



Republic of the Philippines
DEPARTMENT OF FINANCE

Roxas Boulevard Corner Pablo Ocampo, Sr. Street
Manila 1004

10 October 2011

ROBERTO B. TAN

Treasurer of the Philippines
Bureau of the Treasury
Palacio del Gobernador
Gen. Luna cor. A. Soriano Ave.,
Intramuros, Manila 1002

Re: **BIR Ruling No. 370-2011 dated 7 October 2011**

Dear Treasurer Tan,

Attached is a copy of the above captioned ruling of the Bureau of Internal Revenue on the appropriate tax treatment of the discount or interest income arising from the P35 billion worth of 10-year zero coupon treasury bonds issued by the Bureau of Treasury ("BTr") on 18 October 2001 (also known as the "Poverty Eradication and Alleviation Certificates" or the "PEACe Bonds") which are set to mature on 18 October 2011.

The ruling states in part that "[t]he Php 24.3 billion discount on the issuance of the PEACe Bonds should be subject to 20% Final Tax on interest income from deposit substitutes," as provided in Section 27(D)(1) of the Tax Code of 1997. The ruling further states that:

"In view thereof, BTr shall withhold the Final Tax due on interest income derived from the PEACe Bonds prior to its payment on the date of maturity."

For your immediate and appropriate action. Thank you.

Very truly yours,

A handwritten signature in black ink, appearing to read "Cesar V. Purisima", is written over a circular stamp.

CESAR V. PURISIMA
Secretary of Finance

Cc:

Kim S. Jacinto-Henares
Commissioner of Internal Revenue



REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

DEPARTMENT OF FINANCE
Republic of the Philippines



Sections 22(Y) and 27(D) of
the Tax Code of 1997

BIR Ruling No. [DA-007-04]
BIR Ruling No. [DA-491-04]
BIR Ruling No. 008-05

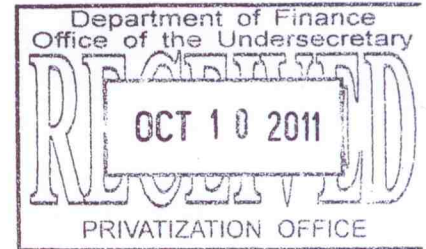
#370-2011

October 7, 2011

Date

DEPARTMENT OF FINANCE
DOF Building, BSP Complex
Roxas Blvd., 1004
Manila

Attention : Hon. Cesar V. Purisima
Secretary of Finance



Gentlemen:

This refers to your letter dated September, 2011 requesting for the proper tax treatment of the discount or interest income arising from the Php 35 billion worth of 10-year zero coupon treasury bonds issued by the Bureau of Treasury (“BTr”) on October 18, 2001 (hereinafter referred to as the “**Poverty Eradication and Alleviation Certificates**” or the “**PEACe Bonds**”).

It is represented that the issuance of the PEACe Bonds by the BTr stemmed from the proposal of the Caucus of Development NGO Networks (“**CODE-NGO**”) sometime in March 2001 for the Department of Finance (“**DOF**”) to issue Php15 billion worth of 10-year zero coupon treasury notes. Under the said proposal, CODE-NGO will purchase the notes and sell them to investors. The net proceeds from the sale of the notes, which were estimated at Php 1.45 billion, will be used by CODE-NGO to establish a fund that will finance anti-poverty projects of non-government organizations (“**NGOs**”) nationwide.

However, the original plan of CODE-NGO did not materialize because the BTr, under the leadership of then Treasurer Eduardo Sergio Edeza, questioned the propriety of issuing the bonds directly to CODE-NGO considering that the latter was not a Government Securities Eligible Dealer (“**GSED**”). Former Treasurer Edeza recommended that the issuance of the bonds be done through an auction and that CODE-NGO should get a GSED to make a tender on its behalf.

Accordingly, on October 16, 2001, the BTr sold the PEACe Bonds via auction to eligible GSEDs. The terms of the issuance of the subject bonds are as follows:

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Authorized Amount	:	Up to Php 50.0 Billion
Minimum Offered Amount	:	Php 30 billion
Issue Price	:	At a Discount
Term	:	Ten (10) years
Redemption	:	In one lump sum at maturity date of the Issue (<i>i.e.</i> October 18, 2011)
Yield to Maturity	:	Market determined
Form	:	Uncertificated, to be registered with the Registry of Scripless Securities
Taxation	:	Not subject to 20% withholding tax as the issue will be limited to a maximum of 19 ⁵ lenders in the primary market (pursuant to BIR Ruling No. 020-2001 dated May 31, 2001)
Eligibilities	:	Eligible as liquidity reserves (Pursuant to MB Resolution No. 1545 dated September 27, 2001)
Security of Issue	:	Direct, unconditional and general obligations of the National Government
Firms Eligible	:	Government Securities Eligible Dealers (GSEDs) and any Financial Institutions (as provided under Sec. 36 of Department of Finance Order (DOF) No. 141-95, as amended)

