

The board of directors or trustees of each corporation, party to the merger or consolidation, shall approve a plan of merger or consolidation setting forth the following:

1. *The names of the corporations proposing to merge or consolidate, hereinafter referred to as the constituent corporations;*
2. *The terms of the merger or consolidation and the mode of carrying the same into effect;*
3. *A statement of the changes, if any, in the articles of incorporation of the surviving corporation in case of merger; and with respect to the consolidated corporation in case of consolidation, all the statements required to be set forth in the articles of incorporation for corporations organized under this Code; and*
4. *Such other provisions with respect to the proposed merger or consolidation as are deemed necessary or desirable.*

Sec.77. Stockholder's or member's approval – Upon approval by majority vote of each of the board of directors or trustees of the constituent corporations of the plan of merger or consolidation, the same shall be submitted for approval by the stockholders or members of each of such corporations at separate corporate meetings duly called for the purpose. Notice of such meetings shall be given to all stockholders or members of the respective corporations, at least two (2) weeks prior to the date of the meeting, either personally or by registered mail. Said notice shall state the purpose of the meeting and shall include a copy or a summary of the plan of merger or consolidation. The affirmative vote of stockholders representing at least two-thirds (2/3) of the outstanding capital stock of each corporation in the case of stock corporations or at least two-thirds (2/3) of the members in the case of non-stock corporations shall be necessary for the approval of such plan. Any dissenting stockholder in stock corporations may exercise his appraisal right in accordance with the

[10] *The Corporation Code of the Philippines(Batas Pambansa Blg. 68) at* http://www.chanrobles.com/legal5title9.htm

Code: Provided, That if after the approval by the stockholders of such a plan, the board of directors decides to abandon the plan, the appraisal right shall be extinguished.

Any amendment to the plan of merger or consolidation may be made, provided such amendment is approved by majority vote of the respective boards of directors or trustees of all the constituent corporations and ratified by the affirmative vote of stockholders representing at least two-thirds (2/3) of the members of each of the constituent corporations. Such plan, together with any amendment, shall be considered as the agreement of merger or consolidation.

Sec.78. Articles of merger or consolidation. – After the approval by the stockholders or members as required by the preceding section, articles of merger or articles of consolidation shall be executed by each of the constituent corporations, to be signed by the president or vice-president and certified by the secretary or assistant secretary of each corporation setting forth:

1. *The plan of the merger or the plan of consolidation;*
2. *As to stock corporations, the number of shares outstanding, or in the case of non-stock corporations, the number of members; and*
3. *As to each corporation, the number of shares or members voting for and against such plan, respectively.*

Sec.79. Effectivity of merger or consolidation. – The articles of merger or of consolidation, signed and certified as herein above required, shall be submitted to the Securities and Exchange Commission in quadruplicate for its approval: Provided, That in the case of merger or consolidation of banks and banking institutions, building and loan associations, trust companies, insurance companies, public utilities, educational institutions and other special corporations governed by special laws, the favorable recommendation of the appropriate government agency shall first be obtained. If the Commission is satisfied that the merger or consolidation of the corporation concerned is not inconsistent with the provisions of this Code and existing laws, it shall issue a certificate of merger or of consolidation, at which time the merger or consolidation shall be effective. If, upon investigation, the Securities and Exchange Commission has reason to believe that the proposed merger or consolidation is contrary to or inconsistent with the provisions of this Code or existing laws, it shall set a hearing to give the corporations concerned the opportunity to be heard. Written notice of the date, time, and place of hearing shall be given to each constituent corporation at least two(2) weeks before said hearing. The Commission shall thereafter proceed as provided in this Code.

Sec.80. Effects of merger or consolidation. – The merger or consolidation shall have the following effects:

1. *The constituent corporations shall become a single corporation which, in case of merger, shall be the surviving corporation designated in the plan of merger; and, in case of consolidation, shall be the consolidated corporation designated in the plan of consolidation;*
2. *The separate existence of the constituent corporations shall cease, except that of the surviving or the consolidated corporation;*
3. *The surviving or the consolidated corporation shall possess all the rights, privileges, immunities and powers and shall be subject to all the duties and liabilities of a corporation organized under this Code;*
4. *The surviving or the consolidated corporation shall thereupon and thereafter possess all the rights, privileges, immunities and franchises of each of the constituent corporations; and all property, real or personal, and all receivables due on whatever account, including subscriptions to shares and other choses in action, and all and every other interest of, or belonging to, or due to each constituent corporation, shall be deemed transferred to and vested in such surviving or consolidated corporation without further act or deed; and*
5. *The surviving or consolidated corporation shall be responsible and liable for all the liabilities and obligations of each of the constituent corporations in the same manner as if such surviving or consolidated corporation had itself incurred such liabilities or obligations; and any pending claim, action or proceeding brought by or against any of such constituent corporations maybe prosecuted by or against the surviving or consolidated corporation. The rights of creditors or liens upon the property of any of such constituent corporations shall not be impaired by such merger or consolidation."*

Based on the foregoing, it could be said that tax-free corporate reorganizations under Philippine law fall into two general categories[11]. The first is one pursuant to a merger or consolidation. The second is the transfer to a controlled corporation, whereby a person transfers property to a corporation in exchange of stock in a corporation as a

[11] *Tax-Free Exchanges at* http://www.bir.gov.ph/leg_tfx.html

result of which he gains control of said corporation. The latter kind of transaction is provided for in the last paragraph of Section 40 (C)(2) cited above.

In turn, there are two kinds of mergers or consolidations under the first category. One is what may be referred to as ordinary merger or consolidation, that described in Section 40(C)(2), subparagraphs (a) to (c) of the NIRC (in relation to the abovementioned provisions of the Corporation Code of the Philippines). The other is what is known as a "de facto merger"[12], whereby a corporation acquires all or substantially all the properties of another corporation solely for stock (Sec.40(C)(6)(b)(ii) of the NIRC which is likewise quoted above).

III. US LAW

As earlier mentioned, the US equivalent of the Philippines' NIRC is the Internal Revenue Code or "IRC". In the latter, the counterpart of Section 40 of the NIRC is not just a provision but numerous and lengthy provisions. These refer to the provisions falling under Parts I to III of Subchapter O of the IRC, on "Gain or Loss on Disposition of Property" (Sections 1001 to 1045), and the entire Part III, entitled " Corporate Organizations and Reorganizations" of Subchapter C, entitled "Corporate Distributions and Adjustments". The latter encompasses Sections 351 to 368 of the IRC.

Part I of Subchapter O, as well as the lone provision under its heading, Section 1001 is entitled "Determination of Amount of and Recognition of Gain or Loss." It

[12] The term "*de facto* merger" was officially used by the Bureau of Internal Revenue in referring to this kind of merger in Revenue Memorandum Ruling No. 1-2002. *See* contents at ftp:ftp.bir.gov.ph/webadmin/p.PDF

provides for, among others, the computation of gain or loss[13], determination of amount realized[14], and the recognition of gain or loss[15].

Part II of Subchapter O provides the "Basis Rules of General Application". Section 1011 thereof outlines the rule on "Adjusted Basis for Determining Gain or Loss". The other provisions thereunder appear under headings that are reflective of their contents: Section 1012[16] ("Basis of Property- Cost"), Section 1013[17] ("Basis of Property Included In Inventory"), Section 1014[18] ("Basis of Property Acquired From A Decedent"), Section 1015[19] ("Basis of Property Acquired By Gifts and Transfers in Trust"), Section 1016[20] ("Adjustments To Basis"), Section 1017[21] ("Discharge of Indebtedness"), Section 1019[22] ("Property On Which Lessee Has Made Improvements"), and Section 1022[23] ("Treatment of Property Acquired From a Decedent Dying After December 31, 2009").

Part III of Subchapter lays down rules for "Common Nontaxable Exchanges". The more important provisions falling thereunder which has an important bearing on the subject of tax-free corporate reorganizations are summarized below.

Section 1031[24] ("Exchange of Property Held For Productive Use or Investment") provides that no gain or loss shall be recognized on the exchange of property held for

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[13] I.R.C. §. 1001(a).

[14] I.R.C. §. 1001(b)

[15] I.R.C. §. 1001(c)
[16] FEDERAL INCOME TAX: CODE AND REGULATIONS, *supra* note 2, at 469.
[17] *Id.*
[18] *See id.*, at 470-471.
[19] *See id.*,at 471-472.
[20] *See id.*at 473-474.
[21] *See id.* at 474-476
[22] *See id.* at 476.
[23] *See id.* at 476-480.
[24] *See id.* at 480-482.

productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held for productive use in a trade or business or for investment.[25] Exceptions to this rule[26] are exchanges involving stock in trade or other property held primarily for sale; stocks, bonds, or notes; other securities or evidences of indebtedness or interest; interests in a partnership, certificates of trust or beneficial interests; or choses in action. Section 1031 also provides for non-recognition of gain or loss on exchanges of property between related persons[27], under certain conditions.

Section 1032 of the IRC provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation and similarly, no gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option, or with respect to a securities futures contract to buy or sell its stock.

Section 1033 provides , among others, that no gain shall be recognized if property if property as a result of its destruction in whole or in part, theft, seizure, or requisition or

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[25] I.R.C. §. 1031(a)(1)

[26] I.R.C. §. 1031(a)(2).

