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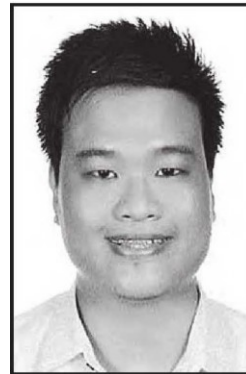


## **TOP OF MIND**

By **CARLO JOHN R. PASCUAL**

# Additional guidelines for tax-free exchanges

The Bureau of Internal Revenue (BIR) recently issued Revenue Memorandum Order (RMO) No. 17-2016 which provides for additional guidelines for the non-recognition of gain or loss on the transfer of property in exchange for shares of stock. As a general rule, the entire amount of the gain or loss arising from the sale or exchange of property shall be recognized. However, Section 40 (C) (2) of the National Internal Revenue Code provides for certain exceptions. In case of a plan of merger or consolidation, no gain or loss shall be recognized if such transaction involves, a) transfer of property in exchange for shares of stock, b) transfer of shares of stock for other shares of stock, or c) transfer of securities in exchange for shares of stock. The same provision likewise provides that "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 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." These transactions are better known as tax-free exchanges.



For the effective enforcement of Section 40 (C) (2) of the Tax Code, the BIR issued Revenue Regulations (RR) No. 18-2001 which set the guidelines on the monitoring of the basis of property transferred and shares received as a result of a tax-free exchange of property for shares. It also prescribed the penalties in case of non-compliance and authorized the imposition of proper fees for such monitoring. And to further implement and complement the rules set by RR No. 18-2001, the BIR issued RMO No. 32-2001 which revised and updated the requirements and conditions precedent to the non-recognition of gain or loss in the said transactions.

Under this new RMO, it specifically provides for the number of shares to be issued by the transferee corporation (corporation issuing shares of stocks for properties) in exchange for the property it will receive from the transferor (recipient of the shares of stocks of the transferee corporation). It should be noted the value of shares to be issued by the transferee corporation must be equivalent to the fair market value of the property to be transferred by the transferor/recipient of the

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shares of stocks. In other words, the exchange must be for value for value in order for such transaction to be considered tax-free. Hence, the fair market value of the property transferred shall be the basis in computing the number of shares to be issued by the transferee corporation.

After such transaction is completed, the transferee corporation is required to: a) record in its books the property or asset transferred at its fair market value, b) annotate in the certificate of title of ownership of properties the tax-free exchange transaction and c) place a note in the audited financial statements submitted to the BIR indicating the property was acquired under Section 40 (C) of the Tax Code, 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. On the part of the transferor of the property / asset, it is also required to: a) record in its books the shares received at its substituted value, b) annotate in the certificate of title of ownership of properties the tax-free exchange transaction, and c) place a note in the audited financial statements submitted to the BIR indicating that the property was acquired under Section 40 (C) of the Tax Code, date of the transaction, the substituted basis of the property, the number of shares exchanged for the property, and the name of the transferee corporation. Emphasis must be given in the annotation of the tax-free exchange transaction in the certificate of ownership of properties because failure to comply with this requirement will make the tax-free exchange ruling null and void. As provided under RMO No. 32-2001 pursuant to RR No. 18-2001, parties to a tax-free exchange transaction are required to apply before the Law Division of the BIR for a certification/ruling affirming that said transaction falls under Section 40 (C) (2) of the Tax Code.

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Furthermore, there are instances where the property or asset being exchanged involves shares of stocks. If the properties to be transferred are listed shares of stocks, the value of such shares shall be based on the closing price on the day when the shares are transferred or exchanged. But in case no sales are made on the day of the transfer, then the value shall be based on the closing price on the day nearest to the date of the transfer. On the other hand, if the properties to be transferred are not listed and traded shares of stock, the value of such shares shall be based on the book value of the shares of stock as shown in the annual financial statements with the asset therein adjusted to its fair market value as of a date not earlier than 90 days from the date of the transaction. Moreover, if the company asset to be transferred include shares in other corporation, the said shares shall be adjusted to its fair market value as of date not earlier than 90 days from the date of the transaction. It must be noted that such adjustment shall be done in accordance with RR No. 6-2013.

And finally, in case when the transferee corporation or transferor of the property/asset decides to subsequently transfer, assign or sell the property/asset and/or shares of stocks that it received, both the transferee and transferor are required to present a copy of the tax-free exchange ruling. Please take note the requirement applies to all instances that must be complied with. Hence, the substituted basis as defined in RR No. 18-2001 will be the basis in computing the gain or loss resulting from said subsequent sale/transfer.

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