Perspectives on Estate and Donor's Tax Laws: Introduction to and Evaluation of the Tax Aspects of Estate Planning

*Atty. Serafin U. Salvador, Jr.**

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* '68 LL.B., University of the Philippines College of Law. The Author is a professor in Taxation at the Ateneo de Manila University School of Law, University of the Philippines College of Law, and Far Eastern University-La Salle MBA-LLB Program. He retired in 2001 as Head of the Tax Division of SGV & Co. where he was the tax lawyer and tax principal from 1971-2001. He is currently the managing partner of the law firm SALVADOR, GUEVARA & ASSOCIATES. The Author is the holder of the Tan Yan Kee Foundation Endowment Fund professorial chair at the Ateneo de Manila University School of Law.

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> *Anyone may so arrange his affairs that his taxes shall be as low as possible: he is not bound to choose that pattern which best pays the Treasury. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands: taxes are forced exactions, not voluntary contributions.*
>
> *- Judge Learned Hand*

INTRODUCTION

The main consideration in any estate planning program is the personal wishes and requirements of the client and his family. If the client's goals are not achieved, then the plan has failed in its primary objective, regardless of any tax savings which might have been accomplished by the plan. Accordingly, the basic purpose of an estate plan is to devise means which will meet the personal needs and desires of the client.

In proper perspective, tax considerations are secondary, but they can never be ignored because they may bear importance on whether one's ultimate desires are in fact achieved. Tax considerations in estate planning are by no means limited to estate and gift taxes. The income tax is also highly relevant. But, even if taxes are secondary in importance to the personal goals of an estate owner, and even if all forms of taxation may have a bearing on what should be done, it remains true that no one should undertake to plan his estate or assist another to do so without a basic and firm understanding of the estate and gift tax laws.

This Article will identify and evaluate the commonly adopted methods of estate planning tools available under the Philippine legal system. In Parts I and II, there will be a general discussion of estate and donor's taxation, respectively, as provided for in the National Internal Revenue Code of the Philippines (NIRC),[1] as amended by the Tax Reform Act of 1997,[2] and pertinent Bureau of Internal Revenue (BIR) issuances, circulars, and regulations.

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1. The National Internal Revenue Code of the Philippines [NIRC], Presidential Decree No. 1158 as amended up to Republic Act No. 8424 (1977).

2. An Act Amending the National Internal Revenue Code, as Amended, and for Other Purposes [TAX REFORM ACT OF 1997], Republic Act No. 8424 (1998).

In Part III, there will be a study of the different methods of estate planning available to estate owners. This portion of the Article will show the different kinds of estate planning, with an evaluation of the advantages and disadvantages of each type, and particularly, the tax aspects involved under each scenario. Pertinent illustrations and tables will likewise be provided for easy reference and further understanding.

TABLE 1 – ESTATE TAX FORMULA

Gross Estate
Less: Deductions Allowed
Net Estate
Less: Share of Spouse in Conjugal Property
Taxable Net Estate

PART I: ESTATE TAX

A. *Definition and Nature of Estate Tax*

It has been stated that death transfers taxes, or the "taxation of property transferred by an individual to others at his or her death is one of the oldest and most common forms of taxation."[3] In the Philippines, this refers to estate taxes. An estate tax is a tax on the privilege of the decedent to transmit property at the time of death. As such, it is in the nature of an excise tax.[4] The tax is also imposed on "certain transfers of property, made by the decedent during his lifetime which, under the law, are in the nature of testamentary dispositions."[5]

3. JOHN K. MCNULTY, FEDERAL ESTATE AND GIFT TAXATION: IN A NUTSHELL 1 (1983).

4. There are three main classifications of taxes: personal taxes (also called poll or capitation tax), property taxes, and excise taxes. Excise tax is imposed on the performance of an act, the enjoyment of a right or privilege, or the engagement in an occupation.

5. CRISPIN P. LLAMADO JR., ET AL., PHILIPPINE TAXES ON TRANSFER AND BUSINESS 17 (2d ed. 1998).

The taxpayer is the estate of the deceased person and not the heir receiving the property. The estate, when used in connection with probate proceedings, encompasses the "totality of assets and liabilities of the decedent, including all manner of property, real and personal, choate or inchoate, corporeal, or incorporeal."[6] Prior to 1 January 1973, an inheritance tax was also imposed on the legal right or privilege to succeed, with the heirs as the taxpayers. This, however, has since been abolished by law.[7]

Under the New Civil Code of the Philippines,[8] the rights to succession are transmitted at the moment of the death of the decedent.[9] The "heirs succeed immediately to all the property of the deceased ancestor…at the moment of death as completely as if the ancestor had executed and delivered to them a deed for the same before his death."[10]

Estate tax is based on the market value of the decedent's properties at the time of his death.[11] Hence, it has been held by the Supreme Court that:

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6. BLACK'S LAW DICTIONARY 547 (6d ed. 1990) (*citing* In re: Adams' Estate, 148 C.A.2d 319, 306 P.2d 623, 625 (1950)).

7. Amending Certain Sections of the National Internal Revenue Code, Presidential Decree No. 69 (1973).

8. An Act to Ordain and Institute the Civil Code of the Philippines [NEW CIVIL CODE], Republic Act No. 386 (1950).

9. *Id.* art. 777.

10. Lorenzo v. Posadas, 64 Phil. 353, 360-61 (1937) (*citing* Bondad v. Bondad, 34 Phil. 232 (1916); Mijares v. Nery, 3 Phil. 195 (1905); Suiliong & Co. v. Chio-Taysan, 12 Phil. 13 (1908); Lubrico v. Arbado, 12 Phil. 391 (1909); Inocencio v. Gatpandan, 14 Phil. 491 (1909); Aliasas v. Alcantara, 16 Phil. 489 (1910); Ilustre v. Alaras Frondosa, 17 Phil. 321 (1910); Malahacan v. Ignacio, 19 Phil. 434 (1911); Bona v. Briones, 38 Phil. 276 (1918); Osorio v. Osorio & Ynchausti Steamship Co., 41 Phil. 531 (1921); Fule v. Fule, 46 Phil. 317 (1924); Dais v. Court of First Instance of Capiz, 51 Phil. 396 (1928); Baun v. Heirs of Baun, 53 Phil. 654 (1929)).

11. It is interesting to note that in the United States, under the Federal System of Estate Taxation, there is what is termed as *alternate valuation election* where the assets included in the decedent's estate may be valued at fair market value as of six months from after the decedent's death. *See e.g.*, Roger A. McEowen, *Federal Estate Taxation* (October 2003), *available at*

> [w]hatever may be the rule in other jurisdictions, we hold that a transmission by inheritance is taxable at the time of the predecessor's death, notwithstanding the postponement of the actual possession or enjoyment of the estate by the beneficiary, and the tax measured by the value of the property transmitted at that time regardless of its appreciation or depreciation.[12]

As early as 1937, it has also been settled in the Philippines that estate taxation is "governed by the statute in force at the time of the death of the decedent."[13] This is further reiterated in Revenue Regulations No. 2-2003 (RR 2-2003), dated 16 December 2002, governing estate and donor's taxation.[14]

B. *Pertinent Concepts in Estate Taxation*

1. Gross Estate

The starting point in determining liability for estate taxes is the gross estate of its decedent. Gross estate includes real and personal property, tangible or intangible, wherever located in the case of citizens and resident aliens. In case of non-resident aliens, only such property as are situated in the Philippines are included in their gross estate.[15]

Some other items included in the gross estate under the NIRC are the following: decedent's interest, transfer in contemplation of death,

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http://www.oznet.ksu.edu/library/agec2/mf2422.pdf (last accessed Dec. 8, 2005).

12. *Lorenzo*, 64 Phil. at 364.

13. *Id.* at 366.

14. Consolidated Revenue Regulations on Estate Tax and Donor's Tax Incorporating the Amendments Introduced by Republic Act No. 8424, the Tax Reform Act of 1997 [RR 2-2003], Revenue Regulations No. 2-2003, § 3 (Dec. 16, 2002).