[27] §. 1031(f), IRC. As to what constitutes a "related person", §.1031(f) makes a cross-reference to the meaning given such term by Section 267(b) of the IRC. In turn, Section 267(b) enumerates the following as related persons: 1)members of the family as defined in subsection (c)(4) – brothers and sisters, whether by the whole or half blood; spouse, ancestors, and lineal descendants; 2) an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; 3) two corporations which are members of the same controlled group; 4) a grantor and a subsidiary of any trust; 5)A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; 6) A fiduciary of a trust and a beneficiary of such trust; 7)A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; 8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; 9) a person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or by members of the family of such individual; 10) A corporation and a partnership if the same person own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership; 11) An S corporation and another S corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; 12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or 13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

condemnation or threat or imminence thereof is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted.[28] There shall also be non-recognition of gain such if the same is converted into money or into property not similar or related in service or use to the property so converted up to the extent of the cost of the property so converted.[29]

Section 1035 provides that no gain or loss shall be recognized on the exchange of a contract of life insurance for another contract of life insurance or for an endowment or annuity contract;[30] a contract of endowment insurance for another contract of endowment insurance under specified conditions or for an annuity contract;[31] an annuity contract for an annuity contract.[32]

Section 1036 provides that no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.[33] For the purpose of this section, non-qualified preferred stock, as defined in Section 351 (g) (2) (to be quoted later in this paper) shall not be considered a stock.[34]

The other provisions on non-taxable exchanges under Part III are Section 1038 (on certain re-acquisitions of real property), Section 1031 (Transfers of Property Between Spouses or Incident to Divorce), Section 1044 (Rollover of Publicly Traded Securities Into Specialized Small Business Investment Companies), and Section 1045 (Rollover of Gain From Qualified Small Business Stock to Another Qualified Small Business Stock).

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[28] §. 1033 (a) (1), IRC.
[29] I.R.C. §. 1033(a)(2).
[30] I.R.C. §.1035 (a) (1)
[31] I.R.C. §. 1035 (a)(2)
[32] I.R.C. §. 1035 (a)(3)
[33] I.R.C. §. 1036 (a).
[34] I.R.C. §. 1036 (b).

The provisions of the IRC directly relating to tax-free corporate exchanges are the aforementioned provisions falling under Part III (Corporate Organizations and Reorganizations) – Sections 351, 354, 355, 356, 357, 358, 361, 362, and 368. To facilitate their comparison with Section 40(c) of the Philippines' NIRC, said provisions are quoted hereunder, as follows:

"PART III – CORPORATE ORGANIZATIONS AND REORGANIZATIONS

SUBPART A- CORPORATE ORGANIZATIONS

SEC.351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR

(a) GENERAL RULE- No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) RECEIPT OF PROPERTY – If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under subsection (a), other property or money, then –

(1) gain (if any) to such recipient shall be recognized, but not in excess of –

(A) the amount of money received, plus

(B)the fair market value of such other property received

(2) No loss to such recipient shall be recognized.

(c) SPECIAL RULES WHERE DISTRIBUTION TO SHAREHOLDERS –

(1) IN GENERAL – In determining control for purposes of this section, the fact that any corporate transferor distributes part or all of the stock in the corporation which it receives in the exchange to its shareholders shall not be taken into account.

(2) SPECIAL RULE FOR SECTION 355 – If the requirements of section 355 (or so much of section 356 as relates to section 355) are met with respect to a distribution described in paragraph (1), then, solely for purposes of determining the tax treatment of the transfers of property to the controlled corporation by the distributing

corporation, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account in determining control for purposes of this section.

(d) SERVICES, CERTAIN INDEBTEDNESS, AND ACCRUED INTEREST NOT TREATED AS PROPERTY – For purposes of this section, stock issued for -

1) *services,*
2) *indebtedness of the transferee corporation which is not evidenced by a security, or*
3) *interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt.*

shall not be considered as issued in return for property.

(e) EXCEPTIONS – This section shall not apply to -

(1)TRANSFER OF PROPERTY TO AN INVESTMENT COMPANY – A transfer of property to an investment company. For purposes of the preceding sentence, the determination of whether a company is an investment company shall be made –

(A) by taking into account all stock and securities held by the company, and

(B) by treating as stock and securities-

- *(i) money,*
- *(ii) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives,*
- *(iii) any foreign currency,*
- *(iv) any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly-traded partnership (as defined in section 7704(b) or any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any preceding clause, this clause or clause (v) or (viii),*
- *(v) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution,*
- *(vi) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if*

substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any of the preceding clause or clause (viii);

(vii) to the extent provided in regulations prescribed by the Secretary, any interest in any entity not described in clause (vi), but only to the extent of the value of such interest that is attributable to assets listed in clauses (i) through (v) or clause (viii), or

(viii) any other asset specified in regulations prescribed by the Secretary.

The Secretary may prescribe regulations that, under appropriate circumstances, treat nay asset described in clauses (i) through (v) as not so listed.

(2) TITLE 11 OR SIMILAR CASE – A transfer or property of a debtor pursuant to a plan while the debtor is under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368 (a)(3)(A), to the extent that the stock received in the exchange is used to satisfy the indebtedness of such debtor.

(f) TREATMENT OF CONTROLLED CORPORATION – If -

(1) property is transferred to a corporation (hereinafter in this subsection referred to as the "controlled corporation") in an exchange with respect to which gain or loss is not recognized (in whole or in part) to the transferor under this section, and

(2) such exchange is not in pursuance of a plan of reorganization, section 311 shall apply to any transfer in such exchange by the controlled corporation in the same manner as if such transfer were a distribution to which subpart A of part I applies.

(g) NONQUALIFIED PREFERRED STOCK NOT TREATED AS STOCK

(1) IN GENERAL – In the case of a person who transfers property to a corporation and receives nonqualified preferred stock -

(A) subsection (a) shall not apply to such transferor, and

(B) if (and only if) the transferor receives stock other than non-qualified preferred stock –

(i) subsection (b) shall apply to such transferor; and

(ii)such nonqualified preferred stock shall be treated as other property for purposes of applying subsection (b).

(2) NONQUALIFIED PREFERRED STOCK – For purposes of paragraph (1)-

(A) IN GENERAL – The term "nonqualified preferred stock" means preferred stock if -

(i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock,

(ii) the issuer or a related person is required to redeem or purchase such stock,

(iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or

(iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices.

(B) LIMITATIONS – Clauses (i), (ii), and (iii) of subparagraph (A) shall apply only if the right or obligation referred to therein may be exercised within the 2—year period beginning on the issue date of such stock and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

(C) EXCEPTIONS FOR CERTAIN RIGHTS OR OBLIGATIONS -

(i) IN GENERAL – A right or obligation shall not be treated as described in clause (i), (ii), or (iii) of subparagraph (A) if -

(I) It may be exercised only upon the death, disability, or mental incompetency of the holder,or

(II) In the case of a right or obligation to redeem or purchase stock transferred in connection with the performance of services for the issuer or a related person (and which represent reasonable compensation), it may be exercised only upon the holder's separation from service from the issuer or related person.

(ii) EXCEPTION – Clause (i)(I) shall not apply if the stock relinquished in the exchange, or the stock acquired in the exchange is in –

(I) a corporation if any class of stock in such corporation or a related party is readily tradeable on an established securities market or otherwise, or

(II) any other corporation if such exchange is part of a transaction or series of transactions in which such corporation is to become a corporation described in subclause (I).

(3) DEFINITIONS – For purposes of this subsection –

(A) PREFERRED STOCK – The term "preferred stock" means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

(B) RELATED PERSON – A person shall be treated as related to another person if they bear a relationship to such other person described in section 267(b) or 707(b).

(4) REGULATIONS – The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purpose of this subsection and sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). The Secretary may also prescribe regulations consistent with the treatment under this subsection and such sections, for the treatment of nonqualified preferred stock under other provisions of this title.

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Subpart B – Effects on Shareholders and Securities In Certain Reorganizations

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE –

(1) IN GENERAL – No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) LIMITATIONS –

(A) EXCESS PRINCIPAL AMOUNT – Paragraph (1) shall not apply if -

(i) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(ii) any such securities are received and no such securities are surrendered.

(B) PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST – Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock (including nonqualified preferred stock, as defined in section 351 (g) (2), securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

(C) NONQUALIFIED PREFERRED STOCK -

(I) IN GENERAL – Nonqualified preferred stock (as defined in section 351(g)(2) received in exchange for stock other than nonqualified preferred stock (as defined) shall not be treated as stock or securities.

(II) RECAPITALIZATIONS OF FAMILY-OWNED CORPORATIONS. –

(I) IN GENERAL – Clause (i) shall not apply in the case of a recapitalization under section 368(a)(1)(E) of a family-owned corporation.

(II) FAMILY-OWNED CORPORATION – For purposes of this clause, except as provided in regulations, the term "family-owned corporation" means any corporation which is described in clause (i) of section 447(d)(2)(c)throughout the 8-year period beginning on the date on the date which is 5 years before the date of the recapitalization. For purposes of the preceding sentence, stock shall not be treated as owned by a family member during any period described in section 355(d)(6)(B).

(III) EXTENSION OF STATUTE OF LIMITATIONS – The statutory period for the assessment of any definciency attributable to a corporation failing to be a family-owned corporation shall not expire before the expiration of 3 years after the date the Secretary is notified by the corporation (in such manner as the Secretary may prescribe) of such failure, and such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

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(b) EXCEPTION –

(1) IN GENERAL – Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1) unless -

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets, and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

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SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION

(a) EFFECT ON DISTRIBUTEES –

(1) GENERAL RULE – If –

(A) a corporation (referred to this section) as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution.

