Technical Report

Policy Review of Financial Sector Taxation

by Zambrano & Gruba Law Office

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Preface

This report is the result of technical assistance provided by the Economic Modernization through Efficient Reforms and Governance Enhancement (EMERGE) Activity, under contract with the CARANA Corporation, Nathan Associates Inc. and The Peoples Group (TRG) to the United States Agency for International Development, Manila, Philippines (USAID/Philippines) (Contract No. AFP-I-00-00-03-00020 Delivery Order 800). The EMERGE Activity is intended to contribute towards the Government of the Republic of the Philippines (GRP) Medium Term Philippine Development Plan (MTPDP) and USAID/Philippines' Strategic Objective 2, "Investment Climate Less Constrained by Corruption and Poor Governance." The purpose of the activity is to provide technical assistance to support economic policy reforms that will cause sustainable economic growth and enhance the competitiveness of the Philippine economy by augmenting the efforts of Philippine pro-reform partners and stakeholders.

This technical report was written by the Zambrano & Gruba Law Office following its study of financial sector taxation in the Philippines. The study team was led by Atty. Lily K. Gruba, a managing partner of the firm. It was requested by Mr. Romeo L. Bernardo, Chairman, Capital Market Development Committee of the Financial Executives Institute of the Philippines (FINEX), in a letter dated April 27, 2005, and by Dr. Conchita L. Manabat, Chairperson, Capital Market Development Council, in a letter dated May 25, 2005.

The views expressed and opinions contained in this publication are those of the authors and are not necessarily those of USAID, the GRP, EMERGE or its head offices.

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Acronym Guide

BAP	Bankers Association of the Philippines
BIR	Bureau of Internal Revenue
BOI	Board of Investments
BSP	Bangko Sentral ng Pilipinas
CGT	Capital Gains Tax
CMDC	Capital Market Development Council
CTA	Court of Tax Appeals
CTF	Common Trust Fund
CWT	Creditable Withholding Tax
DOF	Department of Finance
DST	Documentary Stamp Tax
EWT	Expanded Withholding Tax
FCDU	Foreign Currency Deposit Unit
FINEX	Financial Executive Institute of the Philippines
FWT	Final Withholding Tax
GRT	Gross Receipts Tax
IC	Insurance Commission
ICAP	Investment Company Association of the Philippines
IHAP	Investment House Association of the Philippines
NIRC	National Internal Revenue Code
OBU	Offshore Banking Unit
PD	Presidential Decree
PFA	Philippine Finance Association
PIRA	Philippine Insurers and Reinsurers Association
PLIA	Philippine Life Insurance Association
PSE	Philippine Stock Exchange
RA	Republic Act
RMC	Revenue Memorandum Circular
RMO	Revenue Memorandum Order
RR	Revenue Regulations
SEC	Securities and Exchange Commission
SRC	Securities Regulation Code
STT	Stock Transaction Tax
UIT Fund	Unit Investment Trust Fund
VAT	Value-Added Tax

Executive Summary

Introduction

(1) The overall objective of the policy review of the Philippine financial sector taxation is to recommend a tax-neutral financial market. The first module of the study sketches the landscape as it is tasked to: (a) review all major tax-related issues in the bank and non-bank sectors; (b) identify instances of tax arbitrage; (c) recommend possible changes to improve tax neutrality. Future modules are envisioned to focus on fiscal policy/economic analysis.

(2) The report begins with the generally accepted fundamental principles of a sound tax policy (i.e., simplicity, neutrality and fairness) and an overview of the Philippine taxation laws pertaining to the financial sector. It then unfolds in four parts. The first part inventories the prevailing tax treatment of the institutions comprising the Philippine financial sector, namely, the banks, insurance companies, investment houses, pre-need companies, securities dealers and brokers, finance companies, and mutual funds. The second part surfaces the major tax-related issues or concerns of the financial sector. These issues are classified as either cross-sectoral or sector-specific. The third part surveys the prevailing tax treatment of the financial sector in Hong Kong, Thailand and Singapore. The final part gives recommendations geared to address the arbitrage situations from the legal perspective, citing, where appropriate, the practice in these foreign jurisdictions. Also, it determines whether the tax issues raised by the various players of the Philippine financial sector can be addressed administratively or through legislation.

(3) Financial sector taxation is seen as aiming to promote the development of the capital market by mobilizing savings, to promote the development and trading of financial instruments, and to ensure that the financial sector bears an equitable share in the total tax burden. In this context, tax neutrality means equivalent taxation of equivalent financial transactions such that taxation does not distort the pattern of financial transactions that investors choose to undertake. The lack or absence of neutrality spawns tax arbitrage: the unequal taxation of equivalent transactions distorts investment decisions by giving primacy to tax considerations and gives competitive advantage to the sector favored by the unequal tax treatment.

Cross-Sectoral Tax Issues

(4) Classified as cross-sectoral tax issues are the incidence of tax arbitrage and the shifting interpretation of relevant tax laws. Tax arbitrage potentially exists in the following:

(a) 20% Final Withholding Tax Exemption

(5) The interest income derived by individuals (resident, resident alien, nonresident alien engaged in trade or business in the Philippines) from long-term bank deposit or bank-issued investment certificates is exempt from the 20% final tax. For non-bank financial institutions, the NIRC exempts from income tax the *gains* from sale, exchange or retirement of certificates of indebtedness with maturity of more than five (5) years. The *Nippon Life* case held that the term *gains* exclude *interest*. Thus, interest income from long-term certificates of indebtedness issued by non-bank financial institutions to individuals is subject to 20% final tax.

(6) Similarly, investments in long-term insurance products are not exempt from the 20% final tax.

(b) Trust Accounts

(7) Interest income from common or individual trust funds where the trustee is a bank is exempt from the 20% final withholding tax (FWT). Where the trustee in a common trust fund is an Investment Houses with trust license, interest income is subject to 20% FWT.

(8) The interest income derived by a pre-need company's trust fund from long-term investments is not exempt from the 20% FWT.

(c) Preferential Tax Treatment of Expanded Foreign Currency Deposit System

(9) Interest income derived by individuals (citizens and resident aliens), domestic and resident foreign corporations from a bank under the expanded foreign currency deposit system is subject to 7.5% final tax. Also, interest income from foreign currency loans granted by banks under the expanded system to residents (other than offshore units in the Philippines and other depositary banks under the system) is subject to 10% final tax. Any income of nonresidents from transactions with banks under the expanded system is exempt from income tax.

(10) This preferential income tax treatment fuels the migration of funds from peso-denominated investment products to foreign currency bank deposits.

(d) Retirement Plan

(11) Retirement plans administered by trust departments of banks and employee trust fund covered by a trust agreement with banks are exempt from income tax.

(12) Life insurance companies are permitted to administer retirement funds under a Deposit Administration Contract, but the income generated therefrom is subject to income tax. Similarly situated are pre-need companies vis-à-vis their pension plans. Extending the exemption to life insurance and pre-need companies requires that they be permitted to act as trustees of private benefit retirement plans.

(e) Educational Plan

(13) Pre-need companies are subject to value added tax (VAT). As such, the premiums on pre-need education plans are subject to the 12% VAT. On the other hand, educational plans offered by life insurance companies are subject to the 5% premium tax.

(14) The other area of cross-sectoral tax issues concerns the shifts in the interpretation of tax laws that impact on the financial sector. These notably include the following:

(a) 19-lender rule

(15) The definition of *deposit substitutes* refers to the term *public*, which means borrowing from twenty (20) or more individuals or corporate lenders at any one time. Interest income from deposit substitutes is subject to FWT.

(16) BIR Ruling No. 020-01 confirmed that the issuance of government debt instruments and securities to a single entity does not constitute borrowing from the public such that such instruments and securities are not deemed as deposit substitutes. This position was superseded by BIR Ruling No. 007-04. It ruled that mere issuance of government debt instruments and securities falls within the scope of *deposit substitutes* regardless of the number of lenders at the time of origination. Both the issuance and subsequent distribution in the secondary market constitute public borrowing of the government. As such, interest income from such government instruments and securities is subject to FWT.

(b) Determining the tax base for GRT

(17) The issue is whether the withholding tax portion on interest income forms part of gross receipts in computing the gross receipts tax (GRT). From 1952 to 1996, the Board of Tax Appeals ruling in the *National City Bank* case prevailed: the term *gross receipts* means the whole amount received as interest without deductions. In 1996, the Court of Tax Appeals (CTA) held in the *Asian Bank* case that the FWT on bank's passive interest income does not form part of its taxable gross receipts. In 1999, the Court of Appeals reversed the CTA's *Asian Bank* ruling, holding that the gross interest income earned, without deductions, is the proper GRT tax base. In

2003, the Supreme Court held in the *China Bank* case that the withholding tax portion on interest income forms part of gross receipts in computing GRT.

Sector-Specific Tax Issues

Banks

(18) The banking sector advocates for rationalizing the tax treatment of financial institutions and instruments, and the tax administration in the financial sector. Its specific issues include the tax treatment of deposit substitutes, the creditable withholding tax (CWT) and the documentary stamp tax (DST). As regards deposit substitutes, the sector posits that banks are active income earners such that income from deposit substitutes should be subject to the regular income tax in lieu of the present 20% FWT. On a related matter, the sector proposes that definition of *public* be confined to lenders who are passive income earners thereby active lenders such as banks and non-bank financial institutions would be deemed as non-public. Finally, the sector suggests the exclusion of reverse repurchase agreements from the definition of *deposit substitutes*. With respect to the CWT on financial services, the sector contends that this tax imposes administrative difficulties to all parties concerned, raises equity issues in view of the inability to utilize the CWT, and shifts the credit risk of the BIR from the banks to their clients, who generally have a higher credit risk. As for the DST, the sector argues that imposing DST on electronic documents will discourage the use of electronic means in financial transactions such as remittances. Further, the sector views the DST on the acceptance or payment of any bill of exchange or order for payment of money drawn in a foreign country but payable in the Philippines as discouraging investment.

Insurance

(19) The cross-sectoral tax issues affecting the life insurance sector pertain to the non-exemption of long-term insurance products from the FWT and of the retirement plans administered by life insurance companies from income tax. The sector's specific tax concern centers on the BIR's interpretation of RA No. 9243 that DST on life insurance policies is due every time the corresponding premium is collected. In addition, the sector contests the assessment of deficiency DST prior to RA No. 9243, which is based on the *Lincoln Life* ruling that for DST purposes the amount insured by the policy at the time of issuance includes future increases pursuant to an "automatic increase clause." For its part, the non-life insurance sector assails the imposition of the VAT on reinsurance premiums and commissions on the primary ground that there is no taxable sale of goods or services in reinsurance transactions but merely a distribution of risk

arising from an existing policy. As regards the DST, the non-life insurance sector advocates for a lowered rate for its policies in order to be competitive with its foreign counterparts, proposes that the computation of the tax base revert from *gross premiums* to *net premiums*, and suggests the lengthening of the imprinting period to conform to the 90-day cycle for premium payments observed in the industry. Finally, the sector requests for the issuance of the relevant rules for the account classification that is apt for the non-life insurance business in connection with the minimum corporate income tax.

Investment House

(20) The investment houses sector raises the cross-sectoral issues on the tax advantage afforded to long-term bank investment products as opposed to long-term certificates of indebtedness of all other non-bank financial institutions. The sector offers two options to equalize the situation: either by extending the exemption from the 20% FWT to the non-bank sector or removing the exemption granted to banks. It also raises the cross-sectoral issue on the preferential tax treatment of the expanded foreign currency deposit system. In addition to these concerns, the sector raises the issue of "double taxation" of repurchase facilities, which the BIR treats as collateralized borrowing transaction or deposit. This treatment further compounds the weak secondary capital market in the Philippines.

Pre-Need

(21) Apart from the issue that income from the long-term investment of a pre-need company's trust fund is subject to the 20% FWT and that pre-need companies be permitted to act as trustee of private retirement benefit plans, the pre-need sector is concerned with the computation of the tax base for the VAT. The issue is whether a pre-need company's mandatory contributions to the trust fund may be deducted from the applicable tax base. While the deduction was clearly permitted under the previous law on the VAT, the advent of RA No. 9337 and its accompanying regulations muddled the clarity such that there is room to interpret that the deduction is disallowed. Sustaining such interpretation could redound to the pre-need plan holders shouldering the burden of the VAT.

Securities Dealers & Brokers

(22) For the securities dealer and brokers sector, a key concern is to address the high transaction cost in the stock exchange, which to a large extent can be attributed to the stock transaction tax, the VAT on stockbrokering services and the impending expiration of the exemption of stock exchange transactions from DST. The sector is also concerned with the assessment of deficiency DST on brokers even for dealer or house accounts and on

sales transaction in the stock exchange where the counter-party is an entity exempt from DST, e.g. GSIS, SSS. The IPO tax is viewed by the sector as adversely affecting the decision of corporations to go public. Finally, the sector pushes for the establishment of real estate investment trust in the country.

Financing Companies

(23) The financing companies sector advocates for the uniform tax treatment of leases. It thus proposes that financial lease and operating lease by financing companies be excluded from the coverage of the GRT and instead be subject to the VAT. This change in tax treatment will (a) place financial leasing on equal footing with loans, where the borrower is allowed to take the input VAT credit upon purchase of the asset, and (b) place operating lease on equal footing with lease by non-financing company-lessors which is subject to VAT. Further, the present GRT base of gross rentals for operating lease (vs. interest income alone for financial lease) effectively taxes the principal. The sector also pushes for the exclusion of the financial lease and operating lease from the coverage of the CWT on the ground that financing companies are more reliable tax payors than their clients and the inability to avail of the CWT due to the thin spreads of financing companies. Finally, the sector suggests amendments to RA No. 8556 in the following aspects: updating the definition of *financial lease* to conform to international accounting standards; extending the incentives accorded to finance lease under section 10 to operating lease (apart from issuing specific guidelines to implement this provision for financial lease); and permitting the option to purchase the leased asset in a financial lease.

Mutual Funds

(24) The mutual fund sector treats the unit investment trust fund (UITF) as clearly distinguishable from mutual fund products. As per the directive of the Bangko Sentral ng Pilipinas, the UITF shall not include long term funds designed to avail of the exemption from the 20% FWT. As such, the tax incentive granted to long-term common trust funds does not apply to UITFs. Also, the sector views the DST as a recurring tax burden that erodes the yield of the funds when the holding period is less than one year.

