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TAX LAW FOR BUSINESS

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The applicability of VAT in pre-incorporation subscription agreements

One of the most important considerations for investments is the calculated rate of return on investment. It is generally the standard used to measure if an endeavor is worth pursuing.

The application of certain taxes can significantly impact the cost to participate in a particular investment, as well as the eventual rate of return. It goes without saying, then, that it is vital to clarify the taxability of investment transactions. One such investment vehicle where application of tax was made an issue is a pre-incorporation subscription. Particularly, it is important to clarify if pre-incorporation subscriptions are subject to value- added tax (VAT).

In CTA Case 9145, the CTA resolved an issue where a taxpayer was being assessed with deficiency VAT arising from its transfer of real property pursuant to a pre-incorporation stock subscription agreement.

The Bureau of Internal Revenue (BIR) insists that the transfer of the said real property constituted a sale subject to VAT. The matter is complicated by the fact that the taxpayer in this case is engaged in the real-estate business. This made the BIR conclude that the subscription was pursued in the ordinary course of business, as the properties exchanged for the subscription are the same type that the taxpayer would list as part of its inventory.

The CTA resolved the issue by clarifying the nature of a pre-incorporation subscription agreement. The Tax Court harmonized the provisions of the Tax Code on VAT, as well as Sections 61 and 62 of the Corporation Code. It ruled that given the provisions of the Corporation Code, a pre-incorporation subscription agreement is not a sale, which is subject to VAT.

In addition, it is interesting to note that the Tax Court also ruled that the pre-incorporation subscription in question was not entered into in the course of trade or business. The honorable CTA considered the primary purpose of the taxpayer, and from there concluded that entering into pre-incorporation subscriptions are not part of the same. The earlier discussion on the nature of pre-incorporation subscriptions should have been sufficient to address the issue at hand.

The further discussion on the taxpayer’s regular course of business, however, raises more questions. Does this mean that if entering into such subscriptions are part of a taxpayer’s primary purpose, the said transaction is subject to VAT? Given that the Court already ruled on the nature of pre-incorporation subscriptions, the answer should be in the negative. However, since the Court found it necessary to touch on the primary purpose of the taxpayer, it may be more prudent to make careful considerations when entering into pre-incorporation subscription agreements.

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