With regard to the taxation of the discount or interest income realized from the issuance of the PEACe Bonds, the BTr specified in the Public Offering of Treasury Bonds that "...the issue being limited to 19 lenders and while taxable shall not be subject to 20% final withholding tax."¹

The foregoing tax treatment of the interest income arising from the PEACe Bonds was based on three (3) BIR Rulings issued shortly before the auction ("**2001 Rulings**"), which provides:

1. BIR Ruling No. 020-2001 dated May 31, 2001 –

In response to the request of the CODE-NGO and considering that the PEACe Bonds were proposed to be issued to a single entity (therefore complying with the "19-Lender Rule"), the said Bonds were not considered to be a "public" borrowing, the PEACe Bonds are not considered "deposit substitutes", as defined under Section 22 (Y) of the 1997 Tax Code. Hence, it was resolved that the interest income arising from the PEACe Bonds is not subject to the 20% final withholding tax, to wit:

"As defined in Section 22(Y) of the 1997 Tax Code, to wit:

The term "deposit substitutes" shall mean an alternative form of obtaining funds from the Public (the term 'public' means the borrowing from twenty (20) or more individual or corporate lenders at any one time), other than deposits, through the issuance, endorsement, or acceptance of debt instruments for the borrower's own account, for the purpose of relending or purchasing or receivables and other obligations, or financing their own needs or the needs of

¹ BTr Memorandum to all GSEDs dated October 9, 2001

their agents or dealer. These instruments may include, but need not be limited to banker's acceptances, promissory notes, repurchase agreements, including reverse repurchase agreements entered into by and between the Bangko Sentral ng Pilipinas (BSP) and any authorized agent bank, certificates of assignment or participation and similar instruments with recourse: Provided, however, That debt instruments issued for interbank call loans with maturity of not more than five (5) days to cover deficiency in reserves against deposit liabilities, including those between or among banks and quasi-banks, shall not be considered as deposit substitute debt instruments.

Thus, to be classified as "deposit substitutes", the borrowing of funds must be obtained from twenty (20) or more individuals or corporate lenders at any one time. In the light of your representation that the PEACe Bonds will be issued only to one entity, i.e., Code NGO, the same shall not be considered as "deposit substitutes" falling within the purview of the above definition. Hence, the withholding tax on deposit substitutes will not apply."

2. BIR Ruling No. 035-2001 dated August 16, 2001 –

In connection with the request of BTr seeking further clarification on BIR Ruling No. 020-2001 dated May 31, 2001 relative to the meaning of the word "public", particularly on the interpretation of the phrase "at any one time", Section 22(Y) of the 1997 Tax Code, this Office resolved as follows:

"1. In connection with your query as to the meaning of the word "public", particularly on the interpretation of the phrase "at any one time", Section 22(Y) of the 1997 Tax Code defines the term "public" in relation to "deposit substitutes", as "borrowing from twenty (20) or more individual or corporate lenders at any one time".

It should be noted that **at the time of issuance or origination of the PEACe Bonds, there is no borrowing from the public, since the bonds are-being issued only to one entity, that is, RCBC.** It has been the practice of the BSP that debt instruments and certificates are being issued only to banks and/or financial institutions.

You also wish to know whether the phrase 'at any one time' in respect to borrowing from the 'public' may refer to single borrowing only, e.g., time of origination only, or one series or tranche, i.e., sale to secondary market; and that in any case, whether the number of would-be holders shall be the factor in determining whether or not the bonds or certificates of indebtedness are to be considered "deposit substitutes".

In this particular instance, **the phrase 'at any one time' covers only the origination or original issuance of the bonds regardless of whether sale or trading is made in the secondary market. Thus, in the case of PEACe Bonds, the determining factor in ascertaining whether such bonds are 'deposit substitutes', is the fact of their original issuance to a single entity, RCBC.**

The flowchart attached to your letter shows that RCBC will sell the bonds to CODE-NGO, which will then sell bonds to RCBC Capital as underwriter. In this regard, it should be noted that CODE-NGO cannot acquire the bonds directly, not being an accredited government securities dealer, hence, the original purchase by RCBC, and subsequent sale of the same bonds to CODE-NGO. RCBC Capital, on the other hand, purchases the bonds for its own account, and not for the account, or as agent of, any other buyer. **Under these circumstances, it is clear that the bonds are issued to a single entity, whether such entity be RCBC, CODE-NGO or RCBC Capital. In this regard, a representation or warranty should be made to the effect that the bonds are acquired upon their original issuance by the original purchaser thereof, for and on its own behalf, or on behalf of a single purchaser only, and in the latter case, that the purchaser is acquiring such bonds for its own account and not for the account of other entities.** (Emphasis provided)