Overview of Financial Sector Taxation in Hong Kong, Thailand and Singapore

(25) Annexed to the report is a discussion of the financial sector tax system implemented in Hong Kong, Thailand and Singapore. The taxes that impact on the financial sector of these jurisdictions are described in the succeeding paragraphs.

Hong Kong

(26) Under the **Profits Tax**, persons, including corporations, partnerships, trustees and bodies of persons carrying on any trade, profession or business in Hong Kong are chargeable to tax on all profits (excluding profits arising from the sale of capital assets) arising in or derived from Hong Kong from such trade, profession or business. The Profits Tax is charged on the assessable profits for a year of assessment. *Assessable profits* are the net profits (other than profits arising from the sale of capital assets) for the basis period, arising in or derived from Hong Kong. The Profits Tax rate is 17.5% for incorporated business and 16% for unincorporated business.

(27) **Stamp Duty** is chargeable on certain documents specified in the Stamp Duty Ordinance which imposes a fixed duty on some documents and an ad valorem duty on others. Fixed duties vary from HKD3.00 to HKD100.00. Ad valorem duties range from 0.3% to 3.75%.

Thailand

(28) **Personal Income Tax** (PIT) is a direct tax levied on the income of a person. Income chargeable to the PIT is called “assessable income,” which covers income both in cash and in kind. The tax rate is progressive, ranging from 5% to 37%.

(29) **Corporate Income Tax** (CIT) is a direct tax levied on a juristic company or partnership which is established under Thai or foreign law and carries on business in Thailand or derives certain types of income from Thailand. The CIT rate varies depending on the type of taxpayer ranging from 2% to 30%.

(30) **Value Added Tax** is an indirect tax imposed on the value added of each stage of production and distribution. Any person or entity who regularly supplies goods or provides services in Thailand and has an annual turnover exceeding 1.8 million Baht is subject to VAT in Thailand. The VAT rate is 7%.

(31) **Specific Business Tax** (SBT) is an indirect tax imposed on certain businesses that are excluded from VAT coverage. These businesses include: (a) Banking, Finance and similar businesses; (b) Life Insurance; (c) Pawn Brokerage; (d) Real Estate; and (e) any other business specified by the Royal Decree, i.e., business engaged in repurchasing agreement and factoring. The SBT rate is 2.5% or 3%.

(32) **Stamp Duty** is a tax on instruments listed in the stamp duty schedule under the Thai Revenue Code.

Singapore

(33) Singapore's **Individual Income Tax**, like Thailand's Personal Income Tax, is a direct tax on the income of individuals. The IIT rate ranges from 0% to 21%.

(34) Under the **Corporate Income Tax**, a company will be taxed on any income accruing in or derived from Singapore or received in Singapore from outside Singapore, regardless of the company's tax residence status in Singapore. Starting 2005, a company is charged a flat Corporate Income Tax rate of 20% on its chargeable income.

(35) The **Goods and Services Tax** (GST) is a tax on domestic consumption. It is levied on: (a) goods and services supplied in Singapore by any taxable person in the course or furtherance of a business; and (b) goods imported into Singapore by any person. The GST is akin to the VAT. The Goods and Services Act specifies certain financial services as GST-exempt. The GST rate is 5%.

(36) **Stamp Duty** is a tax on commercial and legal documents that record and give effect to certain transactions. It is payable only on documents relating to immovable property, stocks and shares as these are enumerated in the First Schedule to the Stamp Duties Act.

Cross-Country Comparison of Tax Treatment: Significant Observations

(37) The study highlights the prevailing tax treatment of key financial sector transactions, products or undertakings in the different jurisdictions by drawing up matrices reflecting how these transactions are taxed. The significant observations from this exercise are summed up as follows:

(38) *Bank Deposits*. The Philippines make a distinction between peso-denominated and foreign currency-denominated bank deposits in imposing income tax on interest income, with the latter enjoying a concessionary rate. In the three foreign jurisdictions, a uniform income tax treatment applies to bank deposits, regardless of the currency in which

these are held. Also, in these foreign jurisdictions, income tax exemption, at varying degrees, is afforded the taxpayer-depositor. The narrow scope of the Stamp Duty in both Singapore and Hong Kong further reduces the tax exposure of the transaction. In contrast, ad valorem DST is imposed on time deposits in the Philippines, while a fixed Stamp Duty applies to all kinds of interest-bearing bank deposits in Thailand.

(39) *Debt instrument, bonds, debentures, certificates of indebtedness*. In the Philippines, the treatment of interest income derived by individuals from debt instruments varies depending on the maturity period and whether the issuer is a bank or a non-bank financial institution—i.e., long-term instruments issued by banks are eligible for income tax exemption, which entitlement does not equally apply where the issuer is a non-bank entity. In the foreign jurisdictions, no similar distinction prevails. In Hong Kong, exemption from Profits Tax or a concessionary Profits Tax rate applies to interest and gains derived from debt instruments depending on the maturity and holding period. In Singapore, outright IIT exemption is given while a concessionary CIT rate is applied. No DST or Stamp Duty is imposed in Singapore and Hong Kong.

(40) *Collective Investment Schemes.* The Philippines gives preferential income tax treatment on interest income derived from common trust funds where the trustee is bank over that of a non-bank trustee. In all four jurisdictions, income or profits tax exemption is generally granted to income derived by individuals from collective investment schemes. In Singapore, interest and gains of qualifying unit trusts are entitled to income tax exemption.

(41) *Life Insurance.* Among the four jurisdictions, only the Philippines imposes a premium tax. In Hong Kong, life insurance companies are given the choice on how assessable profit is to be computed for purposes of the Profits Tax. In Thailand, life insurance is subject to SBT. Singapore treats life insurance and reinsurance premiums as either GST-exempt or zero-rated. While Singapore and Hong Kong does not impose Stamp Duty on life insurance policies, the Philippines imposes DST on life insurance policies at an ad valorem rate significantly higher than the Stamp Duty rate imposed by Thailand. However, Thailand also imposes fixed Stamp Duty on reinsurance policies.

(42) *Non-Life Insurance.* In Singapore, a concessionary CIT rate is applied to the income derived by non-life insurance companies from insuring and reinsuring offshore risks. In Hong Kong, a concessionary Profits Tax rate apples to reinsurance of offshore risks. In the Philippines, Thailand and Singapore, non-life insurance is subject to VAT or GST. In addition to having the highest VAT rate, the Philippines imposes VAT on both non-life insurance premiums and commissions and on non-life reinsurance premiums and commissions. In Singapore, the insurance premiums of

international marine and aviation insurance, travel insurance and export credit insurance are deemed zero-rated for GST purposes. Again, no DST is imposed by both Singapore and Hong Kong on non-life insurance. As between the other two jurisdictions, the Philippines' DST rate dwarfs the Stamp Duty rate imposed by Thailand.

(43) *Share Transfers*. By virtue of the Stock Transaction Tax, the Initial Public Offering tax and the DST, the Philippines has the highest transaction cost for the transfer of shares among the four jurisdictions. Thailand notably exempts from PIT the gains derived by individuals from the transfer of share listed and transferred in its local stock exchange. In all four jurisdictions, Stamp Duty or DST is imposed. In addition to having the highest ad valorem DST rate, the Philippines further imposes DST on both the secondary transfer of unlisted shares—while, imposing a temporary exemption for listed shares—and the original issuance of shares.

Final Report: Policy Review of Financial Sector Taxation (First Module)

1 Introduction

1.1 Background of the Study

1. The overall objective of the policy review on the domestic financial sector taxation of the Philippines is to recommend a tax-neutral financial market where the interests of both the government and the capital market players are preserved and balanced. The inherent complexity of the task necessitates that the review be made in phases.

2. As a result, EMERGE and the Capital Market Development Council ("CMDC") identified the first module of the review to consist of a study that includes: (a) a review of all major tax-related issues in the bank and non-bank sectors; (b) an identification of products/transactions/undertakings where tax arbitrage may exist; and (c) recommendation of possible changes that could improve tax-neutrality. Subsequent modules shall focus on the fiscal policy or economic analysis, which shall not be treated by the present study.

1.2 Overview of the Study

3. The study begins with foundational considerations. These include the fundamental principles of financial sector taxation and a cursory overview of the significant Philippine tax laws impacting on the financial sector. The report then unfolds in four main parts.

4. The first part of the report covers the prevailing tax treatment of the financial sector players. It begins by discussing the general background of each sub-sector, with particular attention on their respective legal foundations, regulatory framework and primary economic activities. It then proceeds to inventory the different tax treatment of the general product line or principal transactions and instruments of each sub-sector.

5. The second part of the report surfaces the major tax-related issues or concerns of the financial sector. These issues or concerns are treated as either cross-sectoral or sector-specific.

6. The third part surveys the prevailing tax treatment of the financial sector in Hong Kong, Thailand and Singapore.

7. The final part gives recommendations geared to address the arbitrage situations from the legal perspective, citing, where appropriate, the practice in the above-mentioned jurisdictions. Also, it determines whether the tax issues raised by the various players of the Philippine financial sector can be addressed administratively or through legislation.

2 Foundational Considerations

2.1 Underpinning Principles of Tax Policy

8. What makes for a good or sound tax policy? The economist Adam Smith is widely credited to have enunciated the basic principles of taxation in his 1776 treatise *The Wealth of Nations*. Over the years, experts have offered several permutations of

Smith's seminal insight.[1] Nonetheless, there is universal acceptance of these three fundamental principles: (1) *administrative simplicity*; (2) *economic neutrality* or *efficiency*; and (3) *fairness* or *equity*.[2]

9. Administrative simplicity means that the tax system is "[n]ot costly for either government or taxpayers to calculate or administer."[3] A tax system "should be capable of being properly and efficiently administered by the government and enforced with the least inconvenience to the taxpayer."[4] From the ordinary taxpayer's perspective, the tax system should be easy to understand, "and it should minimize the cost of complying with the tax laws"; from the government's view, "the tax system

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[1] According to Harvey S. Rosen, the two main principles of a tax system are *fairness* and *efficiency*. Harry S. Rosen, "Taxation," Microsoft Encarta Online Encyclopedia 2005 *available at* http://encarta.msn.com/text_761573037_49/Taxation.html (last accessed Oct. 12, 2005) [hereinafter Rosen]. For Joseph Stiglitz, the characteristics of good taxes as *economic efficiency, administrative simplicity, flexibility, transparency,* and *fairness*. "Canons of Taxation" *avalibale at* http://www1.worldbank.org/publicsector/pe/Tax/canonsoftaxation.html (last accessed Oct. 12, 2005). The Washington Policy Center enumerates the guiding principles as *simplicity, accountability, economic neutrality, equity and fairness, complementary, competitiveness, balance,* and *reliability*. Washington Policy Center, "Guiding Principles of a Fair and Effective Tax System," (Jan. 2002) *available at* http://www.washingtonpolicy.org/TaxLimitation/PBGuppyTaxPrinciples.html (last accessed Oct. 12, 2005) [hereinafter Washington Policy Center]. The American Institute of Certified Public Accountants lists the ten guiding principles thus: *equity and fairness*, *certainty*, *convenience of payment, economy in collection, simplicity, neutrality, economic growth and efficiency, transparency and visibility, minimum tax gap,* and *appropriate government revenues*. Rene G. Bañez, Re-Modelling the Philippine Tax System: The Key to National Survival and Growth, Lecture Before the Ateneo Center for Continuing Legal Education & Research (Aug. 18, 2004).

[2] Richard K. Vedder & Lowell E. Galloway, *Some Underlying Principles of Tax Policy* (Sept. 1998) (prepared for the Joint Economic Committee of the U.S. Congress) (the article adds *transparency* as a fourth principle that is particularly relevant in democratic societies) [hereinafter Vedder & Galloway]. *See also* Vito Tanzi & Howell H. Zee, *Tax Policy for Emerging Markets: Developing Countries*, 53(2) NATIONAL TAX JOURNAL 299, 210 n.28 (June 2000) (saying that "tax policy should be guided by the general principles of *neutrality*, equity and simplicity") [hereinafter Tanzi & Zee] *and* Mattias Levin & Peer Ritter, *Taxation of Financial Intermediation in Industrialized Countries*, *in* TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES 197, 198 (Patrick Honohan ed., 2003) (asserting that tax systems must adapt to changing economic circumstances in "aiming at the goals of *efficiency*, equity and simplicity) [hereinafter Levin & Ritter].

[3] *Id.* at 3.

[4] JOSE C. VITUG & ERNESTO D. ACOSTA, TAX LAW AND JURISPRUDENCE 2 (2nd ed. 2000).

should be easy to administer, and should help promote efficient, low-cost administration."[5]

10. Economic neutrality, or simply neutrality, means that the tax system, in raising the needed revenues for the government, should not control the lives of the taxpayers; rather, it "should exert minimal impact on the spending and business decisions of individuals and businesses."[6] Taxes inevitably impact on the resource allocation decisions of the private sector. Usually, the effect redounds to a reduction or restraint of private trade: "Basically, taxation reduces spending on private sector goods and services traded in markets. The benefits from exchange – to both the purchaser and seller – are reduced when trade is restrained by taxation."[7]

11. Fairness pertains to the distribution of the tax burden. A fair tax system is one founded upon the ability-to-pay principle, which requires both *horizontal equity* and *vertical equity*.[8] Horizontal equity provides "that people in equal positions should pay the same tax"; while vertical equity refers to "the idea that a tax system should distribute the burden fairly across people with different abilities to pay."[9]

[5] Washington Policy Center, *supra* note 1.

[6] *Id.*

[7] Vedder & Galloway, *supra* note 2, at 3.

[8] Rosen, *supra* note 1. *See also* JOSE C. VITUG & ERNESTO D. ACOSTA, TAX LAW AND JURISPRUDENCE 2 (2nd ed. 2000).

[9] *Id. See also* Vedder & Galloway, *supra* note 3, at 7.