15. NIRC, § 85; RR 2-2003, § 4.

> Sec. 85. The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated: Provided, however, That in the case of a nonresident decedent who at the time of his death was not a citizen of the Philippines, only that part of the entire gross estate which is situated in the Philippines shall be included in his taxable estate.

revocable transfers, property passing under general power of appointment, proceeds of life insurance, prior interests, and transfers for insufficient consideration.[16] Expressly excluded from the gross estate is the capital of the surviving spouse of a decedent.[17]

a) Decedent's Interest

With respect to the decedent's interest, it must be to the extent of the interest at the time of death.[18] It has been held in the case of *Pablo Lorenzo v. Juan Posadas, Jr.*[19] that:

> [i]f death is the generating source from which the power of the state to impose inheritance [estate] taxes takes its being and if, upon the death of the decedent, succession takes place and the right of the state to tax vests instantly, the tax should be measured by the value of the estate as it stood at the time of the decedent's death, regardless of any subsequent contingency affecting value or any subsequent increase or decrease in value.[20]

b) Transfers in Contemplation of Death

For transfers in contemplation of death, it is to the extent of any interest therein of which the decedent has at any time made a transfer in contemplation of or to take effect in possession at or after death.[21]

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16. *See* NIRC, § 85(A)-(G).
17. *Id.* § 85(H).
18. *Id.* § 85(A).
19. Lorenzo v. Posadas, 64 Phil. 353 (1937).
20. *Id.* at 363 (1937) (*citing* 61 C.J. 1692, 1693; 26 R.C.L. 232; Knowlton v. Moore, 178 U.S. 41 (1900)) (*insertion supplied*).
21. NIRC, § 85(B). This section states:

> (B) *Transfer in Contemplation of Death.* — To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from the property, or (2) the right, either alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom; except in case of

The provision on transfers in contemplation of death precludes the escape from estate tax liabilities of lifetime gifts made in the nick of time.

It should be noted that the provision which presumed that all gifts made by a decedent within three years, and then later two years prior to his death, as made in contemplation of death has long been *deleted* from the NIRC.[22] At present, such a presumption no longer exists for the purposes of estate and gift taxation.

The NIRC does not give a definition of the phrase *in contemplation of death*, thus prompting the need to borrow from U.S. jurisprudence. The U.S. Estate Tax Regulations[23] partly defines it as follows:

> A transfer in contemplation of death is a disposition of property prompted by the thought of death (though it need not be solely so prompted). A transfer is prompted by the thought of death if it is made with the purpose of avoiding the tax, or as a substitute for testamentary disposition of property or for any other motive associated with death. The bodily and mental condition of the decedent and all other attendant facts and circumstances are to be scrutinized to determine whether or not such thought prompted the disposition.[24]

Further, the phrase *contemplation of death* has been defined as:

> a bona fide sale for an adequate and full consideration in money or money's worth.

22. A Decree to Consolidate and Codify All the Internal Revenue Laws of the Philippines, Presidential Decree No. 1158, § 78(c)(3). The following section has been *deleted* from the NIRC, as amended by the Tax Reform Act of 1997:

> (3) [The relinquishment of any such power, nor admitted or shown to have been in contemplation of the decedent's death, made within three years prior to his death without such a consideration and affecting the interest or interest (whether arising from one or more transfers or the creation of one or more trusts) of a value or aggregate value, at the time of such death, in excess of two thousand pesos, then to the extent of such excess, such relinquishment or relinquishments shall, unless shown on the contrary, be deemed to have been made in contemplation of death within the meaning of this Chapter.]

23. 26 U.S.C.A. (IRC 1954).

24. Sec. 20.2025-1(c), *cited in* TOMAS P. MATIC, JR., ESTATE AND GIFT TAXATION IN THE PHILIPPINES 87 (1981 ed.).

> [t]he apprehension or expectation of approaching dissolution; not that general expectation which every mortal entertains, but the apprehension which arises from some presently existing sickness or physical condition or from some impending danger. As applied to transfers of property, the phrase "in contemplation of death" means that thought of death is the impelling cause of transfer and that motive which induces transfer is of the sort which leads to testamentary disposition and is practically equivalent to "*causa mortis*."[25]

What is required, therefore, is an analysis of the subjective motive of the transfer or the "subjective state of mind of the particular decedent."[26] Obviously, the one most likely to know the subjective motive is necessarily dead before the beginning of any controversy. It, therefore, depends upon a conglomeration of objective facts that can be mustered to show affirmative proof or rebut the question whether a transfer was made by the decedent in contemplation of death.

Based on American cases, the following circumstances were considered and weighed in determining the dominant motive of the decedent in making *inter vivos* transfers of his property:

1. The age of the decedent at the time the transfer was made.[27] It must be noted, however, that "age will always be an extremely vital factor, but advanced age is never conclusive;"[28]
2. The decedent's health, as he knew it, at or before the time of transfer.[29] This has been held as one of the most important evidentiary factors;[30]

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25. *See* BLACK'S LAW DICTIONARY, *supra* note 6, at 318 (*citing* In re: Cornell's Estate, 66 A.D. 162, 73 N.Y.S. 32; Nicholas v. Martin, 128 N.J.Eq. 344, 15 A.2d 235, 243; Pate v. C.I.R., C.C.A.8, 149 F.2d 669, 670); *see also* BLACK'S LAW DICTIONARY, *supra* note 6, at 1498 (Transfer in contemplation of death is defined as: "[a] transfer made under a present apprehension on the part of the transferor, from some existing bodily or mental condition or impending peril, creating a reasonable fear that death is near at hand.")
26. *See* U.S. v. Sells, 283 U.S. 102 (1931).
27. *See* McLure v. Commissioner, 56 F.2d 548 (5th Circuit), *cert. denied*, 287 U.S. 609, 53 S.Ct. 13 (1932).
28. WILLIAM J. BOWE, ESTATE PLANNING AND TAXATION 232 (3d ed. 1972).
29. *See* Estate of Johnson v. Commissioner, 10 T.C. 680 (1948).
30. BOWE, *supra* note 28, at 232.

3. The interval between the transfer and the decedent's death;[31]
4. The amount of property transferred in proportion to the property retained.[32] Where a large percentage of the estate owner's assets, in relation to his overall wealth, is given, this points to contemplation of death;[33]
5. The nature of the property given by the decedent;[34]
6. The nature and disposition of the decedent, whether cheerful or gloomy, sanguine or morbid, optimistic or pessimistic;
7. The relationship of the donee or donees to the decedent, whether they were the natural objects of his bounty;
8. The existence of a long established gift making policy on the part of the decedent;
9. The existence of a desire on the part of the decedent to escape the burden of managing property;[35] and
10. The concurrent making of a will.[36]

Certain motives that would *preclude* a transfer in contemplation of death are the following: to see the children enjoy the property while the donor is alive, to save on income taxes, and others.[37]

As a word of caution, if a gift is made under circumstances which may raise the question of contemplation of death, it is advisable to collect and preserve objective data contemporaneously which would tend to establish *lifetime motive* for the gift. If the circumstances are such that doubt might be cast on a gift being made because of the *age* of the donor, it would be advisable that the personal physician of the

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31. *See* Becker v. St. Louis Union Trust Co., 296 U.S. 48 (1935).
32. *See* Mclure v. Commissioner, 56 F.2d 548 (5th Circuit), *cert. denied*, 287 U.S. 609, 53 S.Ct. 13 (1932).
33. BOWE, *supra* note 28, at 233.
34. *Id.* at 232 ("For example, a life insurance policy is particularly vulnerable to attack, as insurance is intimately connected to death.").
35. *See* Vanderlip v. Commissioner, 155 F.2d 152 (2nd Circuit), *cert. denied*, 329 U.S. 728, 67 S.Ct. 83 (1946).
36. BOWE, *supra* note 28, at 234.
37. *See* LLAMADO JR., *supra* note 5, at 33.

donor be made a witness to the donation so that he can attest later on the good health of the donor in case a question arises.

c) Proceeds of Life Insurance

Proceeds of life insurance[38] under policies taken out by the decedent upon his own life shall be included in his gross estate in the following cases: (i) to the extent the amount receivable by the estate of the deceased, his executor or administrator as insurance proceeds under policies taken out by the decedent upon his own life, irrespective of whether or not the insured retained the power of revocation; or (ii) to the extent the amount receivable by any beneficiary designated in the policy, except when it is expressly stipulated that the designation of the beneficiary is irrevocable.

In the first case, it does not matter whether the designation is revocable or irrevocable; in the second case, the designation is revocable.[39] Thus, failure to indicate in any insurance policy that the beneficiary is *irrevocably designated* will result in the inclusion of the insurance proceeds as part of the decedent's gross estate.

d) Valuation

Once it is established that a particular property interest is included in the decedent's gross estate, the value of the interest must be determined.[40] The properties comprising the gross estate shall be valued based on their fair market value at the time of death.[41] The valuation of the property depends on the kind of property involved.

If the property is *real property*, the fair market value shall be the fair market value as determined by the Commissioner of Internal

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38. NIRC, § 85(E). The law provides:

> To the extent of the amount receivable by the estate of the deceased, his executor, or administrator, as insurance under policies taken out by the decedent upon his own life, irrespective of whether or not the insured retained the power of revocation, or to the extent of the amount receivable by any beneficiary designated in the policy of insurance, except when it is expressly stipulated that the designation of the beneficiary is irrevocable.

39. *See* LLAMADO JR., *supra* note 5, at 39.

40. NIRC, § 88.

41. *Id.* § 88(B).