3. BIR Ruling No. [DA-175-01] dated September 29, 2001 –

In relation to the subsequent request of BTr for clarification on the application of BIR Ruling No. 020-2001 dated May 31, 2001 and BIR Ruling No. 035-2001 dated August 16, 2001 to other cases of issuances or only to the proposed issuance of the PEACe Bonds, this Office ruled, viz:

"We hereby confirm the foregoing rulings, after taking into account the above-stated features of the proposed PEACe bond issuance:

I. As defined in Section 22(Y) of the 1997 Tax Code, the term "deposit substitutes" as an alternative form of obtaining funds from the "public" requires that the borrowing must be made from twenty (20) or more individual or corporate lenders at any one time. **Corollarily, if the proposed PEACe Bonds are issued to less than twenty (20) individual or corporate lenders, the borrowing shall not be considered as "public" borrowing. Hence, the instrument shall not be classified as "deposit substitutes".**

II. In connection with your query as to the meaning of the phrase "at any one time" as an element of public borrowing in order that the same may be considered as "deposit substitutes", we hereby reiterate that **the phrase 'at any one time' covers only the origination or original issuance of the bonds regardless of whether sale or trading is made in the secondary market.**

However, in the case of PEACe Bonds, since the determining factor in ascertaining whether or not such bonds are 'deposit substitutes' is the original issuance to more than twenty (20) individual or corporate lenders, it holds to say that the issuance to less than 20 individual or corporate lenders will necessarily exclude them from the coverage of "deposit substitutes". Such being the case, the time element, i.e., "at any one time" required in "public borrowing" shall not apply in the instant case."

During the auction, RCBC was declared as the winning bidder having tendered the lowest bid interest rate of 12.75% for a total face value of Php 35 billion. Thus, the BTr issued the PEACe Bonds to

RCBC and latter paid BTr approximately Php 10.7 billion for Php 35 billion worth of treasury bonds, thus resulting in a discount of approximately Php 24.3 billion.

It appears from their later public statements that RCBC then sold the PEACe Bonds to CODE-NGO. The latter, in turn, sold the bonds to RCBC Capital for approximately Php 12.1 billion, thereby realizing a "gain" of approximately Php 1.4 billion.

About three years after the issuance of the PEACe Bonds, **BIR Ruling No. 007-04** dated July 16, 2004 was issued in response to the request for confirmation of the BTr on the tax consequences of its regular and special issuance of treasury bills and bonds, thereby reversing the 2001 Rulings, to wit:

"In previous BIR rulings issued to BTR, this Office had enunciated the rule that to be able to determine whether the financial assets, i.e., debt instruments and securities are deposit substitutes, the "20 or more individual or corporate lenders" rule must apply. Moreover, the determination of the phrase "at any one time" for purposes of determining the "20 or more lenders" is determined at the time of the original issuance. This has been so on the basis of the fact that it is on the original issuance that the act of lending is done.

Moreover, since the financial assets involved are basically debt instruments and government securities, and usually traded in the debt market, the reckoning time of determining the 20 lenders is done in the primary market considering that it is the time when the issuer "sells" the new financial asset to the public. In effect, it is the time, the borrower is said to "issue" the financial asset. After a certain period of time, the financial asset is bought or sold (i.e., exchanged or traded) among investors. The market where the activity takes place is referred to as the secondary market. (See page 11, Chapter I of Capital Markets — Institutions and Instruments, Third Edition by Frank J. Fabozzi and Franco Modigliani). Thus, it has been concluded that the time element "at any one time" is deemed to be reckoned when the borrowing or "issuance" is done in the primary market. Subsequent trading among investors in the secondary market is merely an act of buying and selling and not borrowing in nature. This therefore, removed the secondary market from the very act of borrowing or lending itself, as a necessary element required by the term "deposit substitutes".

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*Significantly, we have noted BTR's contention and position on the matter. In short, as we understand from the discussion we had with the representative of the BTR, **since the object of the issuance is to obtain the required government funding, the issuance and subsequent distribution (exchange and trading) of Government debt instruments and securities in the secondary market to other market participants, specifically, the investors, is in itself a public borrowing of the government. The financial assets (i.e., debt instruments and securities) in the hands of the investors represent a claim to future cash for which the borrowing entity, at maturity date, must have to pay. It is, however, in the secondary market that the investing public make the indirect investment in the borrowing entity, in this case, the Government.***

*In view of the foregoing, this Office opines and so rules that **mere issuance of government debt instruments and securities is deemed as falling within the coverage of "deposit substitutes" irrespective of the number of lenders at the time of origination. Accordingly, since government debt instruments and securities are not exempt from taxes, interest income derived therefrom shall be subject to the following:***