2.2 Financial Sector Taxation

12. When applied to financial sector taxation, these guiding principles take on nuanced contours. Such "mutation" is fueled by the objectives of financial sector taxation, namely: (a) to promote the development of the capital market by encouraging or mobilizing savings; (b) to promote the development and trading of financial instruments; and (c) to ensure that the financial sector bears an equitable share in the total tax burden.[10] As is the case in the overall tax system, financial sector taxation involves a complex and delicate balancing act between the interests of government and that of the financial sector players:

> Deciding just how much the domestic financial sector should be taxed, and in what way, is a complex problem for policymakers. On the one hand, governments need revenue and the financial sector is an administratively convenient source. On the other hand, given the central role of finance achieving sustained economic growth, policymakers should not repress the sector's development by an onerous tax burden.[11]

13. Savings mobilization and capital market development are symbiotic. The capital or financial market is often seen as "providing savers the venue to accumulate surplus funds at an expected premium while offering borrowers a mechanism to accessing these funds at an expected premium" such that the market's effectiveness is adjudged "by its ability to cultivate saving (i.e., saving mobilization) and its capacity

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[10] House Bill on the Financial Sector Tax Reform Package (draft).

[11] Nicholas Stern, *Foreword* to TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES at xi (Patrick Honohan ed., 2003)

to intermediate this saving in various desired funding maturities (i.e., term transformation)."[12]

14. The crucial role played by a well-developed capital market in the task of mobilizing savings cannot be overemphasized: "Savings mobilisation requires a capital market that provides accessible instruments—both equities and fixed income securities—to encourage savings and lower the cost of financial transactions."[13] On the other hand, increasing the rate of domestic savings "can contribute to better developed capital markets for mobilizing and allocating long[-]term capital to grow the businesses of promising domestic companies."[14]

15. Owing to the overall objective of the policy review, the study focuses on the principle of neutrality in financial sector taxation. In the context of this sub-sector of the tax system, neutrality refers to "the principle that taxation should not distort the pattern of financial transactions that investors, both individuals and firms, choose to undertake."[15] Otherwise put, neutrality in financial sector taxation means "the

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[12] Johnny Noe E. Ravalo, Financial Market Core Principles and An Enabling Environment (draft report) para. 13.

[13] Emilio T. Antonio, Jr. & Victor A. Abola, Capital Market Development in the Philippines: Problems and Prospects 13 (AT10 Research Conference, The Role of Capital Markets in Asian Economic Development, Mar. 7-8, 2002) [hereinafter Antonio & Abola].

[14] Securities and Exchange Commission, *The Non-Bank Financial Sector Development Plan: Blueprint for Growth and Expanded Contributions to the Philippine Economy, 2004-2016*, at 10 (Draft-July 20, 2004) *available at* http://www.sec.gov.ph/notices/draft/nbfs20july2004.pdf [hereinafter NBFS Blueprint].

[15] Robin Boadway & Michael Keen, *Theoretical Perspectives on the Taxation of Capital Income and Financial Services*, *in* TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES 31, 56 (Patrick Honohan ed., 2003) [hereinafter Boadway & Keen]. *See also* Levin & Ritter, *supra* note 2, at 207 (describing that a "tax system is neutral against financing choices when a given present discounted pre-tax flow of profits yields the same discounted after-tax income, irrespective of the means of finance").

equivalent taxation of equivalent financial transactions."[16] This focus dovetails with the observation that in developing countries neutrality and simplicity in financial sector taxation essay key roles:

> In developing countries where markets are taking on an increasingly important role in allocating resources, the most important objective of tax policy is to minimize the interference by the tax system in that allocation process, subject, of course, to revenue and redistribution requirements. This means not only that the tax system should be as neutral in design as possible, it should also have simple and transparent administrative rules and procedures, so that *ex ante* neutrality is not negated by *ex post* non[-]neutrality due to the inability of the tax administration to enforce the tax system as designed.[17]

16. This observation rings true in the Philippine setting where the distortive impact of taxation on resource allocation is widely seen as prevalent. The situation is described thus:

> As for the Philippines, ... tax preferences have been given to certain products/providers that have the affect of distorting the competitive balance. Thus, if there is a significant tax break accorded to a particular product and not to others that are virtual substitutes, that tax break gives consumers an incentive to purchase that product over the competing alternatives. This distortion undercuts the forces of competition, which normally award financial success to the provider whose product has the right combination of price and features to appeal to the broadest possible audience.[18]

17. The absence or lack of neutrality in the financial sector tax system disturbs the competitive balance among the various players in the capital market. The imbalance is the breeding ground for tax arbitrage.

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[16] Glenn May, *An Evaluation of Some Financial Instrument Tax Reform Proposals*, 50(1) CANADIAN TAX JOURNAL 218, 219 (2002) (citing Tim Edgar's assertion that the primary goal of tax reform is tax neutrality).

[17] Tanzi & Zee, *supra* note 2, at 308.

[18] NBFS Blueprint, *supra* note 12, at 46.

18. The financial sector's capacity for arbitrage has been identified as a key distinguishing feature or element of the sector in relation to other sectors.[19] In the context of the financial sector, tax arbitrage prevails where there is lack or absence of uniformity in the tax treatment of similar financial instruments and financial institutions. It results in the distortion of investment decisions whereby tax considerations overshadow other considerations such as relative prices and economic costs and yields. It also creates a competitive advantage to the specific financial institutions favored by the tax treatment over the others.

2.3 Overview of Philippine Financial Sector Taxation Laws

19. As in all other sectors of the Philippine economy, the taxation of the financial sector is governed by the National Internal Revenue Code of 1997 ("NIRC of 1997"), as amended. The NIRC of 1997 directly traces its provenance to Presidential Decree ("PD") No. 1158 or the NIRC of 1977, which consolidated and codified all the internal revenue laws embodied in the NIRC of 1939, as amended, and in the various other laws and presidential decrees.[20] In consolidating and codifiying the various amendments to the NIRC of 1977, PD No. 1994 embodied the NIRC of 1986. Prior to 1997, the NIRC of 1986 last underwent comprehensive amendments in 1993.[21]

[19] Partick Honohan, *Avoiding the Pitfalls in Taxing Financial Intermediation*, *in* TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES 1, 17 (Patrick Honohan ed., 2003). The other key feature is the financial sector's sensitivity to inflation and thus to non-indexed taxes. *Id.*

[20] 1 HECTOR S. DE LEON & HECTOR M. DE LEON, JR., THE NATIONAL INTERNAL REVENUE CODE ANNOTATED 15 (8th ed. 2003) [hereinafter DE LEON].

[21] RODELIO T. DACSIL, COMPENDIUM OF LAWS ON TAXATION 7 (2005).

20. On 01 January 1998, Republic Act ("RA") No. 8424, or the Tax Reform Act of 1997, took effect, which comprehensively amended what is now known as the NIRC of 1997.[22] From January 1998 to August 2005, the following statutes where passed and enacted to further amend the NIRC of 1997, which amendments directly impact on the financial sector:

- RA No. 8761 imposed the Value-Added Tax ("VAT") on services rendered by banks, non-bank financial intermediaries, finance companies, and other financial intermediaries not performing quasi-banking functions beginning 01 January 2001. This date was moved to 01 January 2003 pursuant to RA No. 9010.

- RA No. 9238 excluded from VAT coverage the services rendered by banks, non-bank financial intermediaries performing quasi-banking functions, and other financial intermediaries not performing quasi-banking functions. In lieu of the VAT, this law re-imposed the Gross Receipts Tax ("GRT") on these financial institutions beginning 01 January 2004.

- RA No. 9243 amended Title VII of the NIRC of 1997 on Documentary Stamp Tax ("DST").

- RA No. 9294 restored the tax exemption of Offshore Banking Units ("OBUs") and Foreign Currency Deposit Units ("FCDUs").

[22] *See* DE LEON, *supra* note 17, at 16-18 (enumerating the important changes effected by the Tax Reform Act of 1997).

- RA No. 9337 which (a) increased the corporate income tax rate from thirty-two percent (32%) to thirty-five percent (35%), (b) substantially amended the VAT provisions of the NIRC of 1997, including the possible increase of the rate from ten percent (10%) to twelve percent (12%) beginning 01 January 2006 upon the occurrence of specified conditions, and (c) raised the GRT rate from five percent (5%) to seven percent (7%) on (i) royalties, rentals of real or personal property, profits from exchange and all other items treated as gross income, and on (ii) net trading gains within the taxable year on foreign currency, debt securities, derivatives and other similar financial instruments. Originally slated to take effect on 01 July 2005, this law eventually took effect on 01 November 2005 after the Supreme Court upheld with finality the validity of the statute in its resolution of 18 October 2005, denying the motion for reconsideration filed in *Abakada Guro Party List Officers v. Executive Secretary*, G.R. Nos. 168506, 168207, 168461, 168463 & 168730, 01 September 2005. The delayed effectivity of RA No. 9337 impacted on the Consolidated Value-Added Tax Regulations of 2005: Revenue Regulations ("RR") No. 14-2005 dated 22 June 2005 practically never went into force and was superseded by RR No. 16-2005 dated 01 September 2005. The delay also affected the increase in the VAT rate from 10% to 12%: instead of taking effect by 01 January 2006, the increase took effect on 01 February 2006 as per Revenue Memorandum Circular ("RMC") No. 07-2006, which publishes the memorandum from the Executive Secretary approving the rate increase.

21. It should be noted that one of the key reform packages introduced in 2001 was the Financial Sector Tax Reform Bill, which unfortunately did not materialize into legislation. It had four components: (a) introduction of Financial Institutions Tax on banks and non-banks; (b) introduction of Thin Capitalization Rule or Maximum Debt Funding Percentage Rule; (c) rationalization of taxation of FCDU; and (d) rationalization of the DST, including its elimination on secondary market trading and securities lending and borrowing transactions.[23] Only the last component has been legislated through RA No. 9243.

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[23] THE WORLD BANK & INTERNATIONAL MONETARY FUND, FINANCIAL SECTOR ASSESSMENT PROGRAM: PHILIPPINES IOSCO OBJECTIVES AND PRINCIPLES ON SECURITIES REGULATION at 11 (Jul. 2002) [hereinafter FINANCIAL SECTOR ASSESSMENT PROGRAM]. *See also* NBFS Blueprint, *supra* note 12, at 49 *et seq.*

PART I – INVENTORY OF TAXES

3 Tax Treatment of Financial Institutions and Instruments

22. The Philippine financial sector may be broadly divided into the banking sector and the non-bank financial institution sector. The banking sector is further subdivided into the different types of banks permitted by law. In contrast, for purposes of this study, the non-bank financial institution sector includes, insurance companies, investment houses, finance companies, securities dealers and brokers, pre-need companies, and mutual funds.[24]

23. This section of the report treats each sub-sector by first giving a brief background of the industry, emphasizing on its statutory basis, regulatory framework and key economic activity. Then a matrix of the present tax treatment is laid out, which is followed by an exposition of the details of the tax treatment.

3.1 Banks

3.1.1 General Background

24. Banks or banking institutions refer to those entities as defined in Section 3 of RA No. 8791, as amended, or the General Banking Law of 2000. The term *banks* or *banking institutions* are synonymous and interchangeable and specifically include universal banks, commercial banks, thrift banks (savings and mortgage banks, stock savings and loan associations, and private development banks), cooperative banks, rural banks, Islamic banks and other classifications of banks as may be determined

[24] *See* Antonio & Abola, *supra* note 11, at 2.

by the Monetary Board of the Bangko Sentral ng Pilipinas ("BSP").[25] The study focuses on commercial and universal banks because these have comparatively much broader licenses to engage in banking and related activities.

25. Commercial Banks are authorized to exercise all such powers as may be necessary to carry on the business of commercial banking, such as: accepting drafts and issuing letters of credit; discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; accepting or creating demand deposits; receiving other types of deposits and deposit substitutes; buying and selling foreign exchange and gold or silver bullion; acquiring marketable bonds and other debt securities; and extending credit, subject to such rules as the Monetary Board may promulgate.[26] These rules may include the determination of bonds and other debt securities eligible for investment, the maturities and aggregate amount of such investment.

26. Commercial Banks may also exercise or perform any of the following: (a) invest in the equities of allied enterprises as may be determined by the Monetary Board; (b) purchase, hold, and convey real estate as specified under Sections 51 and 52 of the General Banking Law; (c) receive in custody funds, documents, and valuable objects; (d) act as financial agent and buy and sell, by order of and for the account of their customers, shares, evidences of indebtedness and all types of

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[25] BSP Circular No. 271, Series of 2001 (Jan. 8, 2001). *See also* General Banking Law of 2000, Republic Act No. 8791 § 3.2 (2000).

[26] General Banking Law of 2000, Republic Act No. 8791 § 29 (2000).

securities; (e) make collections and payments for the account of others and perform such other services for their customers as are not incompatible with banking business; (f) upon prior approval of the Monetary Board, act as managing agent, adviser, consultant or administrator of investment management/advisory/consultancy accounts; (g) rent out safety deposit boxes; and (h) engage in quasi-banking functions.[27]

27. Universal Banks have the authority to exercise the following functions, *in addition* to the powers and services authorized for Commercial Banks*:* (a) the powers of an investment house as provided under existing laws; (b) the power to invest in non-allied enterprises; (c) the power to own up to one hundred percent (100%) of the equity in a Thrift Bank, a Rural Bank, a financial allied enterprise, or a non-financial allied enterprise; and (d) in case of publicly listed Universal Banks, the power to own up to one hundred percent (100%) of the voting stock of only one other Universal Bank or Commercial Bank.[28]

Regulation

28. No person or entity shall engage in banking operations or quasi-banking operations without authority from the BSP. An entity authorized by the BSP to perform universal or commercial banking functions shall likewise have the authority to engage in quasi-banking functions.[29] According to RR No. 09-2004, the term

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[27] Manual of Regulations For Banks § X101b(2) (Dec. 2004) [hereinafter MORB].

[28] *Id.* at § X101(b)(1).

[29] General Banking Law of 2000, Republic Act No. 8791 § 6 (2000).

quasi-banking activities refers to "the borrowing of funds from twenty (20) or more personal or corporate lenders at any one time, through the issuance, endorsement, or acceptance of debt instruments of any kind other than deposits for the borrower's own account, or through the issuance of certificates of assignment or similar instruments, with recourse, or of repurchase agreements for purposes of re-lending or purchasing receivables and other similar obligations, provided, however, that commercial, industrial and other non-financial companies, which borrow funds through any of these means for the limited purpose of financing their own needs or the needs of their agents or dealers, shall not be considered as performing quasi-banking functions."[30]

Authority to engage in Trust Business

29. Only a stock corporation or a person duly authorized by the Monetary Board to engage in trust business shall act as a trustee or administer any trust or hold property in trust or on deposit for the use, benefit, or behalf of others.[31] A trust entity, in addition to the general powers incident to corporations, shall have the power, among others, to establish and manage common trust funds, subject to such rules and regulations as may be prescribed by the Monetary Board.[32] Unless otherwise directed by the instrument creating the trust, the lending and investment of funds and other assets acquired by a trust entity as executor, administrator, guardian, trustee,

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[30] Revenue Regulations No. 9-2004 § 2.4 (Jun. 21, 2004) (implementing Republic Act No. 9238). *See also* MORB, *supra* note 25, at § X234.1 (enumerating the elements of quasi-banking).