Revenue (CIR) or the fair market value as shown in the schedule of values fixed by the provincial and city assessors, whichever is higher.[42]

If the property is in the form of shares of stock, the fair market value shall depend on whether the shares are listed or unlisted in the stock exchanges.[43] Common shares which are unlisted in the stock exchange are valued based on their book value. On the other hand, preferred shares which are unlisted in the stock exchange are valued at their par value. In determining the book value of common shares, appraisals surplus shall not be considered as well as the value assigned to preferred shares, if there are any. For shares which are listed in the stock exchanges, the fair market value shall be the arithmetic mean between the highest and lowest quotations at a date nearest to the date of death, if none is available on the date of death itself.

To determine the value of the right of usufruct, use or habitation, as well as that of annuity,[44] there shall be taken into account the probable life of the beneficiary in accordance with the latest basic standard mortality table, to be approved by the Secretary of Finance, upon recommendation of the Insurance Commissioner.

2. Deductions Allowed to Estate of Residents

a) Actual Funeral Expenses[45]

The law allows the deduction of funeral expenses, whether paid or unpaid, up to the time of interment. The allowable deduction is subject to the following limitations: either the amount of the actual funeral expenses, or an amount equal to five percent of the gross estate, whichever is lower, but not to exceed P200,000.

The law is clear that any amount in excess of the P200,000 threshold, even if paid or still payable, will not be allowed as a deduction. RR 2-

42. For purposes of prescribing real property values, the Commissioner is authorized to divide the Philippines into different zones or areas and shall, upon consultation with competent appraisers from both the private and public sectors, determine the fair market value of real properties located in each particular zone or area.

43. RR 2-2003, § 5.

44. NIRC, § 88(A).

45. NIRC, § 86(A)(1)(a); RR 2-2003, § 6(A)(1).

2003 expressly indicates that "the unpaid portion of the funeral expenses incurred which is in excess of the P200,000 threshold" will not "be allowed to be claimed as a deduction under 'claims against the estate.'"[46]

The term *funeral expenses*, as specifically provided by law, is not confined to its ordinary or usual meaning.[47] As such, funeral expenses are deemed to include the following: the mourning apparel of the surviving spouse and unmarried minor children of the deceased bought and used on the occasion of the burial; expenses for the deceased's wake, including food and drinks; publication charges for death notices; telecommunication expenses incurred in informing relatives of the deceased; cost of burial plot, tombstones, monument or mausoleum but not their upkeep;[48] interment and/or cremation fees and charges; and all other expenses incurred for the performance of the rites and ceremonies incident to interment.[49]

Expenses incurred *after* the interment, such as for prayers, masses, entertainment, or the like are not deductible. Any portion of the funeral and burial expenses borne or defrayed by relatives and friends of the deceased are not deductible.

b) Judicial Expenses of Testamentary or Intestate Proceedings[50]

Judicial expenses allowed as a deduction under this category are those incurred in the inventory-taking of assets comprising the gross estate, their administration, the payment of debts of the estate, as well as the distribution of the estate among the heirs.

Jurisprudence provides that judicial expenses have to be "expenses of administration."[51] The expenses must be essential to the proper

46. RR 2-2003, § 6(A)(1).

47. *See e.g.*, BLACK'S LAW DICTIONARY, *supra* note 6, at 675. Funeral expenses are defined as: "[m]oney expended in procuring the interment, cremation, or other disposition of a corpse, including suitable monument, perpetual care of burial lot and entertainment of those participating the wake."

48. In case the deceased owned a family estate or several burial lots, only the value corresponding to the plot where he is buried is deductible.

49. RR 2-2003, § 6(A)(1)(a)-(g).

50. NIRC, § 86(A)(1)(b); RR 2-2003, § 6(A)(2).

settlement of the estate,[52] or necessary for the management of the estate, for protecting it against destruction or deterioration and possibly for the production of fruits.[53] Expenditures incurred for the individual benefit of the heirs, devisees or legatees are not deductible.[54]

While an executor or administrator is allowed the necessary expenses in the care and management of the estate, not all expenses incurred can be permitted to be deductible. The Court has disallowed personal expenses of the occupant heir of the family residence, but allowed expenses of the administrator to preserve the family home and maintain the family's social standing.[55]

In a case, the Supreme Court held that judicial expenses do not include the compensation paid to a trustee of the decedent's estate when it appeared that such trustee was appointed for the purpose of managing the decedent's real estate for the benefit of the testamentary heir.[56] Likewise, in another case, it was held that premiums paid on the bond filed by the administrator as an expense of administration, where the bond was given in the nature of the qualification for office and not necessarily in the settlement of the estate, were not deductible.[57]

With respect to attorney's fees, the Court has ruled on deductibility or non-deductibility depending on the nature of the legal services the attorney's fees were paid for. In a relatively old case, the attorney's fees were not allowed when such were incident to litigation incurred by the heirs in asserting their respective rights.[58] In a more recent case, after the passage of the Tax Reform Act of 1997 but before the issuance of RR No. 2-2003, the Court held that the notarial fee paid for the extrajudicial

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51. Commissioner of Internal Revenue (CIR) v. Court of Appeals (CA), 328 SCRA 666, 677 (2000) (*citing* Carolina Industries, Inc. v. CMS Stock Brokerage, Inc., 97 SCRA 734 (1980)).

52. *Id.*

53. *See* Lizarraga Hermanos v. Abada, 40 Phil. 124 (1919).

54. 34A AM. JUR. 2D *Federal Taxation* §§ 144, 288 (1995).

55. De Guzman v. De Guzman-Castillo, 83 SCRA 257 (1978).

56. Lorenzo v. Posadas, 64 Phil. 353, 365 (1937), *cited in CIR*, 328 SCRA at 677.

57. Sison v. Teodoro, 100 Phil. 1055 (1957).

58. Johannes v. Imperial, 43 Phil. 597 (1922).

settlement and the attorney's fees paid to the guardian of the property during the decedent's property were deductible expenses.[59]

For clarity, RR No. 2-2003 has expressly provided that judicial expenses may include: fees of executor or administrator, attorney's fees, court fees, accountant's fees, appraiser's fees, clerk hire, costs of preserving and distributing the estate, costs of storing or maintaining property of the estate, and brokerage fees for selling property of the estate.[60]

c) Valid Claims against the Estate[61]

Claims against the estate refer to "obligations and debts which are enforceable against the decedent."[62] The claims against the estate include taxes due from the decedent or for indebtedness. In the case of indebtedness, it is necessary that the following conditions be complied with: that at the time it was incurred, the debt instrument was duly notarized and, if the loan was contracted within three years before the death of the decedent, the administrator or executor shall have submitted a statement showing the disposition of the loan proceeds.

d) Claims of the Decedent against Insolvent[63]

Claims against insolvent persons are "receivables due or owing from persons who are not financially capable of meeting their obligations."[64]

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59. *CIR*, 328 SCRA at 678. The Court ruled thus:

> Coming to the case at bar, the notarial fee paid for the extrajudicial settlement is clearly a deductible expense since such settlement effected a distribution of Pedro Pajonar's estate to his lawful heirs. Similarly, the attorney's fees paid to PNB for acting as the guardian of Pedro Pajonar's property during his lifetime should also be considered as a deductible administration expense. PNB provided a detailed accounting of decedent's property and gave advice as to the proper settlement of the latter's estate, acts which contributed towards the collection of decedent's assets and the subsequent settlement of the estate.

60. RR 2-2003, § 6(A)(2).

61. NIRC, § 86(A)(1)(c); RR 2-2003, § 6(A)(2).

62. LLAMADO JR., *supra* note 5, at 67.

63. NIRC, § 86(A)(1)(d); RR 2-2003, § 6(A)(4).

64. LLAMADO JR., *supra* note 5, at 41.

Any claim of the deceased against insolvent persons is deductible from the gross estate where the value of decedent's interest therein is included in the value of the gross estate.

e) Unpaid Mortgage[65]

Unpaid mortgages upon, or any indebtedness in respect to, property are deductible. Such are deductible where the value of decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate (but not including any income taxes upon income received after the death of the decedent, or property taxes not accrued before his death, or any estate tax).

f) Losses from Casualties or Theft[66]

Losses incurred during the settlement of the estate are deductible provided they are those arising from fires, storms, shipwreck, or other casualties, or from robbery, theft, or embezzlement. Such losses must not be compensated for by insurance or otherwise, must not have been claimed as a deduction for income tax purposes in an income tax return, and were incurred not later than the last day for the payment of the estate tax.

g) Property Previously Taxed[67]

This deduction is commonly referred to as the *vanishing deduction*. The purpose of this deduction is to prevent the double taxation of property that may have been inherited from a decedent within 5 years from his own death.

The deduction is an amount equal to the value specified below of any property forming a part of the gross estate situated in the Philippines of any persons who died within five years prior to the death of the decedent, or transferred to the decedent by gift within five years prior to his death, where such property can be identified as having been received by the decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received.

The following are the allowable percentages of deductibility, depending on the period that lapsed from the first decedent:

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65. NIRC, § 86(A)(1)(e); RR 2-2003, § 6(A)(5).

