

THY WILL BE DONE by Atty. Angelo M. Cabrera

ESTATE TAX AVOIDANCE, CONSEQUENCES III

Rightly or wrongly, people have this notion that establishing a holding company is the best way of avoiding estate taxes especially where real properties are concerned. The idea is to incorporate the real properties by exchanging them for shares of stock in a holding company, such that titles to the real properties are transferred to the holding company.

But this transfer of title is a taxable incident for which capital gains or income tax needs to be paid unless one is able to get a favorable ruling from the BIR approving such transaction as a tax-free exchange under section 40 of the tax code. Unfortunately, the agency is not wont to accommodate any petition these days that tends to curtail its capacity to deliver its revenue target.

But assuming that the transaction was previously approved and the transfer of titles effected in favor of the holding company, does this mean that estate taxes have been avoided by the incorporation of the properties?

No. This process per se does not avoid estate taxes because shares of stocks or anything with value titled under the name of the deceased form part of his gross estate.

One has to take the necessary step of transferring the shares of stock during his lifetime to his intended beneficiaries – his children – in order to take the property beyond the reach of death taxes. Such transfer may either be by way of donation or by sale.

If through a donation, donor's tax anywhere from 2 to 15 percent shall be imposed.

If, on the other hand, the transfer is done through a deed of sale, capital gains tax from the sale of shares of stocks not listed or traded in the stock exchange shall be payable. However, in such sale, the capital gains tax of 5-10% is imposed not on the value of the shares of stocks but on the actual or net gain in the transaction. In other words, if a block of shares is sold at the acquisition cost, there is no gain and therefore, no capital gains tax. This is what makes the incorporation option an attractive scheme. However, the valuation of the shareholdings at the time of sale is ultimately subject to the BIR's review for purposes of determining its true value and consequently the capital gains tax.

Before you start calling your lawyers and accountants to incorporate your properties, be aware that there are other factors to consider, foremost of which is the effect of an incorporated estate on your heirs.

The question is, will this scheme help in achieving or maintaining peace and harmony among the children when the time comes when the patriarch is already gone?

Far from it. The reason is that a corporation is a form of co-ownership. And based on human experience, co-ownership regimes either result in conflict situations where heirs fail to agree on how to manage their co-owned property resulting in the property going into a state of disrepair and deterioration and eventually becoming idle and unproductive; or, inequitable situations, where a domineering heir lords it over the corporation to the detriment of other heirs who either suffer in silence or undermine the company to their collective misfortune.

The problem may not yet be as apparent in the second generation but wait till the cousin consortium takes over in the third generation – that’s when problems may multiply many times over by the increase in the number of shareholders.

If the objective of forming a corporation is to establish a professionally-run family enterprise, then all is well. But if the intention is simply to avoid estate taxes, then it might be well to revisit the approach and determine whether partitioning or distributing the estate (assuming that the same is divisible) is a better alternative in keeping the peace in the family than making all of them co-owners of an incorporated estate.

Sure, carefully crafted tax avoidance schemes may, in fact, significantly reduce taxes. But then again, what profit the heirs if they gain the whole estate but lose their peace in the process? Is it worth the tax savings?

Next week: the liquidity option.

For comments or questions, email cabrera.am@amclawoffice.com.