[31] General Banking Law of 2000, Republic Act No. 8791 § 79 (2000).

[32] *Id.* at § 83.6.

receiver or depositary of the estate of any minor or other incompetent person shall be limited to loans or investments as may be prescribed by law, the Monetary Board or any court of competent jurisdiction.[33]

[33] *Id.* at § 88.

3.1.2 Matrix of Present Tax Treatment

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	CWT	CGT	VAT	GRT	STT	DST
I.	Deposit Transactions with Banks/Others (ie., savings, time deposit)		NA	NA	NA	5%	NA	
	A. Peso	20%						
	1. Ordinary demand and savings deposits							exempt
	2. Non-interest bearing deposits							Php1.50
	3. Time deposits/ high interest deposits							Php1 on each Php200
	B. FCDU	7.50%						
	1. Ordinary demand and savings deposits							exempt
	2. Non-interest bearing deposits							Php1.50
	3. Time deposits/ high interest deposits							Php1 on each Php200
II.	Loans		NA	NA	NA	5% or 1% (depending on maturity period)	NA	Php1 on each Php200
	A. Peso	FWT exempt (but subject to 32% regular income tax)						
	B. FCDU (granted by domestic/resident foreign banks to residents other than OBUs or other banks)	10%						
	C. FCDU (granted by non-resident foreign banks to residents other than OBUs or other banks)	20%						
III.	Other FCDU transactions with nonresidents, OBUs, other banks (ie., lending transactions such as swap agreements, foreign bills of exchange)	FWT exempt (but subject to 32% regular income tax)	NA	NA	NA	5% or 1% (depending on maturity period)	NA	Tax rate depends on nature of instrument

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	CWT	CGT	VAT	GRT	STT	DST
IV.	Investments	Interest Income subject to FWT; Trading Gain either income tax-exempt or subject to 32% regular income tax	NA	NA	NA		NA	
	A. Debt Instruments (interest income and trading gain)					5% (on gross interest income) 7% (on net trading gains)		Php1 on each Php200 (original issue), but repurchase/reverse repurchase agreements are DST exempt; DST exempt (on trading in secondary market or through exchange)
	1. Peso-denominated (maturity period of 5 years or less)	Trading Gain subject to 32% regular income tax						
	a. Government issuance							
	(i) held by domestic/resident foreign banks	20%						
	(ii) held by non-resident foreign banks	32%						
	b. Private issuance							
	(i) held by domestic/resident foreign banks							
	1. borrowed from 19 lenders or less	FWT exempt (but subject to 32% regular income tax)						
	2. borrowed from 20 lenders or more	20%						
	(ii) held by non-resident foreign banks	32%						

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	CWT	CGT	VAT	GRT	STT	DST
	2. Peso-denominated (maturity period of more than 5 Years)	income tax-exempt on Gain from sale, exchange or retirement						
	a. Government issuance							
	(i) held by domestic/resident foreign banks	20%						
	(ii) held by non-resident foreign banks	32%						
	b. Private issuance							
	(i) held by domestic/resident foreign banks							
	1. borrowed from 19 lenders or less	FWT exempt (but subject to 32% regular income tax)						
	2. borrowed from 20 lenders or more	20%						
	(ii) held by non-resident foreign banks	32%						
	3. FX-denominated (maturity period of 5 years or less)							
	a. Government/Private issuance							
	(i) held by domestic/resident foreign banks	FWT exempt (but subject to 32% regular income tax)						
	(ii) held by non-resident foreign banks	tax-exempt on interest income						

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	CWT	CGT	VAT	GRT	STT	DST
	4. FX-denominated (more than 5 Years)	income tax exempt on gain from sale, exchange or retirement						
	a. Government/Private issuance							
	(i) held by domestic/resident foreign banks	FWT exempt (but subject to 32% regular income tax)						
	(ii) held by non-resident foreign banks	tax-exempt on interest income						
	B. Sale of Shares of stock					0% (on dividends and net income of subsidiaries)		
	1. publicly listed	NA	NA	NA			½ of 1%	Exempt (until 2009)
	2. privately held	5% and 10% (on net capital gains); Tax-Exempt (on dividends received by a domestic corporation from another domestic corporation)	NA	NA				NA
V.	Other Income							
	A. Royalties	20%	NA	NA		7%	NA	NA
	B. Real property (sale/rental)	6% (presumed gain) on sale	5% (on rental income)			7% (on gross rental income)		

3.1.3 Details of Present Tax Treatment

Final Withholding Tax

30. The following items of income of a domestic bank/ resident foreign bank and OBUs are subject to final withholding tax[34] ("FWT") at the rates specified:

- Interest on any currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust fund and similar arrangements derived from sources within the Philippines – *twenty percent (20%)*

- Royalties derived from sources within the Philippines - *twenty percent (20%)*

- Interest income derived from FCDUs – *seven and one-half percent (7.5%)*

- Except net income subject to regular income tax payable by banks, income derived by a depository bank or offshore banking unit under the expanded foreign currency deposit system from foreign currency transactions with nonresidents, OBUs in the Philippines, local commercial banks including branches of foreign banks that may be authorized by the BSP to transact

[34] Under the final withholding tax system, the amount of income tax withheld by the withholding agent is constituted as a full and final payment of the income tax due from the payee on the said income. The liability for payment of the tax rests primarily on the payor as a withholding agent. In case of failure to withhold the tax or in case of underwithholding, the deficiency tax is collected from the payor/agent. The payee is not required to file an income tax return for the particular income. The finality of the withholding tax is limited only to the payee's income tax liability on the particular income. It does not extend to the payee's other tax liability on said income, such as when the said income is further subject to a percentage tax. Revenue Regulations No. 02-98 § 2.57(A) (Apr. 17, 1998).

business with FCDUs and other depository banks under the expanded foreign currency deposit system – *exempt*[35]

- Interest income from foreign currency loans granted by depository banks under the expanded foreign currency deposit system to residents other than OBUs in the Philippines or other depository banks under the expanded system – *ten percent (10%)*[36]

Creditable Withholding Tax

31. The following items of income of a *domestic bank* and *resident foreign bank* are subject to creditable withholding tax ("CWT")[37] at the rates specified:

- On gross rental for the continued use or possession of real property used in business which the payor or obligor has not taken or is not taking title, or in which he has no equity – *five percent (5%)*[38]

- Real property, *other than capital assets* (i.e., ordinary assets), sold - *six percent (6%)*[39]

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[35] National Internal Revenue Code of 1997, as amended by Republic Act No. 9294, §§ 27(D)(3) and 28(A)(4) & (A)(7)(b).

[36] *Id.*

[37] Under the creditable withholding tax system, taxes withheld on certain income payments are intended to equal or at least approximate the tax due of the payee on said income. The income recipient is still required to file an income tax return, to report the income and/or pay the difference between the tax withheld and the tax due on the income. The excess of the withheld tax over the tax due on the return shall be subject to refund. Revenue Regulations No. 02-98, §§ 2.57(B) & 2.58.1 (Apr. 17, 1998).

[38] Revenue Regulations No. 02-98, as amended by Revenue Regulations No. 06-2001, § 2.57.2(C) (Apr. 17, 1998).

- Income payments made by the top ten thousand (10,000) private corporations to their local/resident supplier of services – *two percent (2%)*[40]

Capital Gains Tax

32. Further, a domestic bank is subject to a six percent (6%) final tax on 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*. This tax is withheld at source.

Gross Receipts Tax

33. From 1946 to 1997, the GRT was imposed on banks. With the enactment of RA No. 7716, GRT was supposed to be replaced with the VAT effective on 01 January 1998. However, several statutes were passed to delay the implementation of the VAT such that it became effective only on 01 January 2003.[41] Thus, for the brief period of 01 January to 31 December 2003, VAT was imposed on banks in lieu of GRT.

34. Effective 01 January 2004, VAT reverted to GRT pursuant to RA No. 9238. Moreover, RA No. 9337 increased the GRT rate from five percent (5%) to seven

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[39] Revenue Regulations No. 02-98, as amended by Revenue Regulations No. 06-2001, § 2.57.2(J) (Apr. 17, 1998).

[40] Revenue Regulations No. 02-98, as amended by Revenue Regulations No. 17-2003, § 2.57.2(M) (Apr. 17, 1998).

[41] These laws include: (a) Tax Reform Act of 1997, Republic Act No. 8424 (1997) (deferring VAT implementation until 31 December 1999); (b) Republic Act No. 8761 (1999) (deferring VAT implementation until 31 December 2000); (c) Republic Act No. 9010 (2001) (deferring effectivity of VAT to 01 January 2003).

percent (7%) for items (c) and (d) of Section 121 of the NIRC of 1997, Thus, the GRT imposed on the gross receipts derived from sources within the Philippines by banks is tabled as follows:

(a)	on interest, commissions and discounts from lending activities as well as income from financial leasing, on the basis of remaining maturities of instruments from which such receipts are derived:	
	maturity period is five (5) years or less	5%
	maturity period is more than five (5) years	1%
	In case the maturity period is shortened through pretermination, the maturity period shall be reckoned to end as of the date of pretermination.	
(b)	on dividends and equity shares in net income of subsidiaries	0%
(c)	on royalties, rentals of property, real or personal, profits from exchange and all other items treated as gross income under Section 32 of the Tax Code	7%
(d)	on net trading gains within the taxable year on foreign currency, debt securities, derivatives and other similar financial instruments	7%

Services of banks, being subject to GRT, are exempt from VAT.[42]

35. Interestingly, the term *gross receipts* is defined under Title IV of the NIRC of 1997 which governs the imposition of the VAT, and not under Title V, Section 121 which pertains to GRT. Section 108(A) defines it as "the total amount of money or its equivalent representing the contract price, compensation, service fee, rental or royalty, including the amount charged for materials supplied with the services and deposits and advanced payments actually or constructively received during the

[42] National Internal Revenue Code of 1997, as amended by Republic Act No. 9238, § 109(aa) (1997).

taxable quarter for the services performed or to be performed for another person, excluding the value-added tax."

Documentary Stamp Tax

(a) Debt Instruments

36. The original issue of debt instruments is subject to a DST rate of Php1.00 on each Php200, or fractional part thereof, of the issue price. For instruments with a term of less than one (1) year, the DST shall be a proportional amount in accordance with the ratio of the term in number of days to 365 days.[43]

37. The term *debt instrument* covers instruments representing borrowing and lending transactions including, without limitation: (a) debentures; (b) certificates of indebtedness; (b) due bills; (c) bonds; (d) loan agreements (including those signed abroad wherein the object of the contract is located or used in the Philippines); (e) instruments and securities issued by the government or any of its instrumentalities; (f) deposit substitute debt instrument; (g) certificates or other evidences of deposits that are either drawing interest significantly higher than the regular savings deposit taking into consideration the size of the deposit and the risks involved or drawing interest and having a specific maturity date; (h) orders for payment of any sum of money

[43] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 179 (1997). Prior to the amendment, the DST rate for debt instruments was Php0.30 on each Php200 (or fractional part thereof), of the face value of such instrument under Section 180, NIRC of 1997.

otherwise than at sight or demand; and (i) promissory notes, whether negotiable or non-negotiable, except bank notes issued for circulation.[44]

38. The term *deposit substitutes* refers to “an alternative form of obtaining funds from the public (the term *“public”* means borrowing from 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 of receivables and other obligations, or financing their own needs or the needs of their agent 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 BSP and any authorized agent bank, certificates of assignment or participation and similar instruments with recourse, provided that debt instruments issued for inter-bank 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.”[45]

39. The present Section 179 incorporates under the single heading “debt instruments” and subjects to a unitary tax rate all instruments representing borrowing

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[44] *Id.*

[45] National Internal Revenue Code of 1997, as amended, § 22(Y) (1997); Revenue Regulations No. 9-2004 § 2.5 (Jun. 21, 2004) (implementing Republic Act No. 9238 which re-imposed GRT on banks and non-bank financial institutions).

and lending transactions.[46] Previously, instruments such as "debentures and certificates of indebtedness"[47] and "due bills and certificates of obligation"[48] were treated separately. Further, Section 179 introduces the imposition of DST on bank deposits that draw interest significantly higher than the prevailing interest on regular savings deposits or on those that draw interest and have a specific maturity date. In contrast, bank deposit accounts without a fixed term or maturity are DST-exempt under Section 199(k).

(b) Bonds/Debentures/Certificates of Indebtedness issued in foreign countries

40. Section 176 provides that these instruments shall be subject to DST when sold or transferred in the Philippines at such rates as is required by law on similar instruments when issued or sold or transferred in the Philippines. Considering however that the assignment of debt instruments issued in the Philippines and traded in the secondary market or through an exchange are already exempt from DST, it follows that these debt instruments which are issued outside the Philippines but subsequently sold in the Philippines will also enjoy a similar tax exemption on transactions in the secondary market.

[46] Revenue Regulations No. 13-2004 § 5 (Dec. 23, 2004) (implementing Republic Act No. 9243).

[47] National Internal Revenue Code of 1997 § 174 (1997).

[48] *Id.* at § 176 (1997).

(c) Bank checks/drafts/certificates of deposit not bearing interest, and other instruments payable at sight or on demand

41. Under Section 178, these instruments are subject to a DST of Php1.50 per instrument. It is observed however that the amendments introduced by RA No. 9243 created a minimal but unnecessary imbalance when it subjected non-earning deposits (certificates of deposit not bearing interest) to aforesaid DST rate, but at the same time exempted earning deposits (ordinary demand and savings deposits which earn interest) from DST.

42. Trust agreements or assets-held-in-trust accounts do not fall under the term "certificates of deposit" because no debtor-creditor relationship arises in the trust agreement.[49]

(d) Bills of exchange

43. Bills of exchange (between points within the Philippines),[50] the acceptance or payment of bills of exchange drawn in a foreign country but payable in the Philippines,[51] and foreign bills of exchange drawn in but payable out of the Philippines[52] are subject to DST of Php0.30 on each Php200 of the face value of

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[49] Solidbank Corporation v. Commissioner of Internal Revenue, C.T.A. Case No. 6557, May 5, 2005; Commissioner of Internal Revenue v. Traders Royal Bank, C.T.A. EB No. 32 (C.T.A.. Case No. 6392), 14 February 14, 2005.