66. *Id.* § 86(A)(1)(e).

67. *Id.* § 86(A)(2).

TABLE 2 – PERCENTAGES OF VANISHING DEDUCTION

100% - within 1 year
80% - +1 year-2 years
60% - +2 years-3 years
40% - +3 years-4 years
20% - +4 years -5 years

h) Transfer for Public Use[68]

Any transfer for public use is deductible from the gross estate of the decedent. The requirement is that the amount of all bequests, legacies, devices, or transfers to or for the use of the Government of the Republic of the Philippines, or any political subdivision thereof, for exclusively public purposes.

i) The Family Home[69]

For estate tax purposes, the following is deductible: an amount equivalent to the current or fair market value or zonal value of the decedent's family home, whichever is higher. However, if the said current or fair market value or zonal value exceeds One Million Pesos (P1,000,000), the excess shall be subject to estate tax.

As a condition for the exemption to deduction, said family home must have been the decedent's family home as certified by the barangay captain of the locality. Under the law, the family home, which is constituted jointly by the husband and the wife or by an unmarried head of a family, is the dwelling house where they and their family reside, and the land on which it is situated.[70] It is deemed constituted on a house and lot from the time it is occupied as a family residence.[71]

68. *Id.* § 86(A)(3).

69. NIRC, § 86(A)(4); RR 2-2003, § 6(D).

70. The Family Code of the Philippines [FAMILY CODE], Executive Order No. 209, § 152 (1988).

71. *Id.* § 153.

j) Standard Deduction[72]

In estate taxation, a minimum amount is allowed to taxpayers as a deduction from adjusted gross estate in arriving at the taxable estate. This is referred to as the standard deduction.

As such, the NIRC specifically provides that a deduction in the amount of One Million Pesos (P1,000,000) shall be allowed as an additional deduction without need of substantiation. The full amount of P1,000,000 shall be allowed as deduction for the benefit of the decedent.

k) Medical Expenses[73]

All medical expenses, such as the cost of medicines, hospital bills, and doctors' fees, among others, are deductible, subject to certain conditions. The medical expenses, whether paid or unpaid, must be incurred within one year before the death of the decedent, and must be duly substantiated with official receipts for services rendered by the decedent's attending physicians, invoices, statements of account duly certified by the hospital, and such other documents in support thereof. The maximum amount allowed as deduction, whether paid or unpaid, however, should not exceed Five Hundred Thousand Pesos (P500,000).

l) Amount Received by Heirs under Republic Act No. 4917[74]

Any amount received by the heirs from the decedent's employer as a consequence of the death of the decedent's employee in accordance with Republic Act No. 4917[75] is allowed as a deduction provided that the

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72. NIRC, § 86(A)(5); RR 2-2003, § 6(E).

73. NIRC, § 86(A)(6); RR 2-2003, § 6(F).

74. NIRC, § 86(A)(7); RR 2-2003, § 6(G).

75. An Act Providing that Retirement Benefits of Employees of Private Firms shall not be Subject to Attachment, Levy, Execution, or any Tax Whatsoever, Republic Act No. 4917 (1967). Section 1 of the law provides:

> Section 1. Any provision of law to the contrary notwithstanding, the retirement benefits received by officials and employees of private firms, whether individual or corporate, in accordance with a reasonable private benefit plan maintained by the employer shall be exempt from all taxes and shall not be liable to attachment, garnishment, levy or seizure by or under any legal or equitable process whatsoever except to pay a debt of the official or employee

amount of the separation benefit is included as part of the gross estate of the decedent.

3. Net Share of the Surviving Spouse in the Conjugal Partnership or Community Property

After deducting the allowable deductions pertaining to the conjugal or community properties included in the gross estate, the share of the surviving spouse[76] must be removed to ensure that only the decedent's interest in the estate is taxed.

4. Procedure for the Settlement of the Estate Tax[77]

The first step in the settlement of estate tax is the filing of the notice of death.[78] The law provides that where the gross value of the estate exceeds P20,000, although exempt, the executor, administrator, or any of the legal heirs shall give, within two months after the decedent's death or within a like period after the executor or administrator qualifies as such, a written notice thereof to the CIR.

The next step is the filing of the estate tax return.[79] An estate tax return must be filed in all cases where a notice of death is required. The filing is done by the executor, administrator, or any of the legal

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> concerned to the private benefit plan or that arising from liability imposed in a criminal action: Provided, That the retiring official or employee has been in the service of the same employer for at least ten (10) years and is not less than fifty years of age at the time of his retirement: Provided, further, That the benefits granted under this Act shall be availed of by an official or employee only once: Provided, finally, That in case of separation of an official or employee from the service of the employer due to death, sickness or other physical disability or for any cause beyond the control of the said official or employee, *any amount received by him or by his heirs from the employer as a consequence of such separation shall likewise be exempt as hereinabove provided.* xxx (*emphasis supplied*)

76. NIRC, § 85(H).

77. RR 2-2003, § 9.

78. NIRC, § 89.

79. *Id.* § 90.

heirs of the decedent, within six months from the decedent's death. This particular portion of the NIRC was amended by Republic Act No. 7499.[80] The six month period may be extended by the CIR for not more than 30 days for meritorious grounds.

The final stage is the payment of the estate tax.[81] It should be noted that "the accrual of the inheritance tax is distinct from the obligation to pay the same."[82]

The estate taxes are paid simultaneously with the filing of the return, as it is due and payable at the same time the return is filed. The period of payment may be extended by the CIR if he finds that the payment on the due date of the estate tax or any part of the said amount would impose undue hardship upon the estate or any of the heirs. This extension of payment is not to exceed five years in case the estate is settled judicially or two years if the estate is settled extra-judicially.

5. Summary of Amendments under the Tax Reform Act of 1997 (TRA)

There are significant amendments in estate taxation that were introduced by the Tax Reform Act of 1997. These amendments have been implemented by RR No. 2-2003. They are summarized below:

1. Reduction of top estate tax rate from 35 percent to 20 percent.
2. Increase in the ceiling of allowable funeral expenses from P100,000 to P200,000.
3. An amount of P1,000,000 is allowed as a standard deduction[83] against the gross estate in addition to the family home exclusion of P1,000,000.
4. A deduction against gross estate for medical expenses not exceeding P500,000 is provided.

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80. An Act Restructuring the Estate and Donor's Taxes, Amending for the Purpose Sections 77, 79(a), 83(b) and 92 (a) and (b) on Transfer Taxes of the National Internal Revenue Code, as Amended, Republic Act No. 7499 (1992).
81. NIRC, § 91.
82. Lorenzo v. Posadas, 64 Phil. 353, 360 (1937).
83. NIRC, §86 (A)(5).

5. Amount received by the heirs from decedent's employer due to death of decedent under R.A. No. 4917 is deductible provided the amount is included in his gross estate.

6. A certification by a Certified Public Accountant should accompany the estate tax return if the value of the gross estate exceeds P2,000,000[84] (the value of the gross estate requiring such a certification was previously P50,000).

TABLE 3 – ESTATE TAX RATES

Over	*But Not Over*	*The Tax Shall Be*	*Plus*	*Of the Excess Over*
				P200,000 Exempt
P200,000	500,000	0	5%	P200,000
500,000	2,000,000	P15,000	8%	500,000
2,000,000	5,000,000	135,000	11%	2,000,000
5,000,000	10,000,000	465,000	15%	5,000,000
10,000,000	And Over	1,215,000	20%	10,000,000

PART II: DONOR'S TAX/GIFT TAX

84. *Id.* § 90 (A)(3). The new provision states:

> Provided, however, That estate tax returns showing a gross value exceeding Two million pesos (P2,000,000) shall be supported with a statement duly certified to by a Certified Public Accountant containing the following:
>
> (a) Itemized assets of the decedent with their corresponding gross value at the time of his death, or in the case of a nonresident, not a citizen of the Philippines, of that part of his gross estate situated in the Philippines;
>
> (b) Itemized deductions from gross estate allowed in Section 86; and
>
> (c) The amount of tax due whether paid or still due and outstanding.

C. Definition and Nature of Donor's Tax

Donor's tax is synonymous with the term *gift tax*. "It is a tax imposed on the gratuitous transfer of property between two or more persons who are living at the time of the transfer."[85] The gift tax falls upon the gratuitous transmission of property which tends to reduce the estate subject to tax at death.

Like estate tax, donor's tax is in the nature of an excise tax which is imposed on the transfer of property by lifetime gifts. It has been held that: "The donor's tax is not a property tax, but is a tax imposed on the transfer of property by way of gift *inter vivos*."[86]

The purposes of donor's tax are the following: to prevent avoidance of estate taxes, and to compensate for loss of income tax when large estates are split by donations. As a rule, all donations whether outright gifts or made to a trust, are subject to donor's gift tax except donations enumerated in the NIRC and other special laws. For the application of donor's tax, there must be a completed gift.[87]

A donation is defined as an act of liberality whereby a person disposes gratuitously of a thing or right in favor of another who accepts it.[88] There are two individuals involved in donation: the one disposing the thing gratuitously or the *donor*, and the one accepting the thing or the *donee*.