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the merre fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributes (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active business) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes -

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC. – paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a)(1) (D).

(3) LIMITATIONS –

(A) EXCESS PRINCIPAL AMOUNT – Paragraph (1) shall not apply if -

(i) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(ii) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

IN TAXABLE TRANSACTION WITHIN 5 YEARS TREATED AS BOOT – For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction –

(i) which occurs within 5 years of the distribution of such stock, and

(ii) in which gain or loss was recognized in whole or in part,

shall not be treated as stock of such controlled corporation, but as other property.

(C)PROPERTY ATTRIBUTABLE TO ACCRUED INTEREST – Neither paragraph (1) nor so much of section 356 as relates to paragraph (1) shall apply to the extent that any stock (including nonqualified preferred stock, as defined in section 351(g)(2), securities, or other property received is attributable to interest which has accrued on securities on or after the beginning of the holder's holding period.

(D) NONQUALIFIED PREFERRED STOCK – Nonqualified preferred stock (as defined in section 351(g)(2)received in a distribution wit respect to stock other than nonqualified preferred stock (as so defined) shall not be treated as stock or securities).

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(c) REQUIREMENTS AS ACTIVE BUSINESS –

(1) IN GENERAL – Subsection (a) shall apply only if either -

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION – For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if -

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution.

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business -

(i) was not acquired by any distributee corporation directly (or through 1 or more corporations, whether through the distributing corporation or otherwise) within the period described in subparagraph (B) and was not acquired by the distributing corporation directly (or through 1 or more corporations) within such period, or

(ii) was so acquired by any such corporation within such period, but in each case in which such control was so acquired, it was so acquired, only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

For purposes of subparagraph (D), all distributee corporations which are members of the same affiliated group (as defined in section 1504(a) without regard to section 1504(b) shall be treated as 1 distributee corporation.

[Sec.355 (c)]

(d) TAXABILITY OF CORPORATION ON DISTRIBUTION –

(1) IN GENERAL – Except as provided in paragraph (2), no gain or loss shall be recognized to a corporation on any distribution to which this section (or so much of section 356 as relates to this section) applies and which is not in pursuance of a plan of reorganization.

(2) DISTRIBUTION OF APPRECIATED PROPERTY -

(A) IN GENERAL – If –

(i) in a distribution referred to in paragraph (1), the corporation distributes property other than qualified property, and

(ii) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then gain shall be recognized to the distributing corporation as if such property were sold to the distributee at its fair market value.

(B) QUALIFIED PROPERTY – For purposes of subparagraph (A), the term "qualified property" means any stock or securities in the controlled corporation.

(C)TREATMENT OF LIABILITIES – If any property distributed in the distribution referred to in paragraph (1) is subject to a liability or the shareholder assumes a liability of the distributing corporation in connection with the distribution, then, for purposes of subparagraph (A), the fair market value of such property shall be treated as not less than the amount of such liability.

(3) COORDINATION WITH SECTIONS 311 AND 336(A) – Sections 311 and 336(a) shall not apply to any distribution referred to in paragraph (1).

[Sec. 355(d)]

(d) RECOGNITION OF GAIN ON CERTAIN DISTRIBUTIONS OF STOCK OR SECURITIES IN CONTROLLED CORPORATION -

(1) IN GENERAL – In the case of a disqualified distribution, any stock or securities in the controlled corporation shall not be treated as as qualified property for purposes of subsection (c)(2) of this section or section 361(c)(2).

(2) DISQUALIFIED DISTRIBUTION – For purposes of this subsection, the term "disqualified distribution" means any distribution to which this section (or so much of section 356 as relates to this section) applies if, immediately after the distribution -

(A) any person holds disqualified stock in the distributing corporation which constitutes a 50-percent or greater interest in such corporation, or

(B) any person holds disqualified stock in the controlled corporation (or, if stock of more than 1 controlled corporation is distributed, in any controlled corporation) which constitutes a 50-percent or greater interest in such corporation.

(3) DISQUALIFIED STOCK – For purposes of this subsection, the term "disqualified stock" means -

(A) any stock in the distributing corporation acquired by purchase after October 9, 1990, and

(B) any stock in any controlled corporation -

- *(i) acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution, or*
- *(ii) received in the distribution to the extent attributable to distributions on –*
  - *(I) stock described in subparagraph (A) or*

(II) any securities in the distributing corporation acquired by purchase after October 9, 1990, and during the 5-year period ending on the date of the distribution.

(4) 50-PERCENT OR GREATER INTEREST – For purposes of this subsection, the term "50-percent or greater interest" means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock.

(5) PURCHASE – For purposes of this subsection –

(A) IN GENERAL – Except as otherwise provided in this paragraph, the term "purchase" means any acquisition but only if -

(i) the basis of the property acquired in the hand s of the acquirer is not determined (I) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or (II) under section 1014(a), and

(ii) the property is not acquired in an exchange to which section 351, 354, 3555, or 356 applies.

(B) CERTAIN SECTION 351 EXCHANGES TREATED AS PURCHASES. – The term "purchase" includes any any acquisition of property in an exchange to which section 351 applies to the extent such property is acquired in exchange for -

(i) any cash or cash item,

(ii) any marketable stock or security, or

(iii) any debt of the transferor.

(C) CARRYOVER BASIS TRANSACTIONS – If -

(i) any person acquires property from another person who acquired such property by purchase (as determined under this paragraph with regard to this subparagraph), and

(ii) the adjusted basis of such property in the hands of such acquirer is determined in whole or in part by reference to the adjusted basis of such property in the hands of such other person,

such acquirer shall be treated as having acquired such property by purchase on the date it was so acquired by such other person,

(6) SPECIAL RULE WHERE SUBSTANTIAL DIMINUTION OF RISK –

(A) IN GENERAL – If this paragraph applies to any stock or securities for any period, the running of any 5-year period set forth in subparagraph (A) or (B) of paragraph (3) whichever applies) shall be suspended during such period.

(B) PROPERTY TO WHICH SUSPENSION APPLIES – This paragraph applies to any stock or securities for any period during which

the holder's risk of loss with respect to such stock or securities, or with respect to any portion of the activities of the corporation, is (directly or indirectly) substantially diminished by -

(i) an option,
(ii) a short sale,
(iii) any special class of stock, or
(iv) any other device or transaction

(7) AGGREGATION RULES –

(A) IN GENERAL – For purposes of this subsection, a person and all persons related to such person (within the meaning of section 267(b) or 707(b)(1) shall be treated as one person.

(B) PERSONS ACTING PURSUANT TO PLANS OR ARRANGEMENTS – If two or more persons act pursuant to a plan or arrangement with respect to acquisitions of stock or securities in the distributing corporation or controlled corporation, such person shall be treated as one person for purposes of this subsection.

(8) ATTRIBUTION FROM ENTITIES –

(A) IN GENERAL – Paragraph (2) of section 318(a) shall apply in determining whether a person holds stock or securities in any corporation (determined by substituting "10 percent" for "50 percent" in subparagraph (C) of such paragraph (2) and by treating any reference to stock as including a reference to securities).

(B) DEEMED PURCHASE RULE –

(i) any person acquires by purchase an interest in any entity, and
(ii) such person is treated under subparagraph (A) as holding any stock or securities by reason of holding such interest,

(9) REGULATIONS – The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including –

(A) regulations to prevent the avoidance of the purposes of this subsection through the use of related persons, intermediaries, pass-thru entities, options, or other arrangements, and

(C) regulations modifying the definition of the term "purchase".

[Sec. 355(e)]

(e) RECOGNITION OF GAIN ON CERTAIN DISTRIBUTIONS OF STOCK OR SECURITIES IN CONNECTION WITH ACQUISITIONS -

(1) GENERAL RULE – If there is a distribution to which this subsection applies, any stock or securities in the controlled corporation

shall not be treated as qualified property for purposes of subsection ©(2) of this section or section 361 (c)(2).

(2) DISTRIBUTIONS TO WHICH SUBSECTION APPLIES. –

(A) IN GENERAL – This subsection shall apply to any distribution-

(i) to which this section (or so much of section 356 as relates to this section) applies, and

(iii) which is part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

(B) PLAN PRESUMED TO EXIST IN CERTAIN CASES – If 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of distribution, such acquisition shall be treated as pursuant to a plan described in subparagraph (A)(ii) unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.

(C) CERTAIN PLANS DISREGARDED – A Plan (or series of related transactions) shall not be treated as described in subparagraph (A)(ii) if, immediately after the completion of such plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group (as defined in section 1504 without regard to subsection (b) thereof).

(D) COORDINATION WITH SUBSECTION (d). – This subsection shall not apply to any distribution to which subsection (d) applies.

(3) SPECIAL RULES RELATING TO ACQUISITIONS -

(A) CERTAIN ACQUISITIONS NOT TAKEN INTO ACCOUNT – Except as provided in regulations, the following acquisitions shall not be taken into account in applying paragraph (2)(A)(ii):

(i) The acquisition of stock in any controlled corporation by the distributing corporation,

(ii) The acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation,

(iii) The acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation.