[50] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 180 (1997).

[51] *Id.* at § 181.

[52] *Id.* at § 182.

such bill of exchange (or the Philippine equivalent of such value if expressed in foreign currency).

44. The sale of foreign currency (spot sale) by a local bank to the BSP, which is implemented by instructing the local bank's correspondent foreign bank to remit a specific sum of foreign currency to the BSP's foreign correspondent bank for credit to the account of the BSP, is classified as a foreign bill of exchange drawn in but payable out of the Philippines.[53]

(e) Letters of Credit

45. Letters of credit drawn in but payable outside the Philippines are subject to DST of Php0.30 on each Php200 of the face value of the letter of credit (or the Philippine equivalent of such value if expressed in foreign currency).[54]

(f) Mortgages, Pledges, Deeds of Trust

46. Mortgage, pledge or conveyances in trust of both movable and immovable property is subject to DST, as follows: (1) Php20.00, when the amount secured does not exceed Php5,000.00; (2) An additional Php10.00 on each Php5,000.00 or fractional part which exceeds Php5,000.00.[55]

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[53] Consolidated Bank & Trust Co. v. Commissioner of Internal Revenue, CA-G.R. SP No. 35950, March 31,1995; China Banking Corporation v. Commissioner of Internal Revenue, CA-G.R. SP No. 33651, September 23, 1994.

[54] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 182 (1997).

[55] *Id.* at § 195.

(g) Deeds of Sale and Conveyances of Property

47. Such instruments are subject to DST, based either on the consideration to be paid or on the fair market value of the property, as determined by the BIR, as follows: (1) Php15.00, when the consideration, or value received or contracted to be paid for such realty, after making allowance of any encumbrance, does not exceed Php1,000.00; (2) Php15.00, for each additional Php1,000.00, or fractional part in excess of Php1,000.00, of such consideration or value.[56]

(h) Exempt Transactions

48. RA No. 9243 introduced the exemption of the following banking related instruments from DST:

- Assignment or transfer of any mortgage, lease, or policy of insurance, or the renewal or continuance of any agreement, contract, charter, or any evidence of obligation or indebtedness provided there is no change in the maturity date or remaining period of coverage from that of the original instrument.[57] However, such assignment, transfer, renewal or continuance which results in a change in the maturity date or remaining period of coverage of the original instrument is subject to DST.[58]

[56] *Id.* at § 196.

[57] *Id.* at § 199(f).

[58] *Id.* at § 198.

- Fixed income and other securities traded in the secondary market or through an exchange.[59] Securities mentioned in this section refer exclusively to debt instruments.[60] Thus, under RA No. 9243, only the original issuance of debt instruments is subject to DST. The subsequent assignment of the debt instruments is exempt from DST.

- Derivatives, provided that for purposes of exemption from DST, repurchase agreements and reverse repurchase agreements are treated similarly as derivatives.[61] Derivatives refer only to those derivatives issued by entities duly licensed by the BSP to issue and trade in derivatives, and whose issuance is duly authorized by the BSP.[62]

Section 22(Y) of the NIRC of 1997 provides that the term *deposit substitutes*, which instruments are subject to DST, includes repurchase agreements and reverse repurchase agreements. A *repurchase agreement* pertains to a contract whereby the lender of funds will buy and sell back a security owned by another party. *Reverse repurchase agreements* pertain to the government securities sold by the BSP to an

[59] *Id.* at § 199(g).

[60] Revenue Regulations No. 13-2004 § 9 (Dec. 23, 2004).

[61] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 199(h).

[62] Revenue Regulations No. 13-2004 § 9 (Dec. 23, 2004).

authorized agent bank under an agreement that the BSP will buy back the securities on a stipulated future date.[63]

- All forebearances arising from sales or service contracts including credit card and trade receivables, provided that the exemption is limited to those executed by the seller or the service provider itself.[64]

- Bank deposit accounts without a fixed term or maturity.[65] These refer to ordinary demand and savings deposits which are withdrawable upon demand by the depositor and earn an interest rate based on prevailing market rates.[66]

- All contracts, deeds, documents, and transactions related to the conduct of business of the BSP.[67]

- Interbank call loans with maturity of not more than seven (7) days to cover deficiency in reserves against deposit liabilities, including those between or among banks and quasi-banks.[68]

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[63] China Banking Corporation v. Commissioner of Internal Revenue, C.T.A. Case No. 6400, October 14, 2004.

[64] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 199(j).

[65] *Id.* at § 199(k).

[66] Revenue Regulations No. 13-2004 § 9 (Dec. 23, 2004).

[67] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 199(l).

[68] *Id.* at § 199(n).

With the introduction of this provision, it is noted that the maximum maturity period of DST-exempt interbank call loans was increased from five (5) to seven (7) days. However for FWT exemption purposes, an interbank call loan remains to have a maximum maturity period of five (5) days.

3.2 Insurance Companies

3.2.1 General Background

49. PD No. 1460, as amended, or the Insurance Code of 1978 governs the insurance industry. The term *insurance company* pertains to "all individuals, partnerships, associations, or corporations including government-owned or controlled corporations or entities engaged as principals in the insurance business, excepting mutual benefit associations."[69] The insurance business includes the following activities: (a) making or proposing to make, as insurer, any insurance contract; (b) making or proposing to make, as surety, any contract of suretyship as a vocation and not merely incidental to any other legitimate business or activity of the surety; (c) doing any kind of business, including a reinsurance business, specifically recognized as constituting the doing of an insurance business within the meaning of the Insurance Code; and (d) doing or proposing to do any business in substance equivalent to any of the foregoing in a manner designed to evade the provisions of the Insurance Code.[70]

50. The Insurance industry is basically divided into two sub-sectors, namely, life insurance and non-life insurance. Life insurance is insurance on human lives and insurance appertaining thereto or connected therewith.[71] It is a mutual agreement by which a party agrees to pay a given sum on the happening of a particular event

[69] Insurance Code of 1978, Presidential Decree No. 1460, as amended, § 184 (1978).

[70] *Id.* at § 2(2).

[71] *Id.* at § 179.

contingent on the duration of human life, in consideration of the payment of a smaller sum immediately, or in periodic payments by the other party. Life insurance is further classified into: (a) individual life; (b) group life; and (c) industrial life.

51. Non-life insurance covers marine, fire and casualty insurance. In a marine insurance contract, "one party, for a stipulated premium, undertakes to indemnify the other against certain perils or sea-risks to which his ship, freight, and cargo, or some of them, may be exposed during a certain voyage, or a fixed period of time."[72] Fire insurance is insurance against loss by fire, lightning, windstorm, tornado or earthquake and other allied risks, when such risks are covered by extension to fire insurance policies or under separate policies.[73] Casualty insurance is insurance covering loss or liability arising from accident or mishap, excluding certain types of loss by which law or custom are considered as falling exclusively within the scope of other types of insurance such as fire or marine.[74]

52. In addition to the required procurement of a license to operate or do business from the SEC, insurance companies are likewise required to secure a Certificate of Authority from the Insurance Commission ("IC"), which is under the Department of Finance ("DOF"). The IC regulates the insurance industry.

[72] BLACK'S LAW DICTIONARY 805 (6th ed. 1990).

[73] Insurance Code of 1978, Presidential Decree No. 1460, as amended, § 167 (1978).

[74] *Id.* at § 174.

3.2.2 Matrix of Present Tax Treatment

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	CWT	CGT	VAT	Premium Tax	STT	DST
I	Insurance Premiums							
	A. Life	NA	NA	NA	NA	5% (withheld by the payor)	NA	P0.50 on each P200.00
	B. Non-Life	NA	NA	NA	12%	NA	NA	P0.50 on each P4.00
II	Annuities	NA	NA	NA	NA	NA	NA	P0.50 on each P200.00
III	Investments							
	A. Bonds	20% or 7 1/2% of interest earned	NA	NA	NA	NA	NA	NA
	B. Stocks	intercorporate dividends received are exempt	NA	5% or 10% of net capital gains from sale, as the case may be	NA	NA	1/2 of 1%	NA
	C. Loans	20% or 7 1/2% of interest earned	NA	NA	NA	NA	NA	NA
	D. Deposits	20% or 7 1/2% of interest earned	NA	NA	NA	NA	NA	NA
	E. Deposit substitutes	20% or 7 1/2% of interest earned	NA	NA	NA	NA	NA	NA
	G. Real Estate	NA	5% on rent income	6% on presumptive gain from sale	NA	NA	NA	NA
IV.	Income Payments by the Insurance Company	20%, 10%, or 6%, as the case may be	20%, 10%, 5%, 2% or 1%, as the case may be	NA	NA	NA	NA	NA

3.2.3 Details of Present Tax Treatment

Final Income Tax on Passive Income

(a) On Interest, yield or any monetary benefit from deposits, deposit substitutes, trust funds and similar arrangements

53. Income derived or received by domestic and resident foreign insurance companies in the form of interest or yield from its currency bank deposits, deposit substitutes and trust funds and similar arrangement is subject to a final income tax of twenty percent (20%).[75] Meanwhile, interest income derived from a depository bank under the expanded foreign currency deposit system is subject to a final income tax of seven and a half percent (7½%).[76]

54. In any case, such final income taxes are subject to withholding at the same rates on the part of the payor.[77]

(b) On intercorporate dividends

55. Dividends received by a domestic or resident foreign corporation from a domestic corporation are not subject to the income tax.[78] Thus, dividends received by insurance companies from their stock investments in domestic corporations are not subject to the income tax.

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[75] National Internal Revenue Code of 1997, as amended, § 27(D)(1).

[76] *Id.*

[77] Revenue Regulations No. 2-98 § 2.57.1 (G)(1)&(3) (Apr. 17, 1998).

[78] National Internal Revenue Code of 1997, as amended, §§ 27(D)(4) and 28(A)(7)(d).

Final Withholding Tax

56. Under Section 57(A) of the NIRC of 1997, domestic insurance companies, as income payors, are constituted as withholding agents of the Government, thus, required to withhold the tax from its income payments specifically subject to the final tax as provided under Sections 27(D)(1) (on Interest from Deposits and Yield or any other Monetary Benefit from Deposit Substitutes and from Trust Funds and Similar Arrangements, and Royalties), 27(D)(2) (on Capital Gains from the Sale of Shares of Stock Not Traded in the Stock Exchange), 27(D)(3) (on Income Derived under the Expanded Foreign Currency Deposit System) and 27(D)(5) (on Capital Gains Realized from the Sale, Exchange or Disposition of Lands and/or Buildings) of the NIRC 1997. Such amounts withheld constitute the payee's full and final payment of the income tax due on said income.

Creditable Withholding Tax

57. Under Section 57(B) of the NIRC 1997, insurance companies, as income payors, are constituted as withholding agents of the Government, thus, required to withhold a tax from its income payments to natural or juridical persons. RR No. 2-98, as amended, prescribes the applicable withholding tax rates as well as the kinds of payments subject thereto. These taxes withheld, more or less, approximate the income tax liability of the payee on the said income. Furthermore, these are creditable in nature.

58. Gross rentals paid or payable to the insurance company on account of its real properties shall be subject to a CWT of five percent (5%).[79]

Capital Gains Tax

59. The CGT is a final tax imposed on the actual or presumed capital gains from particular transactions.

(a) sale of shares of stock

60. The net capital gains realized during the taxable year by insurance companies, whether domestic, resident foreign or non-resident foreign, from the sale of shares of stock of a domestic corporation, except those sold through the stock exchange, are subject to a final tax at the following rates: (a) not over Php100,000.00 – five percent (5%); (b) on any amount in excess of Php100,000.00 – ten percent (10%).[80]

(b) sales of lands and/or buildings

61. The gain presumed to have been realized by a domestic insurance corporation from the sale of lands and/or buildings is subject to a final tax of six percent (6%).[81] This final tax is subject to withholding by the purchaser-payor.[82]

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[79] Revenue Regulations No. 2-98 § 2.57.2 (C)(1) (Apr. 17, 1998).

[80] National Internal Revenue Code of 1997, as amended, § 27(D)(2) (for domestic corporations), § 28(A)(7)(c) (for resident foreign corporations) & § 28(B)(5)(c) (for nonresident foreign corporations) (1997).

[81] National Internal Revenue Code of 1997, as amended, § 27(D)(5).

Value-Added Tax

62. Under Section 108(A) of the NIRC of 1997, the gross receipts derived from the sale or exchange of services performed or rendered by non-life insurance companies is subject to VAT of twelve percent (12%).

63. For VAT purposes, the "gross receipts from non-life insurance shall mean total premiums collected, whether paid in money, notes, credits or any substitute for money."[83] Accordingly, the following are subject to VAT: (a) non-life reinsurance premiums; and (b) insurance and reinsurance commissions, whether life or non-life.[84]

64. Premium payments from crop insurance, life and disability insurance, and health and accident insurance are not subject to VAT. Furthermore, premium payments received by life insurance companies subject to the percentage tax are no longer subject to VAT pursuant to Section 109(j) of NIRC of 1997.

Percentage Tax

(a) Premium Tax

65. The total premiums collected by life insurance companies doing business in the Philippines shall be subject to a percentage tax of five percent (5%).[85] This tax shall be withheld by the payor of the life insurance premium.[86]

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[82] Revenue Regulations No. 2-98, as amended, § 2.57.1 (G)(5) (Apr. 17, 1998).

[83] Revenue Regulations No. 16-2005, § 4.108-3(i) (Sept. 1, 2005).

[84] *Id.*

[85] National Internal Revenue Code of 1997, as amended, § 123 (1997).

66. In the computation of "premiums collected", the following shall be excluded under Section 123 of NIRC of 1997: (a) premiums refunded within six (6) months after payment on account of rejection of risk or returned for other reason to a person insured; (b) reinsurance by a company that has already paid the tax; (c) premiums collected or received by any branch of a domestic corporation, firm or association doing business outside the Philippines on account of any life insurance of the insured who is a nonresident, if any tax on such premium is imposed by the foreign country where the branch is established; (d) premiums collected or received on account of any reinsurance, if the insured, in case of personal insurance, resides outside the Philippines, if any tax on such premiums is imposed by the foreign country where the original insurance has been issued or perfected; and (e) that portion of the premiums collected or received by the insurance companies on variable contracts in excess of the amounts necessary to insure the lives of the variable contract workers. To this list the following exclusions may be added: documentary stamp and local taxes passed on by the insurance company to the insured;[87] and percentage tax passed on to the insured.[88]

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[86] Revenue Regulations No. 2-98, as amended, Section 5.116 (A)(7).