Donation can be of two kinds: donations *mortis causa*[89] and donations *inter vivos*.[90] The former takes effect upon the death of the donor and partakes of a testamentary disposition, and is thus, properly the subject of estate tax. The latter is a donation between two living persons which is perfected from the time the donor has knowledge of

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85. LLAMADO JR., *supra* note 5, at 133.

86. Lladoc v. CIR, 14 SCRA 292 (1965).

87. RR 2-2003, § 10. The Revenue Regulations provide thus:

> The donor's tax shall not apply unless and until there is a completed gift. The transfer of property by gift is perfected from the moment the donor knows of the acceptance by the donee; it is completed by the delivery, either actually or constructively, of the donated property by the donee.

88. NEW CIVIL CODE, art. 725.

89. *Id.* art. 728.

90. *Id.* art. 729.

the donee's acceptance, and is properly the subject of donor's tax. It has been held that:

> [the] principal characteristics of a donation *mortis causa*, which distinguish it essentially from a donation *inter vivos*, are that in the former it is the donor's death that determines the acquisition of, or the right to, the property, and that it is revocable at the will of the donor.[91]

Furthermore, it has been held that: "[c]rucial in resolving whether the donation was *inter vivos* or *mortis causa* is the determination of whether the donor intended to transfer the ownership over the properties upon the execution of the deed."[92]

The rules for the valuation of the property for purposes of estate taxes are applicable to the valuation of property for gift tax purposes. Thus, the NIRC states that "if gift is made in property, the fair market values thereof at the time of the gift shall be considered the amount of the gift."[93]

The tax computed for each calendar year is on the basis of the total net gifts made during that year exceeding One Hundred Thousand Pesos (P100,000). It should be noted that a donation by the spouses of conjugal property is deemed to be separate donations of the spouses.[94]

D. *Exemptions from Donor's Tax*

The following are not subject to any gift tax:

1. donations not exceeding P100,000 for every year;[95]
2. donations *propter nuptias*[96] made by parents to each of their legitimate, recognized natural or adopted children not exceeding P10,000,[97] besides the P100,000 exemption allowed in the NIRC;[98]

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91. Zapanta v. Posadas Jr., 52 Phil. 557, 559 (1928).
92. Gestopa v. CA, 342 SCRA 105, 110 (2000) (*citing* Reyes v. Mosqueda, 187 SCRA 661, 671 (1990)).
93. NIRC, § 102.
94. *See* Tang Ho v. Board of Tax Appeals and CIR, 97 Phil. 889 (1955) (in this case it was held that a donation of property belonging to the conjugal partnership, made during its existence by the husband alone in favor of the common children, is taxable to him exclusively as sole donor).
95. NIRC, § 92.

3. gifts made to or for the use of the Philippine Government or its agencies not conducted for profit or political subdivisions;

4. gifts in favor of non-stock and non-profit educational and/or charitable or religious corporation, institution, foundation, trust, or philanthropic organization or research institution or organization provided that not more than 30 percent thereof shall be used for administration purposes;[99] and

5. donations exempt under special laws, such as donations in favor of social welfare, cultural, and charitable institutions, no part of the net income of which inures to the benefit of any individual and not more than thirty percent (30%) of the gift is used by the donee for administration purposes.

E. Returns and Payment of Tax[100]

The return is required to be filed within 30 days after the gift is made, but the CIR may, in meritorious cases, grant an extension not exceeding 30 days. The tax shall be paid at the same time the return is filed unless extended by the CIR in cases where payment thereof would impose undue hardship upon the donor.

F. Amendments under Tax Reform Act of 1997 and Donor's Tax Rate

Several amendments have been made under the Tax Reform Act of 1997. They are summarized below:

1. A reduction of top rate form 20 percent to 15 percent.

2. A restructuring of tax brackets.

3. The tax rate for donation to stranger is increased from 10 percent to 30 percent.[101]

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96. Donations *propter nuptias* are dowries in consideration of marriage before its celebration or within one year thereafter.

97. It should be noted that non-resident aliens are not entitled to this exemption.

98. NIRC, § 99.

99. *Id.* § 94.

100. RR 2-2003, § 13.

A stranger, under the law on donor's taxes, is a person who is not any of the following individuals: brother, sister (whether of the whole or half-blood), spouse, ancestor, lineal descendants, or relative by consanguinity within the fourth degree.[102] Also, donations made between business organizations and those between an individual and business organization shall be considered a donation to a stranger.

TABLE 4 – TAX RATES FOR DONORS TAX[103]

Over	*But Not Over*	*The Tax Shall Be*	*Plus*	*Of the Excess Over*
				P100,000 Exempt
P100,000	200,000	0	2%	P100,000
200,000	500,000	2,000	4%	200,000
500,000	1,000,000	14,000	6%	500,000
1,000,000	3,000,000	44,000	8%	1,000,000
3,000,000	5,000,000	204,000	10%	3,000,000
5,000,000	10,000,000	404,000	12%	5,000,000
10,000,000		1,004,000	15%	10,000,000

PART III: ESTATE PLANNING TOOLS

Estate planning is the methodical building, conserving, and transferring of wealth with the least tax impact.[104] It is also referred to as

> [t]hat branch of the law which, in arranging a person's property and estate, takes into account the laws of wills, taxes, insurance, property,

101. An Act Adopting the Simplified Net Income Taxation Scheme for the Self-Employed and Professionals Engaged in the Practice of their Profession, Amending Sections 21 and 29 of the National Internal Revenue Code, as Amended, Republic Act No. 7496 (1992) (complaints from family members initiated this amendment when R.A. No. 7496 introduced the 10% rate on donations to stranger).

102. RR 2-2003, § 10.

103. The foregoing are only the scheduler rates. In case the donee is a stranger, the 30% rate will apply.

104. MATIC, JR., *supra* note 24, at 316.

and trusts, so as to gain maximum benefit of all laws while carrying out the person's own wishes for the disposition of his property upon his death.[105]

The basic objective of estate planning is to conserve a person's estate from erosion or avoidable diminution especially on the account of taxes.[106]

A. *Donations During Lifetime*

Making gifts during one's lifetime is an effective estate planning tool as it presents a myriad of tax saving possibilities.[107] At the same time, by making gifts during his lifetime, the donor is assured that his wishes concerning his estate are being followed by his heirs. The following are the advantages if a decedent donates to his or her heirs during his or her lifetime.

1. The estate tax rate starts at a minimum of five percent to a maximum of 20 percent[108] while the donor's tax is from two percent to 15 percent.[109] Thus, the gift tax is 25 percent *lower* as compared to the estate tax. Prior to the Tax Reform Act of 1997, the difference between the highest estate tax rate of 35 percent as compared to the maximum donor's tax rate of 20 percent is 42 percent. Thus, the difference is getting smaller.

2. The estate tax is based on the fair market value of the property at the time of the taxpayer's death[110] while the gift tax is levied on the market value at the time of the donation.[111] Thus, the donation is shifted from a higher estate tax bracket to a lower gift tax bracket.

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105. BLACK'S LAW DICTIONARY, *supra* note 6, at 549.

106. MATIC, JR., *supra* note 24, at 316.

107. *See e.g.*, *10 Ways to Reduce Estate Taxes*, *at* http://estate.findlaw.com/estate-planning/estate-planning-taxes/estate-planning-taxes-reducing-overview.html (last accessed on Dec. 5, 2005).

108. NIRC, § 84.

109. *Id.* § 99.

110. *Id.* § 88.

111. *Id.* § 102.

3. The subsequent appreciation in the value of the property donated will be shielded from a higher estate tax rate. As a rule, it is preferable to donate properties that will appreciate in value since the estate tax savings will proportionately increase. Because of relatively lower gift tax, further gift tax savings can be achieved by programming gifts of smaller amounts each year rather than bunching the gifts in one year.

4. If the asset donated is a conjugal property, each spouse is considered a donor, and the gift tax payable by each spouse is computed separately, thus resulting in lower gift taxes.

5. Donating income-producing property to one or two members of the family who have little or no income at all can reduce one's income tax liability. This is because one's income tax rates increase progressively with the amount of gross income.[112] Once a donation is made the income is shifted from a higher income tax bracket to a lower bracket.

ILLUSTRATION 1 – ESTATE TAX V. DONATION DURING LIFETIME

Assuming the net taxable asset is worth P10,000,000:

Estate Tax = P1,215,000
Donor's Tax = P1,004,000
If donated at P5,000,000 by each spouse
P404,000 x 2 = P808,000
Difference is P407,000 (P1,215,000 – 808,000)
If split into four (2 years x 2) of P2.5M each donation:
P164,000 x 4 = P656,000
Difference: P559,000 (P1,215,000 – 656,000)

112. *See Id.* § 24.