(iv) The acquisition of stock in the distributing corporation or any controlled corporation to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

This subparagraph shall not apply to any acquisition if the stock held before the acquisition was acquired pursuant to a plan (or series of related transactions) described in paragraph (2)(A)(ii).

(B) ASSET ACQUISITIONS – Except as provided in regulations, for purposes of this subsection, if the assets of the distributing corporation or any controlled corporation are acquired by a successor corporation in a transaction described in subparagraph (A), (C), or (D) of section 368(a)(1) or any other transaction specified in regulations by the Secretary, the shareholders (immediately before the acquisition) of the corporation acquiring such assets shall be treated as acquiring stock in the corporation from which the assets were acquired."

(4) DEFINITION AND SPECIAL RULES – For purposes of this subsection -

(A) 50-PERCENT OR GREATER INTEREST – The term "50-percent or greater interest" has the meaning given such term by subsection (d)(4).

(B) DISTRIBUTIONS IN TITLE 11 OR SIMILAR CASE – Paragraph (1) shall not apply to any distribution made in a title 11 or similar case (as defined in section 368(a)(3).

(C) AGGREGATION AND ATTRIBUTION RULES. –

(i) AGGREGATION – T he rules of paragraph (7)(A) of subsection (d) shall apply.

(ii) ATTRIBUTION – Section 318(a)(2) shall apply in determining whether a person holds stock or securities in any corporation. Except as provided in regulations, section 318(a)(2)(C) shall be Applied without regard to the phrase"50 percent or more in value " for purposes of the preceding sentence.

(D) SUCCESSORS AND PREDECESSORS – For purposes of this subsection, any reference to a controlled corporation or a distributing corporation shall include a reference to any predecessor or successor of such corporation.

(E) STATUTE OF LIMITATIONS – If there is a distribution to which paragraph (1) applies -

(i) the statutory period for the assessment of any deficiency attributable to any part of the gain recognized under this subsection by reason of such distribution shall not expire before the expiration of 3

years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may by regulations prescribe) that such distribution occurred, and

(ii) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(5) REGULATIONS – The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including regulations –

(A) providing for the application of this subsection where there is more than 1 controlled corporation,

(B) treating 2 or more distributions as 1 distribution where necessary to prevent the avoidance of such purposes, and

(C) providing for the application of rules similar to the rules of subsection (d)(6) where appropriate for purposes of paragraph (2)(B).

[Sec.355(f)]

(f) SECTION NOT TO APPLY TO CERTAIN INTRAGROUP DISTRIBUTIONS – Except as provided in regulations, this section (or so much of section 356 as relates to this section) shall not apply to the distribution of stock from 1 member of an affiliated group (as defined in section 1504(a) to another member of such group if such distribution is part of a plan (or series of related transactions) described in subsection (e)(2)(A)(ii)(determined after the application of subsection (e)).

SEC.356. RECEIPT OF ADDITIONAL CONSIDERATION

[Sec.356(a)]

(a) GAIN ON EXCHANGES. –

(1) RECOGNITION OF GAIN. – If –

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized , but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND – If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend

(determined with the application of section 318(a), then there shall be treated as a dividend to each such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

[Sec.356(b)]

(b) ADDITIONAL CONSIDERATION RECEIVED IN CERTAIN DISTRIBUTIONS. – If -

(1) section 355 would apply to a distribution but for the fact that
(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

[Sec.356 (c)]

(c)LOSS. – If –

(1) section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that
(2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,

then no loss from the exchange or distribution shall be recognized.

[Sec.356(d)]

(e) SECURITIES AS OTHER PROPERTY – For purposes of this section –
(1) IN GENERAL – Except as divided in paragraph (2), the term "other property" includes securities.
(2) EXCEPTIONS-
(A) SECURITIES WITH RESPECT TO WHICH NONRECOGNITION OF GAIN WOULD BE PERMITTED. – The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.
(B) GREATER PRINCIPAL AMOUNT IN SECTION 354 EXCHANGE. – If -

(i) in an exchange described in section 354 (other than subsection (c) thereof, securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (c), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C)GREATER PRINCIPAL AMOUNT IN SECTION 355 TRANSACTION. – If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term "other property" means only the fair market value of such excess.

[Sec.356(f)]

(f) EXCHANGES FOR SECTIONS 306 STOCK – Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as a distribution of property to which section 301 applies.

[Sec.356(g)]

(f) TRANSACTIONS INVOLVING GIFT OR COMPENSATION –
For special rules for a transaction described in section 354, 355, or this section, but which –

(1) results in a gift, see section 2501 and following, or
(2) has the effect of the payment of compensation, see section 61(a)(1)

SEC.357. ASSUMPTION OF LIABILITY

[Sec.357(a)]

(a) GENERAL RULE – Except as provided in subsections (b) and (c), if –

(1) the taxpayer receives property which would be permitted to be received under section 351 or 361 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer,

then such assumption shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351 or 361, as the case may be.

[Sec.357(b)]

(b) TAX AVOIDANCE PURPOSE –

(1) IN GENERAL – If taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a)

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) BURDEN OF PROOF- In any suit or proceeding where the burden is on the taxpayer to prove such assumption is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

[Sec.357(c)]

(c)LIABILITIES IN EXCESS OF BASIS -

(1) IN GENERAL – In the case of an exchange –

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) EXCEPTIONS – Paragraph (1) shall not apply to any exchange –

(A) to which subsection (b) (1) of this section applies, or

(B) which is pursuant to a plan or reorganization within the meaning of section 368(a)(1)(G) where no former

shareholder of the transferor corporation recives any consideration for his stock.

(3) CERTAIN LIABILITIES EXCLUDED –

(A) IN GENERAL – If a taxpayer transfers, in an exchange to which section 351 applies, a liability the payment of which either-

(i) would give rise to a deduction, or

ii)would be described in section 736(a),

then for purposes of paragraph (1), the amount of such liability shall be excluded in determining the amount of liabilities assumed.

(B) EXCEPTION – Subparagraph (A) shall not apply to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property.

[Sec. 357(d)]

(d) DETERMINATION OF AMOUNT OF LIABILITY ASSUMED -

(1) IN GENERAL – For purposes of this section, section 358(d), section 358(h), section 362(d), section 368(a)(1)(C), and section 368(a)(2)(B), except as provided in the regulations –

(A) a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability; and

(B) except to the extent provided in paragraph (2), anonrecourse liability shall be treated as having been assumed by the transferee of any asset subject to such liability;

(2) EXCEPTION FOR NONRECOURSE LIABILITY – The amount of the nonrecourse liability treated as described in paragraph (1)B) shall be reduced by the lesser of –

(A) the amount of such liability which an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to satisfy, or

(B) the fair market value of such other assets (determined without regard to section 7701(g).

(3) REGULATIONS – The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and section 362(d). The Secretary may also prescribe regulations which provide that the manner in which a liability is treated as assumed under this subsection is applied, where appropriate, elsewhere in this title.

SEC. 358 BASIS TO DISTRIBUTEES

[Sec. 358(a)]

(a) GENERAL RULE – In the case of an exchange to which section 351, 354, 355, 356, or 361 applies -

(1) NONRECOGNITION OF PROPERTY – The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged –

(A) decreased by -

(i) the fair market value of any other property (except money) received by the taxpayer,

(ii) the amount of any money received by the taxpayer, and

(iii) the amount of loss to the taxpayer which was recognized on such exchange , and

(B) increased by -

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

(2) OTHER PROPERTY – The basis of any property (except money) received by the taxpayer shall be its fair market value.

[Sec. 358(b)]

(b) ALLOCATION OFBASIS -

(1) IN GENERAL – Under regulations prescribed by the Secretary, the basis determined under subsection (a) (1) shall be allocated among the properties permitted to be received without the recognition of gain or loss,

(2) SPECIAL RULE FOR SECTION 355 – In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

[Sec. 358(c)]

(c) SECTION 355 TRANSACTIONS WHICH ARE NOT EXCHANGES – For purposes of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange.

[Sec. 358(d)]

(d) ASSUMPTION OF LIABILITY -

(1) IN GENERAL – Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer, such assumption shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

(2) EXCEPTION – Paragraph (1) shall not apply to the amount of any liability excluded under section 357(c)(3).

[Sec. 358(e)]

(e) EXCEPTION – This section shall not apply to property acquired by a corporation by the exchange of its stock or securities (or the stock or securities of a corporation which is in control of the acquiring corporation) as consideration in whole or in part for the transfer of the property to it.

[Sec. 358(f)]

(f) DEFINITION OF NONRECOGNITION PROPERTY IN CASE OF SECTION 361 EXCHANGE – For purposes of this section, the property permitted to be received under section 361 without the recognition of gain or loss shall be treated as consisting only of stock or securities in another corporation a party to the reorganization.

[Sec. 358(g)]

(g) ADJUSTMENTS IN INTRAGROUP TRANSACTIONS INVOLVING SECTION 355 – In the case of a distribution to which section 355 (or so much of section 356 as relates to section 355) applies and which involves the distribution of stock from 1 member of an affiliated group (as defined in section 1504(a) without regard to subsection (b) thereof) to another member of such group, the Secretary may notwithstanding any other provision of this section, provide adjustments to the adjusted basis of any stock which -

(1) is in a corporation which is a member of such group, and

(2) is held by another member of such group, to appropriately reflect the proper treatment of such distribution.

