" MAPping the Future" Column in the INQUIRER – 16 March 2015

Understanding the PEACE Bond Decision

By: Benedicta Du-Baladad

The Supreme Court (SC) has finally spoken. The PEACE bonds are not deposit substitutes subject to the 20% final tax, therefore, the Bureau of Treasury (BTr) should immediately return to the investors the 20% final tax it withheld and deducted from the redemption value of the bond when it matured in 2011.

The SC anchored its decision on the fact that, upon origination, the bond was issued to only one buyer/lender, the CODE-NGO, and not to 20 or more lenders (the 20-lender rule) which is a requirement for a debt instrument to become a public borrowing making the instrument a deposit substitute subject to the 20% final tax. Well, tax experts and market players expected the decision to be along this line. But the Court did not stop there.

The SC injected a new doctrine as regards the reckoning point for the counting of the 20-lender rule. The phrase '*at any one time*' for purposes of counting the number of lenders (20-lender rule) in determining whether the debt instrument is a deposit substitute was interpreted by SC to mean <u>every transaction transacted in the primary or secondary market</u> in connection with the purchase and sale of securities. With this pronouncement, a debt instrument which is not originally a deposit substitute at origination can become one at any time during its term at the secondary market.

On this basis, the Court ruled that if CODE-NGO/RCBC Capital sold the bonds simultaneously (take note of the word 'simultaneous' which the Court kept repeating in its decision) to 20 or more lenders/investors, the PEACE bonds would have become a deposit substitute and CODE-NGO/RCBC Capital should have been liable to the 20% final tax on the interest/bond discount. The BIR can still run after CODE-NGO/RCBC Capital for the unpaid 20% final tax as the liability has not prescribed because there was omission to pay that justifies the application of a 10-year prescription to be counted from the discovery of omission.

To emphasize this new doctrine, the Court further said that the obligation to withhold the 20% final tax on the corresponding interest on the PEACE bonds would likewise be required of any lender/investor had the latter turned around and sold said PEACE bonds, whether in full or in part, simultaneously to 20 or more lenders or investors.

It used to be that the counting of lenders is reckoned only at the point of origination, the reason being, the act of lending happens only at that point when the owner of the bond raises funds to meet its financial needs. All subsequent transfers are just plain trading – it's the buying and selling of the instrument – but it is not anymore lending. The only exception is in the case of government issuances which are deemed issued to the public regardless of the number of lenders at origination. This is the very issue questioned in the PEACE bond case. Now that is abandoned in the PEACE bond case.

Under this new doctrine of the SC, the borrowing and lending happens throughout the life of the instrument. It introduced the concept of a *direct* and *semidirect* financing – *direct,* being at the origination and s*emidirect,* at the secondary trading when investors change money for the instrument with the holder still taking the borrower's risks. The SC took a totally new concept which is, - that the counting of the 20-lender rule is on "every transaction" executed in the primary and secondary market. It is on every transaction when funds are simultaneously obtained from the public.

In the case of government bonds, for example, the counting of the 20-lender rule happens at any transaction (note the phrase 'any transaction') in connection with the purchase and sale transactions, at any of the following: (1) issuance by the BTr of the bond to GSEDs in the primary market; (2) sale and distribution by GSEDs to various lenders/investors in the secondary market; (3) subsequent sale or trading by a bondholder to another lender/investor in the secondary market through a broker or dealer; (4) sale of a financial intermediary-bondholder of its participation interests in the bonds to individual or corporate lenders in the secondary market.

The Court said that when through any of the foregoing transactions, funds are simultaneously obtained from 20 or more lenders/investors, there is deemed to be a public borrowing and the bonds, at that point in time, are deemed deposit substitutes and the seller shall withhold the 20% final tax on the interest computed on the bonds.

The Court's decision, to some extent, is not so clear at some point with regard to its interpretation of '*at any one time'* for purposes of counting the 20-lender rule, hence, could be subject to different interpretation. Does it mean at any time there are a total of 20 holders regardless of whether investor is a primary or secondary holder? In short, is the counting of the 20-lender accumulated from primary to secondary? Or is it counted on a per transaction basis?

A reading of the entire decision points more to a counting on a 'per transaction' basis whether that transaction be at the primary or secondary market. This finds support from the repetitive use of the word '*every transaction'* and '*simultaneous borrowing*'. The Court also made itself clear when it said that 'the obligation to withhold the 20% final tax would likewise be

required of any lender or investor if the latter turned around and sold said PEACE bonds, in whole or in part, simultaneously to 20 or more lenders.

Applying the doctrine to the PEACE bond case

If we are to apply this new doctrine to the PEACE bond, clearly, there was no public borrowing at origination as there was only one lender, the CODE-NGO. At this point, the bond is not yet a deposit substitute and the BTr has no obligation to withhold the 20% final tax.