1. Requirement of a Gift for Tax Purposes

To exclude one's property from the gross estate, the transfer by gift should be real and not a sham; there must be a present surrender of possession and control – a promise to transfer is not sufficient. To be a valid gift, the property must be delivered to the donee or his representative.[113] There must be a physical transfer of possession, so that the donor no longer controls the property.

Property rights do not necessarily pass if there is no intention to make a present transfer.[114] Parents will frequently execute and record deeds of their real estate to their children with the secret arrangement that the parents will continue to possess and use the property and even have the right to sell. Such circumstances will negate the validity of the gift and throw back the property to the parent's gross estate for determining the death taxes. If the parents continue to collect the rent, pay the taxes, order repairs, make annual leases, discuss offers of sale, obtain and use the proceeds of mortgage placed on the subject property, these are indications of a sham transaction. In fine, the transfer must be *bona fide* because tax authorities usually look at family transfers with a suspicious eye, and everything must be genuinely done to deprive them of the slightest reason to disregard the transfer.

B. Outright Gift or Gift in Trust

Regarding the method of transmitting the assets by way of gifts to loved ones, there is a choice between making an *outright transfer* to a child, for instance, or *creating a trust* for the benefit of the child.

Considering the fact that children, especially minors, often lack the adequate mental capacity to manage property, the trust method appears to be more desirable from a practical standpoint.[115] This is particularly true when what are to be transferred are properties that require management control. The creation of a trust would eliminate the institution of judicial guardianship proceedings and the appointment of a guardian to manage the properties, which might entail a lot of procedural inconveniences.[116] On the other hand, where a

113. RR 2-2003, § 10 ("The transfer of property by gift is…completed by the delivery, either actually or constructively, of the donated property to the donee.").

114. *See* MATIC, JR., *supra* note 24, at 328-29.

115. *Id.* at 328.

116. *See* Revised Rules of Court, rules 93-97.

child is no longer a minor and possesses adequate ability to manage investments, an outright gift to him can be advantageous.

For tax purposes, a trust is recognized as a separate taxpayer,[117] and it therefore acts as a convenient method for splitting the family income. Trust is subject to tax just like an individual; the individual income tax rates apply;[118] it is entitled to a personal exemption of P20,000.[119] The trustee files its income tax return and pays tax on the net income of the property held in trust that is accumulated or held for future distribution to the beneficiary.[120]

On the other hand, any income distributed currently to the beneficiary does not form part of the taxable income of the trust, but shall be taxed to the beneficiary. However, if the income distributed to the child has already been taxed to the trustee because it was

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117. *See* NIRC, Chapter X.

118. *Id.* § 60(A).

119. *Id.* § 62. The section provides: "Section 62. Exemption Allowed to Estates and Trusts. — For the purpose of the tax provided for in this Title, there shall be allowed an exemption of Twenty thousand pesos (P20,000) from the income of the estate or trust."

120. *Id.* § 65. This section states:

> Section 65. Fiduciary Returns. — Guardians, trustees, executors, administrators, receivers, conservators and all persons or corporations, acting in any fiduciary capacity, shall render, in duplicate, a return of the income of the person, trust or estate for whom or which they act, and be subject to all the provisions of this Title, which apply to individuals in case such person, estate or trust has a gross income of Twenty thousand pesos (P20,000) or over during the taxable year. Such fiduciary or person filing the return for him or it, shall take oath that he has sufficient knowledge of the affairs of such person, trust or estate to enable him to make such return and that the same is, to the best of his knowledge and belief, true and correct, and be subject to all the provisions of this Title which apply to individuals: Provided, That a return made by or for one or two or more joint fiduciaries filed in the province where such fiduciaries reside; under such rules and regulations as the Secretary of Finance, upon recommendation of the Commissioner, shall prescribe, shall be a sufficient compliance with the requirements of this Section.

accumulated by such trustee in prior years and distributed only lately, such income is no longer taxable to the beneficiary.

If the trust approach is chosen, it is advisable that the property be transferred to an unrelated, independent trustee[121] who will hold and manage the property for the benefit of the child. The trustee can be a bank and an individual so that he will have personal relationship with the beneficiary and, at the same time, the backing of an institution. Furthermore, the creator of the trust should surrender the power to revoke the trust, and that the income of the trust should not in any way be distributed back to, or held for the benefit of, the grantor to avoid any possibility of the properties held in trust from being thrown back into the trustor's estate.

Briefly, therefore, the following points should be remembered in creating the trust which can be estate tax proof:

1. the trust must be irrevocable;
2. the power to amend the trust should not be reserved in any way;
3. no part of the income of the trust should be used for the benefit or the discharge of the obligations of the grantor;
4. no part of the income of the trust may be accumulated for or distributed to the grantor;
5. the grantor must not retain the power to change the enjoyment of the income or principal of a trust;
6. the grantor must not retain any discretion over the distribution of the income of the trust;
7. the trust must not terminate upon the death or within any period counted from the death of the grantor.

These are some of the important points one must observe in creating a trust purely from the tax standpoint. They may not be all inclusive, considering the circumstances surrounding each grant or transfer in trust.

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121. NEW CIVIL CODE, art. 1440. The parties involved in a trust are the trustor, trustee and beneficiary. The Civil Code defines these individuals as such:

> A person who establishes a trust is called the trustor; one in whom confidence is reposed as regards property for the benefit of another person is known as the trustee; and the person for whose benefit the trust has been created is referred to as the beneficiary.

At this point, it should be emphasized that where (1) the trust is revocable, or (2) the income of the trust is or may be distributed or otherwise for the benefit of the grantor or creator, the trust arrangement is disregarded and the income of the trust will be taxed to the creator of the trust. These pitfalls should, therefore, be avoided. In drafting the trust instrument, extra care should be taken to avoid provisions that may cause the trust income to be taxed to the creator of the trust.

Theoretically, anything that has economic value – cash, stocks, bonds, life insurance, real estate, and others, may be held in trust. There are different types of trust arrangements which can be tailored to suit a planner's personal resources, needs, and objectives.[122] Properly designed trusts will allow one to obtain the maximum benefits to the Trustor.

C. Transfer by Sale

There are instances where an *inter vivos* transfer is accomplished through sale to the beneficiaries.[123] If this is resorted to, extreme caution must be observed because under the NIRC, where property is transferred for *less than adequate consideration* in money or money's worth, the insufficiency of consideration is deemed a gift subject to donor's tax.[124] It must also be proven that the vendee-beneficiary is financially capable to buy the property; otherwise, the transaction may be construed to be a donation subject to donor's tax.

If the transaction can be justified as a sale, the real estate property may be subject to the preferential capital gains tax rate of six percent

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122. Trusts may be any of the following: a living trust (created to function during the decedent's lifetime), a short-term trust (one created for a relatively short time), or a testamentary trust (one created by will or testament); or they may be irrevocable trusts, grandfather trust, multiple trust, generation-skipping trust, or others.

123. NEW CIVIL CODE, § 1458 ("By the contract of sale one of the contracting parties obligates himself to transfer the ownership and to deliver a determinate thing, and the other to pay therefor a price certain in money or its equivalent.").

124. *Id.* § 1470 ("Gross inadequacy of price does not affect a contract of sale, except as it may indicate a defect in the consent, or that the parties really intended a donation or some other act or contract.").

based on the gross selling price or zonal value, whichever is higher.[125] This is if the property may be considered as a capital asset. A *capital asset* has been defined, in the negative, by the NIRC as:

> [p]roperty held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property used in the trade or business, of a character which is subject to the allowance for depreciation…or real property used in trade or business of the taxpayer.[126]

On the other hand, if the real estate property is an *ordinary asset*, the net gains will be subject to the graduated rates of five percent to 32 percent.[127] Under certain instances, the sale of principal residence by individuals may be exempt from capital gains tax if, within 18 months from the sale, the proceeds are fully utilized in acquiring or constructing a new principal residence. However, this tax exemption can only be availed of once every ten years.[128]

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125. NIRC, § 24(D)(1).

> (D) Capital Gains from Sale of Real Property. —
>
> (1) In General. — The provisions of Section 39(B) notwithstanding, a final tax of six percent (6%) based on the gross selling price or current fair market value as determined in accordance with Section 6(E) of this Code, whichever is higher, is hereby imposed upon capital gains presumed to have been realized from the sale, exchange, or other disposition of real property located in the Philippines, classified as capital assets, including *pacto de retro* sales and other forms of conditional sales, by individuals, including estates and trusts: Provided, That the tax liability, if any, on gains from sales or other dispositions of real property to the government or any of its political subdivisions or agencies or to government-owned or - controlled corporations shall be determined either under Section 24(A) or under this Subsection, at the option of the taxpayer…

126. *Id.* § 39(A)(1).

127. *Id.* § 24(A).

128. *Id.* § 24(D)(2).