(h) SPECIAL RULES FOR ASSUMPTION OF LIABILITIES TO WHICH SEUBSECTION (D) DOES NOT APPLY -

(1) IN GENERAL – If, after application of the other provisions of this section to an exchange or series of exchanges, the basis of property to which subsection (a) (1) applies exceeds the fair market value of such property, then such basis shall be reduced (but not below such fair market value) by the amount (determined as of the date of the exchange) of any liability –

(A) which is assumed by another person as part of the exchange, and

(B) with respect to which subsection (d)(1) does not apply to the assumption.

(2) EXCEPTIONS – Except as provided by the Secretary, paragraph (1) shall not apply to any liability if-

(A) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or

(B) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.

(3) LIABILITY – For purposes of this subsection, the term "liability" shall include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title.

Subpart C – Effects on Corporations

Sec. 361. NONRECOGNITION OF GAIN OR LOSS TO CORPORATIONS; TREATMENT OF DISTRIBUTIONS

[Sec. 361(a)]

(a) GENERAL RULE – No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

[Sec. 361(b)]

(b) EXCHANGES NOT SOLELY IN KIND -

(1)GAIN – If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then –

(A) PROPERTY DISTRIBUTED – If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized.

The amount of gain recognized under subparagraph (B) shall not exceed the sum of the money and the fair market value of the other property so received which is not so distributed.

(2) LOSS –If subsection (a) would apply to an exchange but for the fact that the property received in exchange consists not only of property permitted by subsection (a) to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(3) TREATMENT OF TRANSFERS TO CREDITORS – For purposes of paragraph (1), any transfer of the other property or money received in the exchange by the corporation to its creditors in connection with the reorganization shall be treated as a distribution in pursuance of the plan of reorganization . The Secretary may prescribe such regulations as may be necessary to prevent avoidance of tax through abuse of the preceding sentence or subsection (c)(3).

[Sec. 361(c)]

(c)TREATMENT OF DISTRIBUTIONS -

(1) IN GENERAL – Except as provided in paragraph (2), no gain or loss shall be recognized to a corporation a party to a reorganization on the

distribution to its shareholders of property in pursuance of the plan of reorganization.

(2) DISTRIBUTIONS OF APPRECIATED PROPERTY –

(A) IN GENERAL – If –

(i) in a distribution referred to in paragraph (1), the corporation distributes property other than qualified property, and

(ii) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation),

then fain shall be recognized to the distributing corporation as if such property were sold to the distribute at its fair market value.

(B) QUALIFIED PROPERTY – For purposes of this subsection, the term "qualified property" means -

(i) any stock in (or right to acquire stock) in the distributing corporation or obligation of the distributing corporation, or

(ii) any stock in (or right to acquire stock in) another corporation which is a party to the reorganization or obligation of another corporation which is such a party if such stock (or right) or obligation is received by the distributing corporation in the exchange.

(C) TREATMENT OF LIABILITIES – If any property distributed in the distribution referred to in paragraph (1) is subject to a liability or the shareholder assumes a liability of the distributing corporation in connection with the distribution, then for purposes of subparagraph (A) , the fair market value of such property shall be treated as not less than the amount of such liability.

(3) TREATMENT OF CERTAIN TRANSFERS TO CREDITORS – For purposes of this subsection, any transfer of qualified property by the corporation to its creditors in connection with the reorganization shall be treated as a distribution to its shareholders pursuant to the plan or reorganization.

(4) COORDINATION WITH OTHER PROVISIONS – Section 311 and subpart B of part II of this subchapter shall not apply to any distribution referred to in paragraph (1).

xxx xxx xxx

SEC. 362. BASIS TO CORPORATIONS

[Sec. 362(a)]

(a) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS – If property was acquired on or after June 22, 1954, by a corporation

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

[Sec. 362(b)]

(b) TRANSFERS TO CORPORATIONS – If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

(c)SPECIAL RULE FOR CERTAIN CONTRIBUTIONS TO CAPITAL -

(1) PROPERTY OTHER THAN MONEY – Notwithstanding subsection (a) (2), if property other than money -

(A) is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such, then the basis of such property shall be zero.

(2) MONEY – Notwithstanding subsection (a)(2), if money –

(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of any property acquired with such money during the 12-mont period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary.

[Sec. 362(d)]

(d) LIMITATION ON BASIS INCREASE ATTRIBUTABLE TO ASSUMPTION OF LIABILITY -

(1) IN GENERAL – In no event shall the basis of any property be increased under subsection (a) or (b) above the fair market value of such property (determined without regard to section 7701(g) by reason of any gain recognized to the transferor as a result of the assumption of a liability.

(2) TREATMENT OF GAIN NOT SUBJECT TO TAX – Except as provided in regulations, if -

(A) gain is recognized to the transferor as a result of an assumption of an nonrecourse liability by a transferee which is also secured by assets not transferred to such transferee; and

(B) no person is subject to tax under this title on such gain,

then, for purposes of detemining basis under subsections (aa0 and (b) , the amount of again recognized by the transferor as a result of the assumption of the liability shall be determined as if the liability assumed by the transferee equaled such transferee's ratable portion of such liability determined on the basis of the relative fair market values (determined without regard to section 7701(g) of all of the assets subject to such liability.

Subpart D- Special Rule; Definitions

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS

[Sec. 368(a)]

(a) REORGANIZATION -

(1) IN GENERAL – For purposes of parts I and II and this part, the term "reorganization" means –

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exhange solely for all or aa part of its voting stock o(or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under sections 354, 355, or 356;

(E) a recapitalization;

(F) a mere change in identity, form, or place of organization of one corporation, however effected; or

(G) a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan,

stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

(2) SPECIAL RULES RELATING TO PARAGRAPH (1) -

(A) REORGANIZATIONS DESCRIBED IN BOTH PARAGRAPH (1) (c) AND PARAGRAPH (1)(D) – If a transaction is described in both paragraph (1) (c) and paragraph (1) (D), then, for purposes of this subchapter (other than for purposes of subparagraph (C) , such transaction shall be treated as described only in paragraph (1)(D).

(B) ADDITIONAL CONSIDERATION IN CERTAIN PARAGRAPH (1) (C) CASES –If

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1) (c) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1) (C), property of the other corporation having a fair market value which is at least 80 percent of the fair market of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1) (C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation shall be treated as money paid for the property.

(C) TRANSFERS OF ASSETS OR STOCK TO SUBSIDIARIES IN CERTAIN PARAGRAPH (1)(A), (1)(B), (1)(C), AND (1)(G) CASES – The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as "controlling corporation") which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify a transaction under paragraph (1) (A) or (1) (G) if -

(i) no stock of the acquiring corporation is used in the transaction; and

(ii) in the case of a transaction under paragraph (1) (A), such transaction would have qualified under paragraph (1) (A) had the merger been into the controlling corporation.

(E) STATUTORY MERGER USING VOTING STOCK OF CORPORATION CONTROLLING MERGED CORPORATION – A transaction otherwise qualifying under paragraph (1) (A) shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the "controlling corporation") which before the merger was in control of the merged corporation is used in the transaction, if -

(i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation

(other than stock of the controlling corporation distributed in the transaction); and

(ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

xxx *xxx* *xxx*

(G) DISTRIBUTION REQUIREMENT FOR PARAGRAPH (1)(C) –

(i) IN GENERAL – A transaction shall fail to meet the requirements of paragraph (1) (C) unless the acquired corporation distributes the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization. For purposes of the preceding sentence, if the acquired corporation is liquidated pursuant to the plan of reorganization, any distribution to its creditors in connection with such liquidation shall be treated as pursuant to the plan of reorganization.

(ii) EXCEPTION – The Secretary may waive the application of clause (ia0 to any transaction subject to any conditions the Secretary may prescribe.

(H) SPECIAL RULES FOR DETERMINING WHETHER CERTAIN TRANSACTIONS ARE QUALIFIED UNDER PARAGRAPH (1)(D) – For purposes of determining whether a transaction qualifies under paragraph (1) (D)

(i) in the case of a transaction with respect to which the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met, the term "control" has the meaning given such term by section 304(c), and

(ii) in the case of a transaction with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met, the fact that the shareholders of the distributing corporation dispose of part or all of the distributed stock, or the fact that the corporation whose stock was distributed issues additional stock, shall not be taken into account.

xxx *xxx* *xxx*

[Sec. 368(b)]

(b) PARTY TO A REORGANIZATION – For purposes of this part, the term "a party to a reorganization" includes -

(1) a corporation resulting from a reorganization, and

(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1)(B)or (1)(C) of subsection (a), if the stock exchanged for the stock or properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to

a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1)(A), (1)(B), (1)(C), or (1)(G) of subsection (a) by reason of paragraph 2(C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets or stocks are transferred. In the case of a reorganization qualifying under paragraph (1) (A) or (1)(G) of subsection (a)by reason of paragraph (2) (D) of that subsection, the term "a party to a reorganization" includes the controlling corporation referred to in such paragraph (2)(D). In the case of a reorganization qualifying under subsection (a)(1)(A) by reason of subsection (a)(2)(E), the term "party to a reorganization" includes the controlling corporation referred to in subsection (a)(2)(E).