If subsequently, CODE-NGO or its underwriter RCBC Capital issues the bond to 20 or more lenders/investors, the bond becomes a public borrowing or deposit substitute in the hands of CODE-NGO/RCBC Capital and it is liable to pay the 20% final tax imposed on the present value of the discount/interest on the bonds in the amount of 24.83Billion. Under existing rules, the 20% final tax shall be based on the present value of the discount/interest at the time of sale or issuance (2001). In case of non-payment, additional penalty interest shall be imposed at the rate of 20% per annum computed from 2001 until paid, or a total of 13 years if paid this year.

As the tax on the total discount to be earned over the 10-year term of the bond is already paid upfront at this point, the instrument will be considered "tax paid" and the interest income earned by investors for the remaining life of the instrument shall no longer be subjected to tax. When these "tax paid" instruments are traded, the holders will just share the cost of the tax paid in proportion to the interest earned by them. Thus, had CODE-NGO known at that time when it sold the bonds that it is required to pay the 20% tax, it could have added the tax cost to the selling price of the bonds, collected it from the buyers, and remitted the same to the BIR.

If, on the other hand, CODE-NGO/RCBC Capital did not sell the bonds to 20 or more lenders/investors, then there is no obligation on its part to withhold the 20% final tax. The income from the bond earned or to be earned by subsequent shareholders shall remain to be taxable and to be reported in the tax return until such time that the instrument is converted to a deposit substitute by any subsequent holder who breaches the 20-lender rule.

What about the gain of 1.825Billion derived by CODE-NGO from the sale of the bonds? Since the instrument is a long-term instrument with a term of more than 5 years, the trading gain received is not subject to income tax, but the interest income component, if any, is subject to the ordinary corporate income tax of 30% based on net income.

Post Code-NGO, there are several scenarios that could have happened going forward. As this is a 10-year bond, there could have been several layers of trading transactions. Below are possible scenarios:

1. A buyer/investor of CODE-NGO (Investor A) subsequently sold his bondholding to 20 or more investors in the secondary market. - Investor

A is liable to withhold a 20% final tax on the present value of the remaining unaccreted discount as at the time of sale. All subsequent holders of the bond sold by this investor shall no longer be subject to tax on interest income earned as the instrument is already considered "tax paid".

2. On the hand, a buyer (Investor B) sold/traded the bond to less than 20 lenders/investors. - Investor B is not required to withhold the 20% final tax. Interest income earned by subsequent bondholders of Investor B shall be reported in the income tax return until such time that the 20-lender rule is breached by a subsequent holder.
3. One of the buyers is a bank (Investor C) and the bank sold his bond holdings to corporate and individual clients of the bank and the number exceeded 20. - The bank is required to pay the 20% final tax on the unaccreted discount. Exemption from tax may apply to individual clients if the instrument qualify as long-term instrument and the client held on to it for a period of not less than 5 years. Likewise, all the other requirements for tax exemption as required under existing regulations are met.
4. The buyer/investor held on to maturity. - The interest income earned is subject to regular income tax and to be reported in the income tax return. Any income from redemption is exempt from tax.

As can be seen in the above scenarios, if CODE-NGO did not sell to 20 or more lenders, subsequent holders of the bond may still be liable to the 20% final tax if at any point in time it was sold by the latter to 20 or more lenders. The banks which acquired the bonds from CODE-NGO may also be liable to the 20% final tax had they sold, in part or in full, their holdings to 20 or more clients, both individual and corporate.

The rule is, interest income or discount earned prior to the bond becoming a deposit substitute is an income subject to the corporate or individual income tax, depending on the status of the holder. When at any point during the term of the bond the 20-lender rule is breached and the bond becomes a deposit substitute, the seller shall withhold the 20% final tax on the present value of the remaining unaccreted discount. Henceforth, all subsequent holders of that bond on which the tax has been paid (tax paid) shall be exempt from tax on interest income earned from the bond.

Impact on the current practice

This new doctrine to include secondary trading and making every transaction as a reckoning point in determining the 20-lender rule may be faced with difficulties in terms of implementation such as tracking, pricing and etc.

As shown in the illustration above, the application of this doctrine will lead to a situation where a single bond issuance (perhaps with a single code identification) traded in the market can either be 'tax paid' or 'taxable'. Can the current market structure effectively track which are tax-paid vis-à-vis taxable? Will the pricing be the same? Will the infrastructure be able to determine at

what point and in whose hands in the secondary market the instrument became a deposit substitute?

Well, the doctrine in the PEACE bond case may be legal, but will it hold water when applied in real setting?

I would rather prefer the old rule that government issuances are deemed public borrowings subject to 20% final tax as long as its application is clear, feasible and consistent; it does not change midstream by mere whim of the regulators, and if ever these are changed, it applies prospectively.

(This article reflects the personal opinion of the author and does not reflect the official stand of the Management Association of the Philippines. The author is the Governor-in-Charge of the MAP Tax Committee, and the Managing Partner and CEO of the Du-Baladad and Associates [BDB Law]. Feedback at map@map.org.ph and dick.du-baladad@bdblaw.com.ph. For previous articles, please visit <map.org.ph>)