BDB Law wts

DU-BALADAD AND ASSOCIATES

Atty. Esther M. Weigand

TAX LAW FOR BUSINESS

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

Clarifying tax-free exchanges involving transfers of property in exchange for stock

Section 40(C)(2) of the 1997 Tax Code provides for tax-free exchanges of property, wherein no gain or loss is recognized from such transfer. Such transactions may involve transfers of property in exchange for shares of stock, transfers of shares of stock for other shares of stock and transfers of securities in exchange for shares of stock. And, in order for such exchanges to be considered as "tax-free," they must comply with the requirements provided for by certain Bureau of Internal Revenue (BIR) issuances.

Section 40 (C)(2) of the 1997 Tax Code is implemented by Revenue Regulations (RR) 18-2001, which provides the guidelines for the monitoring of the basis of the property transferred and shares received, as a result of tax-free exchanges. The RR, likewise, provides for the penalties and imposition of fines for failure to comply with such guidelines. In relation thereto, Revenue Memorandum Order (RMO) 32-2001 was likewise issued, prescribing the guidelines on the monitoring of the basis of the property transferred and shares of stock received in a tax-free exchange transaction, as well as revised and updated the requirements and conditions precedent to the nonrecognition of gain or loss in said transactions. Both issuances specifically require that tax-free exchanges must be covered by a certification or ruling to be issued by the commissioner of Internal Revenue stating that the transaction qualifies as a tax-free exchange under the 1997 Tax Code. Such certification or ruling was required for purposes of monitoring tax-free exchanges, and serves as confirmation that the subject transaction is indeed tax-free.

The BIR issuances above-mentioned provide for general requirements for all tax-free exchanges. On May 5 the BIR issued RMO 17-2016, providing supplemental guidelines for the nonrecognition of gain or loss involved in tax-free exchanges involving transfers of property in exchange for shares of stock. Specifically, it prescribes the number of shares to be issued by a transferee corporation in exchange for property received from a transferor as a result of a tax-free exchange.

Under the RMO, it is required that in a tax-free exchange, the value of shares to be issued in exchange for property should be equal to the fair market value of the property transferred (value-for-value exchange). Consequently, the number of shares to be issued will be computed on the basis of the fair market value of the property transferred. The transferee corporation is then required to record the property received in its books at its fair market value, include a note in its audited financial statements indicating that the property was acquired pursuant to Section 40(C) of the Tax Code, with the date of the transaction, the substituted basis of the property, the number of shares exchanged for the property, and the name of the shareholder(s) and the breakdown of shares to each. The requirement of noting such tax-free exchange in one’s Audited Financial Statements (AFS) does not do away with the requirement of annotation of the said transaction in the certificate of title of ownership of properties. To do otherwise would result in the nullification of any tax-free exchange ruling covering such transaction, which, however, does not do away with the requirement of obtaining a ruling from the BIR as provided in RMO 32-2001 and RR 18-2001. Any gain or loss resulting from subsequent sales or transfers shall be computed based on the said property’s substituted basis.

On the other hand, for the transferor, the shares it receives as a result of a tax-free exchange should be recorded in its books at its substituted value, as provided in RR 18-2001.

It may also be that the property to be transferred in a tax-free exchange involves shares of stocks. In such a case, the value of the shares of stock shall be as follows:

If the shares transferred are listed, the value is the closing price on the day when the shares are transferred or exchanged. In case no sales are made on the day of the transfer, the value will be the closing price on the day nearest to the date of transfer or exchange.

If the shares transferred are not listed and traded in the local stock exchange, then its book value, as shown in its most recent AFS duly certified by an independent certified public accountant submitted to the BIR, with the assets therein adjusted to their fair market value, will be their value. If in case the assets stated in the AFS include shares in another corporation, the said shares will be adjusted to their fair market value as of a date not earlier than 90 days from the date of the transaction, which adjustment is to be made pursuant to RR 6-2013.

The requirements set forth in RMO 17-2016 are better understood in light of the illustrations provided by the BIR therein.

****

The author is a junior associate of Du-Baladad and Associates Law Offices, a member-firm of World Tax Services.

 If you have any comments or questions concerning the article, you may e-mail the author at esther.weigand@bdblaw.com.ph or call 403-2001 local 340.