[Sec. 368(c)]

(c) CONTROL DEFINED – For purposes of part I (other than section 304), part II, this part, and part V, the term "control", means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

From the foregoing citations of the provisions of the IRC, it can be seen that there are two major ways by which tax-free exchanges resulting to corporate formation or reorganization could occur. One is through the corporate formation provision contained in Section 351 of the IRC. The other is through any of the seven types of reorganizations defined in Section 368(a) thereof.

Section 351 has three major requirements.[35] First, there must be a contribution of property. Second, the contribution must be solely in , exchange for stock, and third, the contributors must control the corporation immediately after the exchange.

As for the various types of reorganizations provided for in Section 368, the listing therein appears to be exclusive such that if a transaction does not fit within any of the subparagraphs A to G, each of which refers to a distinct reorganization type, it would not be deemed a corporate reorganization. Thus, it is customary for each of the seven types to be referred to in accordance with the subparagraph describing it in Section 368 (i.e. Type

[35] BLOCK, *supra* note 5, at 53-56.

A reorganization, Type B reorganization, and so forth).[36] This paper will refer to them similarly.

The seven reorganization types may however be categorized into three general categories.

The first category is acquisitive reorganization[37], one wherein the acquiring corporation acquires control over or combines with another corporation, referred to as the target corporation. Subparagraphs A , B, and C of 368 (a) (1) generally cover this category of acquisitive reorganization. Type A[38] refers to a statutory merger or consolidation. Type B[39] is referred to as a "stock for stock" acquisition. Type C[40] is referred to as a "stock for assets" acquisition.

The second reorganization category defined by 368 (a)(1) is the divisive reorganization[41], where one corporation is divided into two or more corporate enterprises either through a spin-off, split-off, split up or other types of division. This is the transaction covered by 368(a)(1)(D). In a Type D reorganization, a corporation transfers all or part of its assets to another corporation as a result of which the transferee corporation is now controlled by the transferring corporation, shareholders of the transferring corporation, or a combination of the two.

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[36] *See* Chapter 11 of Block's "Corporate Taxation: Examples and Explanations", pp. 305-330, *id.*
[37] *See generally* Block, *supra* note 5, at 331-382 (This refers to Chapter 12 of her book, entitled "Acquisitive Reorganizations")
[38] *id.*
[39] *id.*
[40] id.
[41] *See generally* Block, *supra* note 5, at 383-413 (This refers to Chapter 13 of her book, entitled "Corporate Divisions")

The third reorganization category is internal restructuring[42], the simplest category since it involves only one corporation restructuring itself. Types E[43] and F reorganizations fall under this category. Type E covers a "recapitalization", where shareholders or bondholders of one corporation exchange their stocks or bonds for a different kind of equity interest in the same corporation. A Type F[44] reorganization involves a "mere change in identity, form, or place of organization of one corporation".

IV. COMPARING PHILIPPINE LAW WITH US LAW

This paper will discuss each of the three above-mentioned tax-free transactions under Philippine law, namely – ordinary merger, de facto merger, and transfer to a controlled corporation pursuant to the last paragraph of Section 40(C)2 of the NIRC, and compare them to their counterparts among the various tax-free exchange provisions under the IRC. As such method of study will leave out other tax-free exchange provisions in the IRC which may not have a direct statutory counterpart in the NIRC, this paper will, thereafter, discuss said other tax-free reorganization types under the IRC (i.e. Types E,F, and G, and the triangular reorganizations), and discuss their possible applicability or inapplicability to Philippine tax practice.

1. Ordinary Merger or Consolidation

A merger is commonly understood to occur when one corporation is absorbed into another corporation, with only one of the two corporations surviving.[45] On the other

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[42] *See generally* Block, *supra* note 5, at 415-437(referring to the last chapter of her book, entitled " Recapitalization and Other Corporate Restructuring")
[43] *id.*
[44] *id.*
[45] Corporation Code of the Philippines, *supra* note 8, at Section 76.

hand, a consolidation involves two corporations being combined into a new entity and where both the combining corporations disappear.[46]

A tax-free merger or is provided for under the above-mentioned Section 40 (c) (2) of the NIRC and calls for non-recognition of gain or loss in three merger or consolidation situations: 1) where a corporation exchanges property solely for stock in a corporation also a party to the merger or consolidation[47]; 2) where a shareholder exchanges stock in a corporation solely for the stock of another corporation also a party to the merger or consolidation[48]; and 3) where a security holder of a corporation exchanges securities solely for stock or securities in such corporation, a party to the merger or consolidation[49].

The US counterpart of this transaction is the Type A reorganization provided for in Section 368 (a)(1) (A) – "statutory merger or consolidation". To qualify for this type of reorganization, the transaction must satisfy all of the applicable merger or consolidation requirements under the corporation laws of the federal or state government.[50]

Generally, the two have similar tax consequences. Under the Philippine version, the exchanging corporation, shareholder or security holder would recognize no gain that may be subject to tax. (Sec.40(C)(2), opening paragraph, NIRC). The basis of the stock or securities that will be will be received by the transferor shall be the same as the basis of the property, stock or securities exchanged, decreased by the money received and the fair market value of the other property received, and increased by the amount treated as dividend of the shareholder and the amount of gain recognized on the

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[46] *Id.*
[47] National Internal Revenue Code (NIRC), Sec. 40(c)(2)(a) at http://www.bir.gov.ph/nirc/nirc/nir_t102_ch07.html (the Bureau of Internal Revenue [BIR] website)
[48] *See* NIRC, Sec. 40(c)(2)(b) at the BIR website.
[49] *See* NIRC, Sec. 40(c)(2)(c) at the BIR website
[50] Treas. Reg. §. 1.368-2(b)(1).

exchange.(Sec.40(C)(5)(a), NIRC). On the other hand, the basis 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 (Sec.40(C)(5)(b), NIRC). In case of "boot", gain, if any, but not the loss, shall be recognized but in an amount not in excess of the money and the fair market value of other property received subject to the proviso that if the boot has the effect of a taxable dividend, it shall be so taxed the gain recognized which is not in excess of his proportionate share of the undistributed earnings and profits of the corporation, with the remainder, if any, to be treated as capital gain (Sec.40(c)(3)(a), NIRC). Notably, if the corporation receiving money and/or other property distributes it in pursuance to a plan of merger or consolidation, no gain shall be recognized but if not, the gain, if any, but not the loss shall be recognized but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not distributed. (Sec.40(C)(3)(b), NIRC).

In the same vein, in a Type A reorganization, the shareholder receiving stock of the other corporation party to the merger or consolidation will have no gain or loss pursuant to Section 354 of the IRC and their basis in the shares they received pursuant to this transaction will be the same basis they previously had in their shares which they exchanged.[51] If a shareholder receives both stock and boot, no gain will be recognized on the receipt of the stock, but the gain realized on the boot shall be taxable.[52] The boot is taxable either as a capital gain under §.356(a)(1) or as a dividend under §. 356 (a)(2). On the other hand, the acquiring corporation will not report any gain or loss upon the receipt

[51] I.R.C. §. 358.
[52] I.R.C. §. 356.

of assets from the target corporation in accordance with §. 1032. Its basis on the assets acquired from the target will be the same basis as in the latter's hands under §.362(b). As for the target corporation, it has no gain or loss upon its receipt of the acquirer's stock or securities under §.361(a).

Although in both the Philippine and the US versions, the assumption of liability by any of the party to the merger or consolidation does not disqualify it as an otherwise tax-free transaction (Sec.40 (C)(4)(a), NIRC in relation to §. 354, IRC), there is a variance relating to receipt of securities or debentures. Under the NIRC, if the amount of the liabilities assumed (which include debentures) plus the total amount of the liabilities to which the property is subject exceed the total of the adjusted basis of the property transferred, such excess shall be deemed a gain from a sale or exchange of a capital asset or of property which is not a capital asset, as the case may be. (Sec.40(C)(4)(b), NIRC). On the other hand, the American rule on this is set forth in §.354 of the IRC – non-recognition is not allowed where the principal amount of the securities (or debentures) received exceeds the principal amount of any such securities surrendered, or where any such securities are received and no such securities are surrendered.

2. De Facto Merger

A *de facto* merger refers to the acquisition of one corporation of all or substantially all the properties of another corporation solely for stock (Sec.40(C)(6)(b), NIRC). In addition to the acquisition of all or substantially all such properties, it must be undertaken for a *bona fide* purpose and not solely for the purpose of escaping the burden of taxation . This type of merger is distinguishable from the ordinary merger referred to in the NIRC in relation to the Corporation Code as here, unlike in the ordinary merger,

the transferor is not automatically dissolved in the case of the former. Likewise, there is no automatic transfer to the transferee of all the rights, privileges, and liabilities of the transferor.[53]

The tax-free exchange transaction which closely approximates the *de facto* merger is the Type C reorganization set forth in §. 368(a)(1)(c) of the IRC. Like its Philippine counterpart, it also involves the acquisition by a corporation of "substantially all of the properties" of another corporation, and thus, is known as an "asset acquisition".