[87] Applying, by analogy, Revenue Memorandum Circular No. 11-96 (Jan. 15, 1996) in relation to VAT Ruling No. 6-01 (Feb. 16, 2001) wherein it was held that "the computation of VAT on premium should not include DST, fire service tax and local government tax. In the same manner, these taxes are likewise based on the premium alone and should not be computed inclusive of VAT, otherwise there will be a cascading effect on tax which revenue authorities hope to avoid at every instance."

[88] *Id.*

(b) Stock Transaction Tax

67. Section 127 of NIRC 1997 provides that the sale of shares of stock listed and traded through the local stock exchange, other than a sale by a dealer in securities, shall be subject to a percentage tax of one-half of one percent (1/2 of 1%) based on the gross selling price or gross value in money of the shares of stock sold. Insurance companies are subject to this tax, since they, unlike pre-need companies, are not considered dealers in securities.

Documentary Stamp Tax

68. Under Section 183 of the NIRC 1997, all policies of life insurance or other instruments, upon original issuance or upon renewal, by whatever name the same may be called, upon any life or lives are subject to a DST of fifty centavos (Php0.50) on each two hundred pesos (Php200.00), or fractional part thereof, based upon the amount of premium collected.

69. On the other hand, Section 184 provides that all policies of insurance upon property including marine, inland and fire insurance, are subject to DST of fifty centavos (Php0.50) on each four pesos (Php4.00), or fractional part thereof, based upon the amount of premium charged. However, no DST shall be collected on reinsurance contracts or on any instrument by which cession or acceptance of insurance risks under any reinsurance agreement is effected or recorded.

70. Under Section 185, all other policies of insurance (other than life, marine, inland and fire insurance), are subject to DST at the rate of fifty centavos (Php0.50) on each four pesos (Php4.00) of the premium charged.

71. Finally, Section 186 provides that policies of annuities are subject to DST of fifty centavos (Php0.50) on each two hundred pesos (Php200.00) of the premium or installment payment or contract price collected.

3.3 Investment Houses

3.3.1 General Background

72. PD No. 129, as amended, or the Investment Houses Law, governs the establishment, operation and regulation of the investment houses industry. This law is supplemented by the *Omnibus Rules and Regulations for Investment Houses and Universal Banks Registered as Underwriters of Securities* ("Omnibus Rules for Investment Houses") promulgated by the SEC on 23 July 2002, which updated and superseded the *Basic Rules and Regulations to Implement the Provisions of P.D. 129* of 09 July 1973.

73. Under Section 2(A) of the Omnibus Rules for Investment Houses, the term *investment house* refers to "any enterprise which primarily engages, whether regularly or on an isolated basis, in the underwriting of securities of another person or enterprise, including securities of the Government or its instrumentalities."[89] Underwriting of securities is the act or process of guaranteeing the distribution and sale of securities issued by another person or enterprise, including securities of the Government or its instrumentalities.[90] The term *securities* refers to "shares, participation or interests in a corporation or in a commercial enterprise or profit-making venture and evidenced by a certificate, contract, instrument, whether written or electronic in character," including: (a) shares of stock, bonds, debentures, notes, evidences of indebtedness, asset-backed securities; (b) investment contracts,

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[89] Omnibus Rules and Regulations for Investment Houses and Universal Banks Registered as Underwriters of Securities § 2(A) (Jul. 23, 2002).

[90] *Id.* at § 2(C).

certificates of interest or participation in a profit-sharing agreement, certificates of deposit for future subscription; (c) fractional undivided interests in oil, gas or other mineral rights; (d) derivatives like options and warrants; (e) certificates of assignments, certificates of participation, trust certificates or similar instruments; (f) proprietary or non-proprietary membership certificates in corporations; and (g) other instruments as may in the future be determined by the SEC.[91]

74. The distribution and sale of securities may be on a public basis—i.e, the sale of securities to at least 20 persons or enterprises—or private placement basis—i.e., the sale of securities to less than 20 persons or enterprises.[92]

75. Investment Houses are classified into those that exercise quasi-banking functions ("IHQBs") and those that do not exercise such functions ("IHNQBs").[93] The term *quasi-banking functions* refers to "the function of borrowing funds for the borrower's own account from twenty (20) or more persons or corporate lenders at any one time through the issuance, endorsement, or acceptance of debt instruments of any kind other than deposits which may include but need not be limited to acceptances, promissory notes, participations, certificates of assignment or similar instruments with recourse, trust certificates or of repurchase agreements for

[91] *Id.*

[92] *Id* at § 2(D) & (E).

[93] National Tax Research Center, *Review of the Taxation of Investment Houses*, NTRC TAX RESEARCH JOURNAL vol. XIII (4), 2 (2001).

purposes of relending or purchasing of receivables and other obligations."[94] IHQBs are also subject to BSP regulations and are covered by the Manual of Regulations for Non-Bank Financial Institutions.

76. Under the Omnibus Rules for Investment Houses, the permissible business activities of Investment Houses, in addition to underwriting activities and quasi-banking functions, can be grouped into the following major categories:

- *Trust functions* – the administration, holding and management of funds and/or property of a person (the "trustor") by another (the "trustee") for the benefit of a designated beneficiary;[95]

- *Investment management activities* – refers to any activity resulting from a contract of agreement primarily for financial return whereby the investment manager binds itself to handle or manage investible funds or any investment portfolio in a representative capacity as financial or managing agent, adviser, consultant or administrator of financial or investment management, advisory, consultancy or any similar arrangement which does not create or result in a trusteeship;[96]

[94] Omnibus Rules and Regulations for Investment Houses and Universal Banks Registered as Underwriters of Securities, § 2(K) (Jul. 23, 2002).

[95] *Id.* at § 2(M). *See also* Manual of Regulations for Non-Bank Financial Institutions §§ 4404Q.1 and 4404.2 (2003) (listing the other registration and pre-operating requirements imposed by the BSP).

[96] *Id.* at §2(L). *See also* Manual of Regulations for Non-Bank Financial Institutions §§ 4414Q.1 and 4414.2 (listing the other registration and pre-operating requirements imposed by the BSP).

- *Foreign exchange operations* – servicing of project program requirements of BSP-certified export-oriented firms, export-oriented firms registered with the Board of Investments ("BOI"), and construction or service firms with overseas contracts approved by the Department of Labor and Employment;[97]

- *Dealing in securities* – a dealer in securities is one who is a merchant of stock or securities, whether an individual, partnership or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers, i.e., one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom.[98]

77. Prior registration with or licensing by the SEC is required before both IHQBs and IHNQBs commence their business operations. Any foreign equity participation in an Investment House shall be registered or reported with the BOI and the BSP. Similarly, IHQBs are required to secure a license from the BSP in order to engage in quasi-banking, trust functions, investment management activities and foreign exchange operations.[99] Engagement in the business of a stockbroker or dealer by an

[97] Manual of Regulations for Non-Bank Financial Institutions §§ 4501Q & 4502Q (2003).

[98] Revenue Regulations No. 14-2005 § 4.108-3 (Jun. 2, 2005)

[99] Omnibus Rules and Regulations for Investment Houses and Universal Banks Registered as Underwriters of Securities § 18 (Jul. 23, 2002).

Investment House, however, requires no separate license under Section 28 of the Securities Regulation Code.[100]

[100] *Id.* at § 17.

3.3.2 Matrix of Present Tax Treatment

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	CWT	CGT	VAT	GRT	STT	DST
I	Gross receipts from Operations as Dealer in Securities	NA	NA	NA	12%	NA	NA	NA
II	Fee-Based Income (Underwriting Fee, Arranger's Fee, Service/Professional Fee, Management Fee, Financial Advisory Fee)	NA	10% or 15%, as the case may be, to be withheld by the payor	NA	NA	5% or 7%, as the case may be	NA	NA
III	Net trading gains on foreign currency, debt securities, derivatives and other similar financial instruments	NA	NA	NA	NA	7%	NA	NA
IV	Deposit substitutes, trust funds and similar arrangements, and deposits under the expanded foreign currency deposit system	20% or 7.5% of interest earned	NA	NA	NA	NA	NA	NA
	a. original issuance of deposit substitutes and other debt instruments	NA	NA	NA	NA	NA	NA	P1.00 on each P200.00 or exempt, as the case may be
	b. sale of deposit substitutes and debt instruments in secondary market	NA	NA	NA	NA	NA	NA	exempt
V	royalties, rentals of property, real or personal, profit from exchange and all other items treated as gross income under Section 32 of the Code	NA	NA	NA	NA	7%	NA	NA
VI	Income from Equity Investments/Dividends	intercorporate dividends received are exempt	NA	5% or 10% of net capital gains from sale, as the case may be	NA	0.5% if listed	NA	NA
VII	Interest, commissions and discounts realized from lending activities	NA	NA	NA	NA	5% or 1% depending on maturity	NA	NA

3.3.3 Details of Present Tax Treatment

Final Withholding Tax

78. A final withholding tax of twenty percent (20%) is due on any yield or other monetary benefit realized from deposit substitutes, trust funds and similar arrangements, while a seven and a half percent (7.5%) final withholding tax is imposed on any interest income derived from a depository bank under the expanded foreign currency deposit system.[101]

Creditable Withholding Tax

79. Section 2.57.2(B) of RR No. 2-98, as amended, require that a creditable withholding tax of ten percent (10%) or fifteen percent (15%) be imposed on gross professional fees or any other form of remuneration paid for the services of Investment Houses when acting as management or technical consultants. The 15% rate is imposed when the gross income of the Investment House exceeds Php720,000.00 for the relevant year, and the 10% rate is imposed if otherwise.

80. Fee-based income such as underwriting fee, arranger's fee, service/professional fee, management fee, and financial advisory fee paid or payable to an Investment House is subject to a creditable withholding tax of 10%.[102]

[101] National Internal Revenue Code of 1997, as amended by Republic Act No. 9238, § 27(D)(1) (1997).

[102] Revenue Regulations No. 2-98 §§ 2.57.2 (A)(6) and 2.57.2(B), as the case may be.

Value-Added Tax

81. All transactions entered into by an Investment House as a *dealer in securities* shall be subject to twelve percent (12%) VAT on the basis of the gross income received from its sale or exchange of securities.[103]

Gross Receipts Tax

82. Under Section 121(c) and (d) of the NIRC of 1997, as amended by Section 16 of RA No. 9337, a GRT of seven percent (7%) is imposed on: (a) the net trading gains on foreign currency, debt securities, derivatives and other similar financial instruments realized within each taxable year by IHQBs; and (b) the fee-based income (which includes underwriting fee, arranger's fee, service/professional fee, management fee, financial advisory fee), royalties, rentals of real or personal property, profits from exchange and other items treated as gross income under Section 32 of IHQBs.[104] Prior to RA No. 9337, the rate was five percent (5%). IHNQBs, on the other hand, are subject to a GRT of 5% for all interest, commissions, discounts and all other items treated as gross income under the Section 122 NIRC of 1997, as amended, which includes fee-based income.

83. Under Sections 3(a) and 4(b) of RR No. 09-2004, all interest, commissions and discounts realized from lending activities by IHQBs and IHNQBs shall be subject to the following rates of GRT: (i) five percent (5%) if remaining maturity period is five

[103] National Internal Revenue Code of 1997, as amended, § 108(A) (1997).

[104] *See also* Revenue Regulations No. 09-2004 § 3(d) (Jun. 21, 2004).

(5) years or less, and (ii) one percent (1%) if the remaining maturity period is more than five (5) years.

Documentary Stamp Tax

84. Any initial issuance of deposit substitutes or other types of debt instruments by IHNQBs is subject to a DST of One Peso (Php1.00) on each Two Hundred Pesos (Php200.00), or fractional part thereof, of the issue price of the said debt instruments.[105] Note, though, that pursuant to Section 9(h) of RA No. 9243, as implemented by RR No. 13-04, any issuance by IHQBs of repurchase agreements is exempt from DST.[106] For both IHQBs and IHNQBs, however, any sale of debt instruments in the secondary market shall not be subject to DST.

[105] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 179 (1997).

[106] BIR Ruling DA-296-05 (Jun. 29, 2005).

3.4 Pre-Need

3.4.1 General Background

85. The pre-need sector is governed by RA No. 8799 or the Securities Regulation Code ("SRC"). The SEC, through its Non-Traditional Securities and Instruments Department, regulates pre-need companies.

86. Under Rule 1.3 of the *New Rules on the Registration and Sale of Pre-Need Plans* ("Pre-Need Rules"),[107] a *pre-need company* is one that is authorized/licensed to sell or offer for sale pre-need plans. Pre-need companies can be either of two (2) types, namely: a single-plan company (i.e., sells one type of pre-need plan) or a multi-plan company (i.e., sells more than one type of pre-need plan).

87. A *pre-need plan* is a contract which provides for (i) the performance of future service/s or payment of future monetary consideration at the time of actual need, payable either in cash or installment by planholders at prices stated in the contract, with or without interest, or (ii) insurance coverage and includes life, pension, education, interment, and other plans which the SEC may from time to time approve.[108] Except for pre-need life plans, all the terms and conditions applicable to the insurance contract shall be segregated from the terms and conditions applicable to the pre-need plan.[109]

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[107] New Rules on the Registration and Sale of Pre-Need Plans Under Section 16 of the Securities Regulation Code (Aug. 16, 2001).

[108] *Id.* at Rule 1.2.

[109] *Id.* at Rule 29.1.