D. Life Insurance/Life Insurance Trust

Life insurance[129] is one of the best tools by which the liquidity of the estate can be maintained. Life insurance can prevent premature sale of assets to meet death-related expenses. As expected, immediate funds are necessary at the time of death to meet the cash requirements of a decedent's estate. Whether the family is of modest, moderate, or substantial means, the need for this immediate cash fund is almost universal.

> (D) Capital Gains from Sale of Real Property. —
>
> x x x
>
> (2) Exception. — The provisions of paragraph (1) of this Subsection to the contrary notwithstanding, capital gains presumed to have been realized from the sale or disposition of their principal residence by natural persons, the proceeds of which is fully utilized in acquiring or constructing a new principal residence within eighteen (18) calendar months from the date of sale or disposition, shall be exempt from the capital gains tax imposed under this Subsection: Provided, That the historical cost or adjusted basis of the real property sold or disposed shall be carried over to the new principal residence built or acquired: Provided, further, That the Commissioner shall have been duly notified by the taxpayer within thirty (30) days from the date of sale or disposition through a prescribed return of his intention to avail of the tax exemption herein mentioned: Provided, still further, That the said tax exemption can only be availed of once every ten (10) years: Provided, finally, That if there is no full utilization of the proceeds of sale or disposition, the portion of the gain presumed to have been realized from the sale or disposition shall be subject to capital gains tax. For this purpose, the gross selling price or fair market value at the time of sale, whichever is higher, shall be multiplied by a fraction which the unutilized amount bears to the gross selling price in order to determine the taxable portion and the tax prescribed under paragraph (1) of this Subsection shall be imposed thereon.

129. Ordaining and Instituting an Insurance Code of the Philippines [THE INSURANCE CODE], Presidential Decree No. 612, § 179 (1974) ("Life insurance is insurance on human lives and insurance appertaining thereto or connected therewith.").

Additionally, life insurance provides the capital which can be invested to support the widow and insure the educational needs of the children. In order that proceeds from life insurance will not form part of the estate at death, the beneficiaries of the life insurance should be irrevocably designated.[130] Life insurance policies are a legitimate means of passing on part of the decedent's property tax free, both to the decedent and to his beneficiary.

One of the changes in the NIRC is that the designation of the beneficiary in the policy is presumed to be revocable.[131] In view of this, the insured should specifically make sure that the beneficiaries in his policy are irrevocably designated

Incidentally, if it is believed that the beneficiaries of a decedent's life insurance will not have the expertise nor the inclination to manage the proceeds and invest them wisely, then a life insurance trust can be created whereby the proceeds will be managed by an experienced trustee in accordance with the decedent's wishes. The insurance trustee can be given specified instructions to purchase part of the estate to provide ready cash for the latter to meet its obligations. Moreover, the trustee can be directed to make distributions to the beneficiaries based on their standard of living considering other sources available.

An insurance trust also provides income tax advantages since the income can be split between the trust and the beneficiaries.

E. Family-Owned Corporations

1. Advantages and Disadvantages

Another popular tool in estate planning is the incorporation of a family-owned business. One of the advantages in establishing a corporation[132] is that the individual stockholders are taxed only on amounts that are

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130. *See* NIRC, § 85(E).

131. *See* LLAMADO JR., *supra* note 5, at 39.

132. The Corporation Code of the Philippines [CORPORATION CODE OF THE PHILIPPINES], Batas Pambansa Blg. 68, § 2. A corporation is defined as "an artificial being created by operation of law, having the right of succession and the powers, attributes and properties expressly authorized by law or incident to its existence."

distributed to them as dividends. Dividends can be properly programmed so that they are declared and spread over a number of years. They are taxable at the rate of 10 percent, which is a final tax.[133]

Another advantage of the family corporation is that it assures continuity of ownership in the hands of the children. Certain features of limiting ownership only to the members of the family can be adopted in the company's articles of incorporation. A major incentive to incorporate is that various tax benefits such as qualified pension, profit sharing plans and tax favored fringe benefits may be established for members of the family who will act as officers of the company. Caution must be exercised however, to avoid the application of the fringe benefits tax on these perquisites. Likewise, shares of stock are easier to distribute to the heirs unlike other properties which are not only difficult to divide, but may even give rise to jealousies among them.

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133. NIRC, §24(B)(2). The section provides:

> (2) Cash and/or Property Dividends. — A final tax at the following rates shall be imposed upon the cash and/or property dividends actually or constructively received by an individual from a domestic corporation or from a joint stock company, insurance or mutual fund companies and regional operating headquarters of multinational companies, or on the share of an individual in the distributable net income after tax of a partnership (except a general professional partnership) of which he is a partner, or on the share of an individual in the net income after tax of an association, a joint account, or a joint venture or consortium taxable as a corporation of which he is a member or co-venturer:
>
> Six percent (6%) beginning January 1, 1998;
>
> Eight percent (8%) beginning January 1, 1999;
>
> Ten percent (10%) beginning January 1, 2000.
>
> Provided, however, That the tax on dividends shall apply only on income earned on or after January 1, 1998. Income forming part of retained earnings as of December 31, 1997 shall not, even if declared or distributed on or after January 1, 1998, be subject to this tax.

The attractive feature of a corporation lies in the recognized limited liability of its stockholders whose exposure to risk is limited only to the extent of their subscriptions to the capital of the corporation.

One disadvantage of the corporate set-up is that there will be two tax consequences: one at the corporate level, and another at the shareholder's level, when dividends are declared (at ten percent).

2. Exchange of Property for Shares of Stock

The basic technique normally used in the incorporation of a family business is the exchange of property for shares of stock.[134] This

134. *Id.* § 40(c)(2). This section states:

> Section 40. Determination of Amount and Recognition of Gain or Loss.
>
> x x x
>
> (C) Exchange of Property. —
>
> (1) General Rule. — Except as herein provided, upon the sale or exchange of property, the entire amount of the gain or loss, as the case may be, shall be recognized.
>
> (2) Exception. — No gain or loss shall be recognized if in pursuance of a plan of merger or consolidation —
>
> (a) A corporation, which is a party to a merger or consolidation, exchanges property solely for stock in a corporation, which is a party to the merger or consolidation; or
>
> (b) A shareholder exchanges stock in a corporation, which is a party to the merger or consolidation, solely for the stock of another corporation also a party to the merger or consolidation; or
>
> (c) A security holder of a corporation, which is a party to the merger or consolidation, exchanges his securities in such corporation, solely for stock or securities in another corporation, a party to the merger or consolidation.
>
> 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 a corporation of which as a result of such exchange said person, alone or together with others, not exceeding four (4) persons, gains control of said

particular provision was first inserted in the NIRC in 1965 under Republic Act No. 4522[135] to encourage and facilitate the incorporation of family businesses.

This provision states that "no gains or loss will be recognized if a person transfers property to a corporation in exchange for stock if as a result of such exchange, such persons, alone or together with others not exceeding four persons, gains control of the corporation."[136] Control means ownership of stocks in a corporation possessing at least fifty percent of the total voting power of all classes of stocks entitled to vote.

With this provision, the exchange of property for stock is not considered a taxable event; instead, the tax is deferred to the time where the corporation sells the property or when the stockholders sell their shares of stock. This provision merely allows tax deferral and not truly an exemption since the basis for determining the gains or loss is not the transfer price between the corporation and the stockholders but the original basis of the property in the hands of the original owner or transferor, which is called the *substituted basis*.[137]

a) Steps after Incorporating a Family Corporation

After incorporation of the family-owned business it is expected that the parents will control the corporation while the children will hold minority position. Thus, the parents should adopt a program of gift-giving and/or sale of the majority ownership to their children, otherwise, shareholdings of the parents will still be includible in their gross estate.

As mentioned earlier, the cost of the shares is the original cost of the previously transferred property. However, if a sale of shares can be justified, the net gain or the sale thereof will be taxed at the rate of five

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corporation: Provided, That stocks issued for services shall not be considered as issued in return for property…

135. An Act Exempting from Determination of Gain or Loss any Exchange of Property for Stocks in Corporations under Certain Conditions, Amending for the Purpose Paragraphs Two, Three and Five, Subsection (C), Section Thirty-Five of National Internal Revenue Code, as Amended, Republic Act 4522 (1965).

136. NIRC, § 40(c)(2).

137. To reiterate, the effect, in reality, is a mere deferment of tax and not a tax-free exchange.

percent on the first P100,000 of net gain, and 10 percent on the excess.[138] These rates apply only with respect to shares of stock *not traded* in the stock exchange. Different rates apply in case the shares of stock are traded in the stock exchange.

Thus, the capital gains tax on the shares of stock which are *not listed or traded* in the stock exchange is a maximum rate of 10 percent, which is concededly lower than the maximum donor's tax rate of 15 percent.