The tax consequences of a *de facto* merger is the subject of Revenue Memorandum Ruling No. 1-2002 , dated 25 April 2002 issued by the Philippine Bureau of Internal Revenue.[54] The pertinent portion thereof provides:

> *"xxx The Transferor shall not recognize any gain or loss on the transfer of the property to the Transferee. Consequently, the Transferor will not be subject to capital gains tax, income tax, nor to creditable withholding tax on the transfers of such property to the Transferee. Neither may the Transferor recognize a loss, if any, incurred on the transfer.*
>
> *In addition, the assumption of liabilities or the transfer of property that is subject to a liability does not affect the non-recognition of gain or loss under Section 40(C)(2) of the Tax Code of 1997, since in this case, the total amount of such liabilities does not exceed the basis of the property transferred xxx*
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> *Moreover, the Transferee is not subject to income tax on its receipt of the property as contribution to its capital, even if the value of such property exceeds the par value or stated value of the shares issued to the Transferor. Section 56 of Revenue Regulations No. 2 ("Income Tax Regulations") states:*
>
> > *"Sec. 55. Acquisition or disposition by a corporation of its own capital stock. – xxx The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be*

[53] Revenue Memorandum Ruling No. 1-2002 *supra* note 10,at 2.
[54] *Id.*

> *in excess of, or less than the par or stated value of such stock."*

On the other hand, the tax consequences of a Type C organization may be described as follows. In a situation for instance, in which the target corporation transfers all of its assets to the acquiring corporation solely for stock, the exchange of the target's assets for the acquirer's voting stock is not taxable to the former pursuant to §.361(a) of the IRC. The target's basis in the voting stock it received will be the same basis it had in the transferred assets.

It is notable however that for there to be non-recognition in a Type C reorganization, §.368(a)(2(G) requires that unless the target receives a waiver from the Treasury Secretary, it must distribute the stock, securities and other properties received in pursuance of the plan of reorganization. No such requirement exists in the case of *de facto* mergers. Although Section 40(C)(3)(b) provides only for non-recognition of gain "if the corporation receiving money and/or other property distributes it in pursuance of the plan of merger or consolidation", such requirement is arguably applicable only to ordinary mergers and not to *de facto* mergers. Three reasons may be cited. First, the requirement of distribution is specifically made applicable by the express language of Section 40(C)(3)(b) to apply to "in connection with the exchange described in the above exceptions". The provision on *de facto* mergers appears below said section, in Section 40(C)(6)(b)(ii). Thus, the merger referred to "above" can only refer to the ordinary or statutory mergers outlined in Section 40(c)(2). Second, said distribution requirement alludes to a "plan of merger or consolidation". No such plan is present in a *de facto* merger. Finally, the above-cited Revenue Memorandum Ruling No. 1-2002, the official

pronouncement of the BIR with respect to *de facto* mergers does not contain such distribution requirement.

Another difference between the two lies in the meaning of the phrase "substantially all the properties of another corporation". As for the Philippine version, the effective regulation is still BIR General Circular No. V-253 dated July 16, 1957[55] which defines the said phrase as "the acquisition by one corporation of at least 80% of the assets, including cash of another corporation" which "has the element of permanence and temporary holding". On the other hand, the position of the Internal Revenue Service is that "substantially all" means 90% of the fair market value of the target's net assets and 70% of the fair market value of the target's gross assets (Rev. Proc. 77-37,§.3.01, 1977-2 C.B. 568)[56]

3. Transfer To A Controlled Corporation

The above-mentioned transaction is set forth in the last paragraph of Section 40 (C)(2) of the NIRC and provides for non-recognition of gain or loss in a situation where a person transfers property to a corporation in exchange for stock in such corporation as a result of which said person gains control of said corporation.

A. COMPARED TO §. 351, IRC

A cursory comparison of the above-mentioned paragraph in the NIRC with Section 351 of the IRC yields many similarities. In both cases, there is a contribution of property. Also, both require that the contribution must be in exchange for stock, and that the contributors must be in control of the corporation immediately after the exchange.

[55] This circular was cited as an authority to support the aforementioned Revenue Memorandum Ruling No. 1-2002.
[56] As cited in BLOCK, *supra* note 5, at 345. It is likewise cited therein that the fair market value of "net assets is the value of those assets net of liabilities.

Generally, the rule with respect to basis, exchange not solely in kind, and assumption of liability are similar in both cases. Of course, they also have similar tax consequence – that is of non-recognition of gain, and thus, the absence of gain that may be taxed, if their respective requirements are met.

One difference between the two lies in the meaning of "control". Under the NIRC, "control" means ownership of stocks in a corporation possessing at least fifty-one percent (51%) of the total voting power of all classes of stocks entitled to vote[57]. In contrast, the IRC has a much stringent requirement. It defines "control"[58] as referring to ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote *and* at least 80 percent of the total number of shares of all other classes of stock of the corporation. In the latter, one may note the use of the word "and"[59], signifying that the 80% requirement must refer separately to both voting stocks, on one hand, and all other kinds of stocks, on the other.

Another difference lies in the number of transferors. The NIRC specifically limits the number of transferors to one, the transferor "alone or together with others, not exceeding four persons" - which means a maximum of five (5) persons- who should gain control of said corporation.[60] The IRC however, does not contain such numerical limitation. It just provides for "person or persons"[61] which means the transferor could be more than five persons.

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[57] NIRC, Section 40 (C)(6)(c).
[58] I.R.C., §. 368(c).
[59] Obviously, the use of the conjunctive "and" rules out that the statute rules out an alternative application of the 80% requirement to both voting stocks and all other stocks.
[60] NIRC, Section 40(C)(2), last paragraph.
[61] I.R.C., §. 351(a).

Another difference lies in the consideration. Under the IRC, what may be exchanged for property is "stock".[62] In the NIRC, it is "stock or unit of participation". "Unit of participation" refers to interests in partnership. Under the NIRC, partnerships are considered covered by the term "corporations".[63] This position is supported by specific provisions of the NIRC that relates not only to the definition of the terms "corporation" but also that for "shares of stock", and "shareholders". The pertinent definitions are cited below:

> *"Se. 22. Definitions*
>
> *xxx* *xxx* *xxx*
>
> *(B) The term "corporation" shall include partnerships, no matter how created or organized, joint stock companies, joint accounts (cuentas en participacion), association or insurance companies, but does not include general professional partnerships and joint venture or consortium formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal and other energy operations pursuant to an operating consortium agreement under a service contract with the government. General professional partnerships formed by persons for the sole purpose of exercising their common profession, no part of the income of which is derived from engaging in any trade or business.*
>
> *xxx* *xxx* *xxx*
>
> *(L) The term "shares of stock" shall include shares of stock of a corporation, warrants and/or options to purchase shares of stock, as well as units of participation in a partnership (except general professional partnerships), joint stock companies, joint accounts, joint ventures taxable as corporations, associations and recreation or amusement clubs (such as golf, polo, or similar clubs, and mutual fund certificates).*
>
> *xxx* *xxx* *xxx*
>
> *(M) The term "shareholder" shall include holders of a share/s of stock, warrant/s, and/or options to purchase shares of stock of a corporation, as well as a holder of a unit of participation in a partnership*

[62] *Id.*
[63] NIRC, Section 22 (B).

(except general professional partnerships) in a joint stock company, a joint account, a taxable joint venture xxx"

Furthermore, any doubt to the contrary was settled by the issuance of BIR Ruling [DA-040-02-05-98][64] which specifically held that units of participation in partnerships shall be considered as shares of stock for purposes of the non-recognition provision of the NIRC.

As to what may be considered "property" both codes exclude "services"[65] from its ambit. The IRC however, in addition, also specifically excludes "indebtedness of the transferee corporation which is not evidenced by a security"[66] and "interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt[67]". While not included in the exclusions under Philippine law, it may be argued that such exclusion on indebtedness and interest on indebtedness may also apply in the Philippine context as using indebtedness as the sole consideration for the exchange negates "continuity of interest", the rationale for gain non-recognition of this type of transaction.

As additional exceptions, the IRC excludes from non-recognition transfers of property to an investment company[68] and transfer of property of a debtor pursuant to a Title 11 or similar case[69]. The NIRC does not have provisions similar to those.

Furthermore, the IRC has a separate provision on "treatment of controlled corporation"[70] which sets forth the possibility that property transferred may be deemed a taxable dividend pursuant to "subpart A of Part I" (of Subchapter C) in relation to

[64] *See Rulings and Issuances* at the BIR website.
[65] NIRC, Section 40(c)(2), last paragraph; I.R.C., §. 351(d)(1).
[66] I.R.C. §. 351(d)(2).
[67] I.R.C. §. 351(d)(3).
[68] I.RC. §. 351(e)(1).
[69] I.R.C. §. 351(e)(2).
[70] I.R.C. §. 351(f).

Section 311 thereof. No counterpart exists in the NIRC. There are however rulings issued to the effect that where a parent company transfers assets to its wholly-owned subsidiary solely for shares of stock of the latter and as a result of which the parent corporation gains further control of the subsidiary, the same is a tax-free transaction. (BIR Ruling No. S-34-175-97 dated June 17, 1997)[71].[72]

The IRC also specifically excludes from being considered as "stock" in the tax-free transaction covered by Section 351 "non-qualified preferred stock". Thereunder, a preferred stock is one which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. A preferred stock becomes non-preferred if the holder of such stock has the right to require the issuer or related person to redeem or purchase the stock, the issuer or a related person is required to redeem or purchase such stock, the issuer or a related person has the right to redeem or purchase the stock, or the dividend rate on such stock varies in whole or in part. Philippine law does not contain such prohibition. Under the NIRC, the only consideration for a stock to be considered as such for this transaction is that it must have voting power so that the 51% requirement for acquisition of control would be met[73].