Trust Fund

88. The Pre-Need Rules require pre-need companies to establish independently with the trust department of a trust company, bank or investment house doing business in the Philippines, a Trust Fund for each type of pre-need plan for the purpose of guaranteeing the delivery of benefits to the planholders and their beneficiaries.[110] The Trust Fund shall have as a minimum limit on the deposit contribution thereto an amount equivalent to forty-five percent (45%) of the amount collected for life plans and fifty-one percent (51%) of the total amount collected for other plans unless a higher deposit contribution is determined by the actuary and subsequently approved by the SEC.[111]

89. In order to ensure the liquidity of the Trust Fund and to obtain sufficient capital growth to meet the growing actuarial reserve liabilities, Rule 17 of the Pre-Need Rules permits the investment of the Trust Fund only in the following, subject to defined qualifications: (a) short-term and long-term fixed income instruments, including government securities, savings/time deposits and common trust fund with a commercial bank of satisfactory BSP examination rating, commercial papers registered with the SEC and with SEC rating of "1" for short term and "Aaa" for long term, and direct loans with a maximum term of two (2) years to corporations which are financially stable, profitable for the last three (3) years and have a good track record of paying their previous loans from the Trust Fund of Pre-Need Companies;

[110] *Id.* at Rules 16.1 & 16.5(a).

[111] *Id.* at Rule 16.2.

(b) mutual funds registered with the SEC, where such funds are invested only in fixed income instruments and blue chip securities; (c) stocks listed on the main board of the Philippine Stock Exchange ("PSE"); and (d) real estate properties.

Liquidity Reserve Fund

90. Pre-need companies are also required to set aside no less than ten percent (10%) of the net value of the Trust Fund assets per type of pre-need plan as a *Liquidity Reserve Fund* to cover the benefits of the planholders for the ensuing year, unless the actuary of the pre-need company determines otherwise.[112] This fund may be invested in the following: (1) Loans secured by a hold-out on, assignment or pledge of deposits maintained either with the trustees or other banks, or of deposit substitutes or the trustee itself or mortgage and chattel mortgage bonds issued by a trustee; (2) Treasury notes or bills, BSP Certificates of Indebtedness which are short-term, other government securities or bonds and other evidences of indebtedness or obligations the servicing and repayment of which are fully guaranteed by the Republic of the Philippines; (3) Repurchase agreements with any of the entities mentioned in the previous item as underlying instruments thereof; (4) Savings or time deposits with government-owned banks or commercial banks; and (5) Fixed income instruments.[113]

[112] *Id.* at Rule 18.1.

[113] *Id.*

91. The various sources of income of a pre-need company may be summarized as follows: (a) Income from Sale of Pre-Need Plans – This includes profits realized from the sale of pre-need plans, which profits are recognized based on the installment payments actually collected from planholders; (b) Fee-Based Income, which includes Handling Fee, New Issue Fee, Amendment/Reconstruction/Replacement Fee, Reinstatement Fee, Commission Income;[114] (c) Investment/Interest Income – amount of interest from securities of affiliates and unconsolidated subsidiaries, marketable securities and other securities held by the Pre-Need Company other than income generated by the Trust Fund; and (d) Capital Gains – gain or loss from disposal of securities.

[114] *Id.* at Rule 31.1(2).

3.4.2 Matrix of Present Tax Treatment

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	CWT	CGT	VAT	GRT	STT	DST
I	Gross Receipts	NA	NA	NA	12%	NA	NA	P0.20 on each P200 of the premium or contribution collected
II	Installments Receipts	NA	NA	NA	NA	NA	NA	NA
III	Lapsed Portion of Liabilities	NA	NA	NA	NA	NA	NA	NA
IV	Fee-Based Income	NA	10%	NA	12%	NA	NA	NA
V	Investments							
	A. Deposits and Deposit Substitutes	20% or 7.5% of interest earned	NA	NA	NA	NA	NA	NA
	B. Stocks	intercorporate dividends received are exempt	NA	5% or 10% of net capital gains from sale, as the case may be	NA	NA	NA	NA
	C. Real Estate	NA	5% on rent income	6% on presumptive gain from sale	NA	NA	NA	NA
VI	Income Payments	20%, 10%, or 6%, as the case may be	20%, 10%, 5%, 2% or 1%, as the case may be	NA	NA	NA	NA	NA
VII	Trust Fund Investments	20%	NA	NA	NA	NA	NA	NA

3.4.3 Details of Present Tax Treatment

Final Withholding Tax

92. Under Section 27(D)(1) of the NIRC of 1997, the interest income from investments in deposit, deposit substitutes and trust fund is subject to a twenty percent (20%) FWT; the rate is seven and a half percent (7.5%) for investment in FCDU deposits.

93. An FWT of twenty percent (20%) is imposed on the interest gained on the Trust Fund and the investments of the Trust Fund in time deposits, commercial papers, promissory notes, government securities, loans, bonds, common trust fund or unit investment trust fund.

Creditable Withholding Tax

94. Rental income derived by pre-need companies as well as by the Trust Fund from real estate is subject to CWT of five percent (5%) under Section 2.57.2(C)(1) of RR No. 02-98, as amended.

95. On the other hand, fee-based income is generally subject to a CWT of ten percent (10%) as prescribed under Section 2.57.2(A)(6) and (B) of RR No. 02-98, as amended.

Value-Added Tax

96. Pre-need companies are considered dealers in securities. As such, services provided in the sale of pre-need plans are subject to the VAT at the rate of twelve percent (12%).[115] Service fees are likewise subject to the VAT.

97. VAT at the same rate is also imposed on the investment of the Trust Fund in real estate.

Documentary Stamp Tax

98. On pre-need plans, the DST shall be twenty centavos (Php0.20) on each two hundred pesos (Php200.00), or fractional part thereof, of the premium or contribution collected pursuant to Section 186 of NIRC of 1997, as amended through RA No. 9243.

99. The deeds of conveyance executed for the transfer of properties from the Pre-Need Company as Trustor to the Trustee and administrator of the Trust Fund, with the intention of having the said properties form part of the Trust Fund, is not subject to the DST imposed under Section 175 of NIRC of 1997, but only to the DST imposed on notarial acknowledgments under Section 188.[116]

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[115] Consolidated Value-Added Tax Regulations of 2005, Revenue Regulations No. 16-2005 § 4.108-3(j) (Sept. 01, 2005)

[116] BIR Ruling No. DA-005-03 (Jan. 1, 2003).

3.5 *Securities Brokers and Dealers*

3.5.1 General Background

100. The Philippine equity market is governed by the SRC, as amplified by the *Amended Implementing Rules and Regulations of the Securities Regulation Code*, and is subject to the supervision by the SEC. The market structure is comprised of these players: (a) the exchanges; (b) the clearing agencies and (c) the market intermediaries, which include Investment Houses, Financing Companies, Broker-Dealer Firms, Mutual Funds and Investment Management Companies.[117] Since the other intermediaries are treated elsewhere in this study, this section focuses on Broker-Dealer Firms. These market players are required to register with the SEC.[118]

101. Under the SRC, a *broker* "is a person engaged in the business of buying and selling securities for the account of others."[119] In contrast, a *dealer* is "any person who buys and sells securities for his/her own account in the ordinary course of business."[120] Sections 28 to 31 of the SRC govern the regulation of securities market professionals such as brokers and dealers in securities.

102. The term *exchange* refers to "an organized marketplace or facility that brings together buyers and sellers and executes trades of securities and/or commodities."[121]

[117] FINANCIAL SECTOR ASSESSMENT PROGRAM, *supra* note 20, at 3-4.

[118] Securities Regulation Code, Republic Act No. 8799 § 28 (for brokers and dealers), § 33 (for exchanges) & § 42 (for clearing agencies) (2000).

[119] *Id.* at § 3.3.

[120] *Id.* at § 3.4.

[121] *Id.* at § 3.7.

The Philippine Stock Exchange ("PSE") currently operates the sole stock exchange in the country.[122] Sections 32 to 38 of the SRC deals with exchanges and other securities trading markets.

103. The term *clearing agency* refers to "any person who acts as intermediary in making deliveries upon payment to effect settlement in securities transactions."[123] At present, the SEC-registered clearing agencies are the Securities Clearing Corporation of the Philippines, which operates as the clearing and settlement agency for depository-eligible trades in the PSE, and the Philippine Central Depository, Inc., which is registered as a clearing agency acting as a depository under Section 42.2(f) of the SRC.[124]

[122] RAFAEL A. MORALES, THE PHILIPPINE SECURITIES REGULATION CODE (ANNOTATED) 231 (2005) [hereinafter MORALES]. The other exchanges in the Philippines are the Fixed Income Exchange where fixed-income debt securities are traded and the Commodity Futures Exchange which is expected to reopen. *Id.*

[123] Securities Regulation Code, Republic Act No. 8799, § 3.6 (2000).

[124] MORALES, *supra* note 120, at 27-28.

3.5.2 Matrix of Present Tax Treatment

Nature of Transaction/Instrument		Nature of Tax and Tax Rate							
		FWT	CWT	CGT	VAT	GRT	STT	IPO tax	DST
I	Sale or transfer of shares of stock								
	A.listed	NA	NA	NA	NA	NA	0.5% on gross selling price	NA	Exempt
	B. non-listed	NA	NA	5% or 10% of net capital gains from sale, as the case may be	NA	NA	NA	NA	P0.75 on each P200 of par value; if without par value, 25% of DST paid upon original issue
II	Initial Public Offering	NA	NA	NA	NA	NA	NA	4%, 2% or 1% (based on the proportion of disposed shares to total outstanding shares)	Php1.00 on each P200 of par value. If without par value, Php1.00 on each P200 of the actual consideration for issuance of such shares.
IV	Fees and commissions (broker's commission, transfer fee, cancellation fee)	NA	NA	NA	12%	NA	NA	NA	NA

3.5.3 Details of Present Tax Treatment

Percentage Tax

(a) Stock Transaction Tax

104. Under Section 127(A) of the NIRC of 1997, the sale or transfer of shares of stock listed in and traded through the stock exchange **other than by a dealer in securities** is subject to tax at the rate of one-half of one percent (1/2 of 1%) on the gross selling price or gross value in money of the shares. The tax is paid by the seller or transferror.

(b) Initial Public Offering Tax

105. The disposition of shares of stock by closely held corporations through initial public offering is subject to tax at the following rates based on the gross selling price or gross value in money of the shares of stock disposed in accordance with the proportion of shares of stock disposed to the total outstanding shares of stock after the listing in the local stock exchange:

Up to twenty-five percent (25%)	4%
Over twenty-five percent (25%) but not over thirty-three and one third percent (33 1/3%)	2%
Over thirty-three and one third percent (33 1/3%)	1%

The tax is paid by the issuing corporation in primary offering or by the seller in secondary offering.[125]

Value Added Tax

106. A twelve percent (12%) VAT is imposed on the following standard fees relating to services rendered by brokers and the clearing agency: (a) brokerage commission based on the minimum commission rates prescribed by the PSE; (b) transfer fee of Php100.00; and (c) cancellation fee of Php10.00.

Documentary Stamp Tax

107. The sale or transfer of shares of stock listed in and traded through the PSE is exempt from DST for a period of five years from the date RA No. 9243 took effect, or until 20 March 2009.[126] In contrast, the sale or transfer of shares of stock not listed in the PSE is subject to DST at the rate of (a) Php0.75 on each Php200.00, or fractional part thereof, of the par value of such stock, or (b) for stocks without par value, 25% of the DST paid upon the original issue of said stock.[127]

108. A DST is imposed on every original issue of shares of stock at the rate of Php1.00 on each Php200.00, or fractional part thereof, of the following DST base: (a) where the shares are issued with par value, the par value of such shares; (b) for

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[125] National Internal Revenue Code of 1997, as amended, § 127 (B). "The term *closely held corporation* means any corporation at least fifty percent (50%) in value of the outstanding capital stock or at least fifty percent (50%) of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by or for not more than twenty (20) individuals." *Id.*

[126] National Internal Revenue Code of 1997, as amended by Republic Act No. 9243, § 199(e) (1997).

[127] *Id.* at § 175.

shares without par value, the actual consideration for the issuance of such shares of stock; or (c) where shares without par value are issued as stock dividends, the actual value represented by each share.[128]

[128] *Id.* at § 174. *See also* Revenue Regulations No. 13-2004 § 3 (Dec. 23, 2004).

3.6 Financing Companies

3.6.1 General Background

109. RA No. 8556, or the Financing Company Act of 1998, was enacted to amend RA No. 5980. The Financing Company Act of 1998 places financing companies under the regulation of the SEC. In addition to the statute, the *Rules and Regulations to Implement the Provisions of Republic Act No. 8556,* promulgated by the SEC, regulate the operation of financing companies.

110. Financing companies are corporations primarily organized for the purpose of extending credit facilities to consumers and to industrial, commercial, or agricultural enterprises, by means of the following: (a) direct lending or discounting or factoring commercial papers or accounts receivables; (b) buying and selling contracts, leases, chattel mortgages, or other evidences of indebtedness; or (b) financial leasing of movable and immovable property.[129] The term excludes banks, investment houses, savings and loan associations, insurance companies, cooperatives and such other financial institutions organized or operating under special laws.[130]

111. The following financing companies are also subject to the pertinent rules and regulations of the BSP: (a) those with quasi-banking license; (b) those that are subsidiaries/affiliates of banks; (c) those that are subsidiaries/affiliates of non-bank

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[129] Rules and Regulations To Implement the Provision of Republic Act No. 8556 § 1(a) (May 20, 1999).

[130] *Id.*

financial intermediaries with quasi-banking license; and (d) those with authority to engage in trust operations.[131]

112. Leasing by financing companies is classified as either *financial leasing* or *operating lease*. Under RR No. 09-2004, the term *financial leasing* refers to "a mode of extending credit through a non-cancelable lease contract under which the lessor purchases or acquires, at the instance of the lessee, machinery, equipment, motor vehicles, appliances, business and office machines, and other movable or immovable property in consideration of the periodic payment by the lessee of a fixed amount of money sufficient to amortize at least seventy percent (70%) of the purchase price or acquisition cost, including any incidental expenses and a margin of profit over an obligatory period of not less than two (2) years during which the lessee has the right to hold and use the leased property with the right to expense the lease rentals paid to the lessor and bears the cost of repairs, maintenance, insurance and preservation thereof, but with no obligation or option on his part to purchase the leased property from the owner-lessor at the end of the lease contract."[132] It is a lease "that substantially transfers all the risks and rewards incident to ownership of an asset," with the title thereto may or may not be eventually transferred.[133] In contrast,

[131] Rules and Regulations To Implement the Provision of Republic Act No. 8556, § 7 (May 20, 1999).

[132] Revenue Regulations No. 09-2004 § 2.8 (Jun. 21, 2004) (citing Financing Company Act of 1998, Republic Act No. 8556 § 3(d)).

