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TAX LAW FOR BUSINESS

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

Control in tax-free exchange

In general, gains on sales or exchanges of properties are recognized and subjected to tax.

But I discuss here one of the exceptions to this general rule under the last paragraph of Section 40 (C)(2) of the 1997 Tax Code, as amended—that is, when 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, alone or together with others, not exceeding four persons, gains control of said corporation.

Under Section 40 (6) C of the same Code, control means ownership of stocks in a corporation possessing at least 51 percent of the total voting power of all classes of stocks entitled to vote. In determining the 51 percent stock ownership, only those persons who transferred property for stocks in the same transaction may be counted up to a maximum of five.

The Court of Tax Appeals (CTA) en banc discussed the foregoing exception in a recent case *(CTA EB 1713)* where the Court emphasized the requisites of tax-free exchange, to wit: (a) the transferee is a corporation; (b) the transferee exchanges its shares of stock for property/ies of the transferor; (c) the transfer is made by a person, acting alone or together with others, not exceeding four persons; and, (d) as a result of the exchange the transferor, alone or together with others, not exceeding four, gains control of the transferee.

In this case, five corporations transferred assets to a corporation in exchange for the latter's shares of stocks. After the transfer, the transferors obtained control in such transferee corporation, where the five transferor corporations obtained at least 51 percent (around 99.99 percent) of the total voting stock of the transferee corporation. Here, the CTA considered the transfer as tax-free exchange even though one transferor alone received only less than 51 percent equity after the transfer. This is so because the requirement of the Tax Code for the exemption to apply is that, property is transferred to a corporation by a person, in exchange for stock in such a corporation, of which as a result of such exchange, said person, alone or together with others, not exceeding four persons, gains control of said corporation (BIR Ruling 1217-2018).

Unfortunately, for one of the parties in exchange in BIR Ruling 1113-2018, the BIR declined to grant exemption on the transfer of her parcel of land to a transferee corporation because she obtained only 5.6 percent equity after the transfer, notwithstanding that together with the transfer of parcels of land and other improvements of the other transferors to the same transaction, their combined total voting equity is at 98.5 percent. Here, the BIR ruled that after the transfer, one transferor already obtained control over the transferee corporation, thus, there is no need to combine the shares of the other transferors.

With this BIR ruling, it appears that it would not be possible for all the parties to an exchange transaction (assuming they are only five in number) to be granted exemption from tax on their transfers of their properties in exchange for stocks of a transferee corporation. Only one of the transferors would be exempted from tax and this is also only possible if said transferor alone obtains at least 51 percent total voting equity.

BIR Ruling 1113-2018 thus creates an unusual precedent. Unless otherwise clarified, this will create confusion on what would be the controlling rule in the determination of control.

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