B. COMPARED TO TYPE B REORGANIZATIONS

The tax-free transaction contemplated by the last paragraph of Section 40(c)(2) may also be analogous to the Type B reorganization transaction set forth in §. 368(a)(1)(B), which refers to the "acquisition by one corporation in exchange solely for all or part of its voting stock of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation."

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[71] *See Rulings and Issuances* at the BIR website.
[72] I.R.C. §. 351(g).
[73] *See* NIRC, §. 40(c)(2), last paragraph.

Pursuant to this "stock for stock" transaction, the shareholders of the target corporation will not report gain or loss on the exchange. Under §. 358(a)(1), the target shareholders' basis in the acquiring corporation's stock received in the exchange will be the same basis they previously had in their shares – a substituted basis. This transaction will result in the acquirer becoming the new owner of target corporation, which now becomes the former's subsidiary.

A comparison between the said above-mentioned transactions may be in order especially that the transferor in the transaction contemplated by Section 40(c)(2) may also be a corporation. The said section refers to the transferor as a "person", which could refer not just to individuals but also to juridical persons. It is evident that this interpretation has already been accorded time-honored approval as in a lot of BIR rulings involving this transaction, the transferors are corporations (i.e. BIR Ruling No. 030-2000 dated 10 August 2000; BIR Ruling No. 018-94 dated January 13, 1994; BIR Ruling No. 003-94 dated January 6, 1994[74]).

However, the two differ on the meaning of "control". As earlier discussed, control within the contemplation of the NIRC refers to only fifty-one percent (51%) of the total voting power of all classes of stocks entitled to vote (Section 40(C)(6)(c) while in the IRC , control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. (§. 368(c), IRC).

[74] *See Rulings and Issuances* at the BIR website.

Another difference between the two lies in the fact that in a Type B reorganization, the only consideration that may be used is "voting stock" and thus, boot is not permissible.[75] This is in contrast with the aforementioned transaction in Section 40 (c)(2) in which exchanges not solely in kind are allowable[76].

C. COMPARED TO TYPE D REORGANIZATIONS

The transaction referred to in the last paragraph of Section 40(C)(2) may also be compared to Type D reorganizations described in §. 368(a)(1)(d). The latter type of reorganization is described as "a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer, the transferor or one or more of its shareholders or any combination thereof is in control of the corporation to which the assets are transferred xxx". The transactions covered by this kind of reorganization are also variantly known as spin-offs, split-offs, and split-ups. Unlike mergers or consolidations which result in a single corporation, these divisive forms of reorganizations result to the division into two or more entities of an erstwhile single enterprise.[77]

When such division occurs, a downstream or an upstream merger is not remote, both of which would result to the acquisition of a controlled corporation, a transaction which has been settled to be within the contemplation of Section 40(C)(2) of the NIRC. (Revenue Memorandum Ruling No. 1-2001 dated 29 November 2001)[78]. It is also possible, with the application of the "step transaction doctrine"[79] in such cases that the

[75] Helvering v. Southwest Consolidated Corporation, 315 U.S. 194(1942).
[76] NIRC, Section 40(c)(3).
[77] *See generally* BLOCK *supra* at Chapter 13 ("Corporate Divisions").
[78] *See* http://www.bir.gov.ph/rmr_2001.html
[79] Under this doctrine, a series of transactions is characterized by its true nature by wholistically considering them as part of a larger, integrated transaction, thereby in effect, disregarding an intermediate

prior division will be disregarded, and only the final merger will be considered in characterizing the true nature of the transaction.

A Type D reorganization however, require certain distinct requirements.[80] In particular, the one falling within the meaning of §.355 of the IRC requires firstly, that the distributing corporation must have control immediately before distribution. Secondly, there is also a distribution requirement, non-compliance with which renders the transaction not to qualify for tax-free treatment. Thus, the distributing corporation must distribute all of the stocks in the controlled corporation held immediately before the distribution. Thirdly, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business. Lastly, the transaction must not be used primarily, as a device to distribute earnings and profits of the distributing corporation, the controlled corporation, or both. In addition to these statutory requirements, §.355 incorporates several judicially developed requirements paralleling those required for the reorganization provisions in general. These include business purpose, continuity of the business enterprise, and continuity of proprietary interest requirement.

4. Type E Reorganization

This type of reorganization provided under §. 368(A)(1)(e) of the IRC, a recapitalization, only occurs within a single corporate entity, unlike in the other reorganization types which involve at least two corporations. Examples of this type are equity exchanges involving either exchanging common stocks for other common stocks,

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transaction. *See also* McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

[80] *See* BLOCK, *supra* note 75, at pp.389-390.

or preferred stocks for other preferred stocks, common for preferred stocks or convertible shares, and equity for debt exchanges.

The above-mentioned statutory provision has no counterpart in the Philipppine NIRC.

Notwithstanding that, it appears that the BIR regards recapitalizations or similar transactions as tax-free events. An example of such BIR position is that enunciated in BIR Ruling No. 032-01 dated 27 July 2001[81]. That ruling involves the Philippine Stock Exchange's conversion from a non-stock corporation to a stock corporation in compliance with government regulations. The same ruling likewise cites as authority the case of *Commissioner of Internal Revenue v. A. Soriano Corp. and Court of Tax Appeals*[82]. Thereat, the court held that the conversion of the 11,400 common shares of the Estate of Don Andres Soriano and 138,846 common shares of Dona Carmen vda. De Soriano into 11,400 and 138,860 preferred shares, respectively, with same par value may not be considered as essentially equivalent to a distribution of taxable dividend within the contemplation of Section 83(b). Such conversion was deemed to be merely a "re-classification of petitioner's capital structure"[83].

5. Type F Reorganization

Section 368(a)(1)(F) describes what is referred to as a Type F reorganization as a "mere change in identity, form, or place or organization of one corporation, however, effected."

Like in the case of Type E reorganizations, no statutory counterpart to the above-mentioned Section 368(a)(1)(F) exist in the Philippines. That notwithstanding it may be safe to asset that the changes referred to in a Type F reorganization are non-taxable

[81] *See Rulings and Issuances* at the BIR website.
[82] C.A. G.R. SP No. 26017, 15 January 1993.
[83] *Id.*

events as well under Philippine law in view of the absence of any law providing for the taxation of the same. Furthermore, such changes do no not involve a flow of wealth. It is after all, a cardinal principle in taxation that income, in the broad sense, means all wealth which flows to the taxpayer other than mere return of capital (Section 36, Revenue Regulations No. 2, Income Tax Regulations.

6. Type G Reorganizations

Section 368(a)(1)(G) describes the Type G reorganization as "a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356." Usually, such reorganization calls for the transfer of a bankrupt corporation's assets to another corporation.

Type G reorganization has no counterpart in the NIRC.

Notably, the closest to the US bankruptcy proceedings in the Philippines are the petitions for rehabilitations that can be filed pursuant to the Securities and Exchange Commission Reorganization Act (P.D.902-A, as amended)[84] and the Interim Rules of Procedure on Corporate Rehabilitation (2000)[85]. Sec. 14 of the said interim rules empowers the rehabilitation receiver, the person appointed by the court to oversee the properties subject of the rehabilitation proceedings to do such other things as may be necessary under the circumstances, with court approval. Arguably, this may include recommending a reorganization similar to a Type G proceeding. In the absence of any

[84] P.D. 902-A, as amended *at* http://www.chanrobles.com/legal
[85] Interim Rules of Procedure on Corporate Rehabilitation *at* http://www.chanrobles.com/legal

tax-free recognition of such transaction, it will only be so regarded if it satisfies the requirements of other tax-free transactions, as previously discussed, under Philippine law.

6. Triangular Reorganizations

A triangular reorganization typically involves three corporations – the parent corporation, the target, and the subsidiary corporation. Under US law, tax-free treatment has been extended to such triangular reorganization. Today, it is usual for US tax planners to structure a triangular reorganization of either Types A, B, or C.

In this regard, Section 368(a)(2)(C)[86] explicitly supports such tax-free treatment. It provides:

> *"xxx A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock. A similar rule shall apply to a transaction otherwise qualifying under paragraph (1)(G) where the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met with respect to the acquisition of the assets."*

While no counterpart provision to the above is in the NIRC, tax planners in the Philippines can also resort to triangular reorganizations and receive tax –free treatment in the absence of any prohibition to the contrary, and if they can be structured in a manner that will qualify them under any of the recognized tax-free transactions under Philippine law, discussed in the foregoing.

V. CONCLUSION

This paper validates the fact that Philippine and US tax laws on tax-free corporate exchanges have a lot in common. It also shows that in a lot of areas where Philippine law is silent, US tax laws have already devoted extensive treatment to such areas (i.e. spin-

[86] I.R.C., §.368(a)(2)(C).

offs, triangular reorganizations, etc.). With respect to these areas, the issue is whether the principles developed therein are applicable to the Philippines.

In his book "*De l'esprit des lois*" ("Spirit of the Laws")[87], Montesquieu, the famous French political thinker, postulated that what makes a law effective is its "spirit", referring to the correct fit thereof to the conditions of the locality in which it would be applied. Communing with such spirit is thus seen as the goal of any law.

Viewed in this light, determining the spirit of the aforementioned areas of law is the next logical issue. That could be very taxing but is definitely challenging.

[87] CHARLES SECONDAT, BARON DE MONTESQUIEU, THE SPIRIT OF THE LAWS (Thomas Nugut trans., G. Bell & Sons Ltd., 1914.)