3. Pitfalls of a Family Corporation

While the corporate set-up has a number of advantages, there are certain pitfalls that must be carefully considered.

a) Lock-in of the Asset

When the property is contributed as capital to the corporation, the asset now belongs to the corporation. The stockholders can only recover ownership if the property is distributed as *property* dividends,[139] taxed at 10 percent, or as *liquidating* dividends, which are also taxable.

b) Loss of capital gains tax exemption

If the asset is the principal residence of the taxpayer, the availment of the capital gains tax exemption on the sale thereof if the proceeds are reinvested in the acquisition or construction of another principal

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138. NIRC, § 24(C). The pertinent provision referred to is reproduced as follows:

> (C) Capital Gains from Sale of Shares of Stock not Traded in the Stock Exchange. — The provisions of Section 39(B) notwithstanding, a final tax at the rates prescribed below is hereby imposed upon the net capital gains realized during the taxable year from the sale, barter, exchange or other disposition of shares of stock in a domestic corporation, except shares sold, or disposed of through the stock exchange.
>
> Not over P100,000 5%
>
> On any amount in excess of P100,000 10%

139. *Id.* § 24(B)(2). The rate is 10%.

residence within 18 months, will be lost.[140] This exemption applies only to individual taxpayers.

c) Imposition of Improperly Accumulated Earnings Tax (IAET)

In addition to the corporate income tax, the NIRC imposes on the improperly accumulated taxable income[141] of each corporation a 10 percent improperly accumulated earnings tax (IAET).[142] This additional tax is imposed on every corporation formed or availed of for the purpose of avoiding the income of its shareholders by permitting earning to accumulate instead of being distributed.

The fact that any corporation is a mere holding company or investment company shall be *prima facie* evidence of a purpose to avoid the tax. Likewise, the fact that earnings of a corporation are permitted to accumulate beyond the reasonable needs of the business will be determinative of the purpose to avoid the tax on its stockholders unless the corporation proves the contrary.

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140. *Id.* § 24(D)(2).

141. *Id.* § 29(D) (Improperly accumulated taxable means taxable income adjusted by the following: income exempt from tax, income excluded from gross income, income subject to final tax, and the amount of net operating loss carry-over deducted; and reduced by the following: the sum of dividends actually or constructively paid, and income tax paid for the taxable year.).

142. *Id.* § 29(A).

> Section 29. Imposition of Improperly Accumulated Earnings Tax.
>
> (A) In General. — In addition to other taxes imposed by this Title, there is hereby imposed for each taxable year on the improperly accumulated taxable income of each corporation described in Subsection B hereof, an improperly accumulated earnings tax equal to ten percent (10%) of the improperly accumulated taxable income.

d) Tax Free Exchange *may* be Considered as "Deemed Sale" for VAT Purposes[143]

It is important to take into consideration Revenue Regulations No. 14-2005 (RR 14-2005),[144] which are the Implementing Regulations for the new Value Added Tax (VAT) law.[145] Under RR 14-2005, there is a provision which states that tax free exchange under Section 40(C)(2) of the NIRC will be considered as *deemed sale* for VAT purposes under Section 106(B)(4) of the NIRC, as amended by the new VAT law.[146]

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143. It must be stressed at the outset that as of this writing, the Implementing Regulations have not yet been implemented and are subject of a Temporary Restraining Order by the Supreme Court until the finality of the decision in the case *Abakada Guro Party List, et al. v. Executive Secretary Eduardo Ermita* (G.R. No. 168506, Sept. 1, 2005). These Implementing Regulations are currently being revised by the Department of Finance, thus the use of the word *may*. If these Implementing Regulations are implemented, tax free exchanges will be considered as *deemed sale* for Value Added Tax (VAT) purposes.

144. Consolidated Value-Added Tax Regulations of 2005, Revenue Regulations No. 14-2005 (2005) [RR 14-2005].

145. An Act Amending Sections 27, 28, 34, 106, 107, 108, 109, 120, 111, 112, 113, 114, 116, 117, 119, 121, 148, 151, 236, 237 and 288 of the National Internal Revenue Code of 1997, as Amended, and for Other Purposes, Republic Act No. 9337 (2004).

146. RR 14-2005, §§ 4.106 - 7, 4.016 - 8(B)(1). Section 4.106 - 7 provides:

> Section 4.106 - 7. Transactions Deemed Sale. –
>
> (a) The following transactions shall be "deemed sale: pursuant to Section 106(B) of the Tax Code:
>
> x x x
>
> (2) Retirement from or cessation of business with respect to all goods on hand…The following circumstances, shall, among others, give rise to transactions "deemed sale."
>
> x x x
>
> (i) Change of Ownership of the Business. There is a change of ownership of the business when a single proprietorship incorporates; or the proprietor of a single proprietorship sells his entire business.

Section 4.106 - 8(b)(1) provides that there is no output tax due in the case of change of control of a corporation by the acquisition by the controlling interest

Previously, Revenue Regulations No. 7-95[147] exempted from VAT the transfer of property to a corporation in exchange for its shares of stock under Sections 40(C)(2) and 6(C) of the NIRC.[148] Merger and consolidation continue, however, to be exempt under RR 14-2005.

As of this writing, RR 14-2005 is currently being revised by the Department of Finance. If these regulations are finally implemented, the result will be: in addition to the payment of donor's tax, there will be payment of VAT, which will be quite expensive.[149]

e) Donation *may* be Considered as Subject to VAT[150]

Furthermore, RR 14-2005 considers a donation of real estate properties primarily held for sale or held for lease as subject to VAT.[151] This is

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of such corporation by another stockholder or group of stockholders. However, *the exchange of real estate properties held for sale or for lease, for shares of stock, whether resulting to corporate control or not, is subject to VAT*.

147. *See* Consolidated Value-Added Tax Regulations, Revenue Regulations No. 7-95 (1995).

148. *See* RR 14-2005, § 4.100 – 5(b)(1).

149. The applicable donor's tax rates may either be: the maximum gift tax rate of 15% (on net gifts of more than P1,000,000), or the gift tax rate of 30% in the case of strangers.

150. *See supra* note 143, regarding comments on the regulations implementing the new VAT law.

151. RR 14-2005, § 4.106 -3. This provision states:

> Section 4.106 - 3. Sale of Real Properties. Sale of real properties primarily held for sale to customers or held for lease in the ordinary course of trade or business of the seller shall be subject to VAT.
>
> x x x
>
> Transmission of property to a trustee shall not be subject to VAT if the property is merely held in trust for the trustor and/or beneficiary.
>
> However, if the property transferred is one for sale, lease or use in the ordinary course of trade or business and the transfer constitutes a *completed gift*, the transfer is subject to VAT as a deemed sale transaction pursuant to Section 4.106 7(a)(1) of the Regulations. The transfer is a completed gift if the transferor diverts himself absolutely of control over the

interesting, as a donation is specifically defined as "an act of liberality whereby a person disposes *gratuitously* of a thing or right in favor of another, who accepts it."[152] In effect, the BIR is treating a gratuitous act as a sale.

CONCLUSION

The benefits and detriments of the various techniques vary greatly depending on the individual circumstances of the persons using them. Moreover, many individuals or families can benefit from the utilization of several techniques as part of an overall estate plan.

There is no right or wrong estate planning method or technique – the ultimate object is, always, to have some form of tax savings. For instance, if the asset is useful in a business operation (e.g. rows of apartments or buildings for lease), incorporating it for the benefit of the children in a tax-free exchange will be ideal. On the other hand, if the major asset of the estate owner consists of a residential property, selling the property as a capital asset will result in substantial tax savings. Later on, the estate owner can program his gifts to the heirs to minimize donor's taxes.

To determine the type of estate planning method that is most advantageous, an illustration will be of great assistance. With the illustration given below, based on certain minimum assumptions, and also from the study and discussion on estate and donor's tax, as well as the techniques in estate planning, it can readily be seen that the largest tax savings come from the sale of property as a capital asset. On the other hand, the least tax savings is in the case of a sale as an ordinary asset.

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property, i.e., irrevocable transfer of corpus and/or irrevocable designation of beneficiary. (*emphasis supplied*)

152. NEW CIVIL CODE, § 725.

ILLUSTRATION 2 – COMPARISON

Sale		*Estate Tax*	*Donor's Tax*	*Sale of Shares after Tax Free Exchange*[153]
As Ordinary Asset	*As Capital Asset*			
6% gross tax	5%-32% on net gain	5%-20% graduated rates	2%-15% graduated rates	5% on first P100,000, plus 10% on excess of net gain
Tax Due P600,000	Tax Due P3,165,000	Tax Due P1,215,000	Tax Due P1,004,000	Tax Due P995,000
	Assumption: No cost basis	Assumption: No deduction	Note: If donated at P5M each (spouses) Tax Due P808,000 (P404,000 x 2)	Assumption: No cost basis or other expenses of tax free exchange

153. Take note of the effect of the Implementing Regulations of the new VAT law as explained in this Article. The computation given here does not take into consideration the effects of VAT.