[133] *Id.*

an *operating lease* is defined negatively as “a lease other than a finance lease of a finance company.”[134]

113. It is noteworthy that the Supreme Court, citing RR No. 19-86, defines *operating lease* as “a contract under which the asset is not wholly amortized during the primary period of the lease, and *where the lessor does not rely solely on the rentals during the primary period for his profits, but looks for the recovery of the balance of his costs and for the rest of his profits from the sale or re-lease of the returned asset* at the end of the primary lease period.”[135]

114. Financing companies also engage in receivable financing, which is “a mode of extending credit through the purchase by, or assignment, to, a financing company of evidence of indebtedness or open accounts by discounting or factoring.”[136] In discounting of receivables, “evidence of indebtedness of a third party, such as installment contracts, promissory notes, and similar instruments, are purchased by, or assigned to, a financing company in an amount or for a consideration less than their face value.”[137] On the other hand, in factoring of receivables “open accounts, not evidenced by a written promise to pay supported by documents such as but not limited to invoices of manufacturers and suppliers delivery receipts and similar

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[134] *Id.* at § 2.9.

[135] Beltran v. PAIC Finance Corporation, G.R. Nos. 83113 & 83256, May 19, 1992, 209 SCRA 105, 117.

[136] Rules and Regulations To Implement the Provision of Republic Act No. 8556, § 1(h) (May 20, 1999).

[137] *Id.* at § 1(i).

documents, are purchased by, or assigned to, a financing company in an amount or for a consideration less than the outstanding balance of the open accounts."[138]

[138] *Id.* at § 1(j).

3.6.2 Matrix of Present Tax Treatment

Nature of Transaction/Instrument		Nature of Tax and Tax Rate					
		FWT	CWT*	CGT	VAT	GRT	DST
I	Leasing						
	A. Finance Lease	NA	2% on interest***	NA	NA	5% on interest income	NA
	B. Operating Lease	NA	5% on gross rental	NA	NA	5% on gross rental	NA
II	Loans	NA	NA	NA	NA	5% on interest income	P1.00 for every P200.00
III	Discounting of Receivables	NA	NA	NA	NA	5% on interest income	P1.00 for every P200.00
IV	Deposit with Banks	20%	NA	NA	NA	NA	NA
V	Investments						
	Government Securities Quasi Bank Promisorry Notes	20% on interest income	NA	NA	NA	NA	NA
	Government Securities	32% on trading gain	NA	NA	NA	NA	NA
VI	Borrowings						
	A. Promissory Notes	20%	NA	NA	NA	NA	P1.00 for every P200
	B. Interbank Loan- term	20%	NA	NA	NA	NA	P1.00 for every P200

Nature of Transaction/Instrument		Nature of Tax and Tax Rate					
		FWT	CWT*	CGT	VAT	GRT	DST
VII	Payments						
	Capital Expenditures	NA	1%****	NA	NA	NA	NA
	Services	NA	2%****	NA	NA	NA	NA
	Rentals	NA	5%	NA	NA	NA	NA
	Commissions	NA	10%	NA	NA	NA	NA
	Professional Fees	NA	15%	NA	NA	NA	NA
VIII	Gain on Sale of Acquired Assets	NA	NA	NA	NA	7%	NA

* 1% on cost of asset purchased and/or 1% on Selling Price of leased asset for Top 10,000 Corporations

*** for Lessees belonging to Top 10,000 Corporations and classifying Finance Lease as purchase of services

**** only if Finance Company belongs to the Top 10,000 Corporations as determined by BIR

3.6.3 Details of Present Tax Treatment

Final Withholding Tax

115. The following income derived by financing companies is subject to the twenty percent (20%) FWT: (a) interest income from bank deposits; (b) interest income from investments in government securities, quasi-bank promissory notes and commercial papers. A thirty-two percent (32%) FWT is imposed on the trading gain derived from government securities.

116. Borrowings, through promissory notes and interbank term loans, are subject to a twenty percent (20%) FWT.

Creditable Withholding Tax

117. A CWT of two percent (2%) is imposed on *finance lease* transactions where the lessees belong to the top ten thousand (10,000) private corporations and classify the finance lease as purchase of services.[139]

118. In contrast, a five percent (5%) CWT is imposed on the gross rental in *operating lease* transactions.[140]

119. For finance companies that belong to the top ten thousand (10,000) corporations as determined by the BIR, payments made for capital expenditures is

[139] Revenue Regulations No. 17-2003 § 3 (Mar. 31, 2003) (amending Revenue Regulations No. 02-1998 § 2.57.2(M) (Apr. 17, 1998)).

[140] Revenue Regulations No. 17-2003 § 3 (Mar. 31, 2003) (amending Revenue Regulations No. 02-1998 § 2.57.2 (C)(2) (Apr. 17, 1998)) *and* Revenue Regulations No. 14-2002 § 2 (Sept. 9, 2002) (amending Revenue Regulations No. 02-1998 § 2.57.2(C)(1) (Apr. 17, 1998)).

subject to a one percent (1%) CWT while their payments for services are subject to a two percent (2%) CWT.

120. CWT at the following rates respectively apply to payments made by financing companies: (a) for rentals – five percent (5%); (b) for commissions – ten percent (10%); and (c) for professional fees – fifteen percent (15%).

Gross Receipts Tax

121. The imposition of the GRT on financing companies is governed by: (a) Sections 121 and 122 of the NIRC of 1997, as amended by RA No. 9238 and RA No. 9337; and (b) RR No. 09-2004. As mentioned under the banking sector, the leasing services rendered by financing companies were subject to the VAT for the brief period of 01 January to 31 December 2003.

122. A GRT rate of five percent (5%) is imposed on (a) the interest income alone in cases of financial leasing, or (b) the gross rental in case of operating lease. The substance of the document evidencing the lease transaction, rather than its form, determines whether the transaction is finance lease or operating lease.[141] The same GRT rate applies to the interest income derived by financing companies from lending activities and discounting of receivables.

[141] Revenue Regulations No. 09-2004 § 3 (c) (for financing companies performing quasi-banking functions) & § 4 (for financing companies not performing quasi-banking functions) (Jun 21, 2004).

Documentary Stamp Tax

123. Section 179 of the NIRC of 1997 imposes a DST on every original issue of debt instruments at the rate of one peso (Php1.00) on each two hundred pesos (Php200.00), of fractional part thereof, of the issue price of any such debt instrument. This applies to direct lending and discounting of receivables by finance companies. It also applies to the borrowings of finance companies.

3.7 Mutual Funds

3.7.1 General Background

124. RA No. 2629 or the Investment Company Act governs the investment company industry. The statute is primarily amplified by the *Rules and Regulations Governing Investment Companies Under RA No. 2629* of 31 October 1989 promulgated by the SEC.

125. Under the law, an investment company is "any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting and trading in securities."[142] Investment companies are either open-end or close-end. An *open-end investment company* refers "to an investment company which is offering for sale, or has outstanding, any redeemable security, of which it is the issuer."[143] The law defines a *close-end investment company* as one "other than an open-end company."[144] To further distinguish the two, an open-end investment company "offers for sale continuously and without limit its own outstanding shares and stands ready to redeem the same upon the request of the owner," whereas, a close-end investment company "has a fixed number of shares and is under no contractual agreement to repurchase their shares" and "usually

[142] Rules and Regulations Governing Investment Companies Under Republic Act No. 2629 § 1.1(d) (Oct. 31, 1989)

[143] *Id.* at § 1.1(e).

[144] *Id.* at § 1.1(f).

issues its securities in large blocks and sells it at infrequent intervals as the need for fund[s] arises."[145]

126. A mutual fund is an "investment company that pools money from individuals and institutional investors—its shareholders—to invest in a variety of securities" such as "stocks, bonds, money market securities."[146] These securities are professionally managed on behalf of the shareholders in accordance with express investment objectives.[147] Philippine mutual funds are established as open-end investment companies. As such, a mutual fund "continuously sells its shares and stands to redeem—or buy back—the shares from its investors at the prevailing net asset value per share (NAVPS)."[148]

127. There are three (3) ways by which the investors or shareholders earn from their mutual fund investments, namely: (a) dividend payments; (b) capital gains distribution; and (c) increased net asset value ("NAV"), i.e., "the peso value of one share of stock in the fund, and the price the fund pays [its shareholder] per share when [the shareholder] sell[s]."[149]

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[145] National Tax Research Center, *Review of the Taxation of Mutual Funds*, NTRC TAX RESEARCH JOURNAL vol. viii(2), 5-6 (1996).

[146] Larissa Josephine C. Vila, *Mutual fund: an investment alternative,* BUSINESS WORLD GUIDE TO MUTUAL FUNDS, HEDGE FUNDS AND TRUST FUNDS, Jul. 28, 2005, at 2. Section 22(BB) of the NIRC of 1997 defines *mutual fund company* as an open-ended and close-ended investment company as defined under the Investment Company Act.

[147] *Id.*

[148] *Id.*

[149] *Id.*

128. The Philippine mutual funds market is currently comprised of the following types of funds: stock funds; bond funds; money market funds; balanced funds; and index funds.[150]

[150] *Id. See also* Liezl Eillen C. Antonio, *Choosing the right type of mutual fund*, BUSINESS WORLD GUIDE TO MUTUAL FUNDS, HEDGE FUNDS AND TRUST FUNDS, Jul. 28, 2005, at 6.

3.7.2 Matrix of Present Tax Treatment

Nature of Transaction/Instrument		Nature of Tax and Tax Rate						
		FWT	EWT	CGT	VAT	GRT	STT	DST
I	Issuance of Capital Stock	NA	NA	NA	NA	NA	NA	P1.00 on each P200
II	Redemption of Capital Stock	NA	NA	NA	NA	NA	NA	NA
III	Investment in fixed income securities							
	A. government securities	20%	NA	NA	NA	NA	NA	NA
	B. special savings	20% or 7.5%	NA	NA	NA	NA	NA	NA
	C. corporate bonds	20%	NA	NA	NA	NA	NA	NA
IV	Investment in shares of stock							
	A. listed shares	NA	NA	NA	12% - broker's commission	NA	0.5%	exempt
	B.unlisted shares	NA	NA	5% or 10%	NA	NA	NA	P0.75 on each P200

3.7.3 Details of Present Tax Treatment

Final Withholding Tax

129. The investment by mutual funds in the following Philippine Peso-denominated fixed income securities are subject to the following FWT rates: (a) government securities – twenty percent (20%); (b) special savings – twenty percent (20%); (c) corporate bonds – twenty percent (20%).[151]

130. Investment in foreign exchange-denominated special savings is subject to a FWT rate of seven and a half percent (7.5%).[152]

131. Under Section 24(B)(2) of the NIRC of 1997, dividends received by individuals from mutual fund companies is currently subject to a final tax of ten percent (10%).

Capital Gains Tax

132. The disposition of unlisted shares of stock of a domestic corporation is subject to CGT of five percent (5%) or ten percent (10%).

Value Added Tax

133. Section 108(A) of the NIRC imposes a twelve percent (12%) VAT on broker's commission in the buying and selling of shares listed in the stock exchange.

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[151] Revenue Regulations No. 02-1998, as amended, § 2.57.1 (G)(1) (Apr. 17, 1998).

[152] *Id.* at § 2.57.1(G)(3).

Stock Transaction Tax

134. Under Section 127(A) of the NIRC of 1997, the disposition of shares of stock listed and traded through the local stock exchange is subject to a percentage tax of one-half of one percent (1/2 of 1%).

Documentary Stamp Tax

135. Pursuant to Section 174 of the NIRC of 1997, the original issuance by mutual fund companies of its shares of stock is subject to DST of Php1.00 on each Php200.00, or fractional part thereof, of (a) of the par value of such shares; or (b) on the actual consideration for the issuance of such shares of stock in case of shares without par value; or (c) on the actual value represented by each share in case of stock dividends.

136. Under Section 175 of the NIRC of 1997, the sale or transfer of shares of stock not listed in the PSE is subject to DST rate of (i) Php0.75 on each Php200.00, or fractional part thereof, of the par value of such stock, or (ii) for stocks without par value, 25% of the DST paid upon the original issue of said stock. On the other hand, the transfer of listed shares is not subject to DST for a period of five (5) years from 20 March 2004 in accordance with Section 199(e), NIRC of 1997.

PART II – MAJOR TAX-RELATED ISSUES/CONCERNS

137. This second part of the report surfaces the major tax-related issues raised by the financial sector players through their respective associations. These issues are classified as cross-sectoral and sector-specific.

138. Classified as cross-sectoral are those issues that affect the players as a group and those where one sector may have an advantage over other sectors. These cover the identified instances of tax arbitrage and the administrative and judicial interpretation of tax laws impacting on the financial sector.

4 Cross-Sectoral Tax Issues

4.1 Incidence of Tax Arbitrage

(1) Long-Term Investment Products

139. One of the thrusts of the Tax Reform Act of 1997 or RA No. 8424 was to encourage long-term savings. This translates to tax incentives given to long-term investment products provided by both the bank and non-bank sectors.

140. For the banking sector, the tax incentive took the form of exemption from the 20% FWT of long-term investment banking products pursuant to Section 22(FF), Section 24(B)(1) and Section 25(A)(2) of the NIRC of 1997. Section 22(FF) defines *long-term deposit or investment certificate* as referring to "certificate of time deposit or investment in the form of savings, common or individual trust funds, deposit substitutes, investment management accounts and other investments with a maturity period of not less than five (5) years, the form of which shall be prescribed by the

Bangko Sentral ng Pilipinas (BSP) and **issued by banks only (not by non-bank financial intermediaries and finance companies)** to individuals in denominations of Ten thousand pesos (P10,000) and other denominations as may be prescribed by the BSP."[153]

141. Section 24(B)(1) concerns individual citizens and resident aliens and relevantly provides that "interest income from long-term deposit or investment in the form of savings, common or individual trust funds, deposit substitutes, investment management accounts and other investments evidenced by certificates in such form prescribed by the Bangko Sentral ng Pilipinas (BSP) shall be exempt from the [20% final income] tax imposed under this Subsection." To avail of the exemption the deposit or investment must not be pre-terminated before the fifth year; otherwise, the interest income shall be subject to final tax of 5%, 12% and 20% depending on the holding period. An identical exemption from the 20% FWT is given to non-resident aliens engaged in trade or business in the Philippines as per Section 25(A)(2).

142. On the other hand, Section 32(B)(7)(g) of the NIRC of 1997 provides the incentives granted to long-term debt instruments, which are "not limited only to instruments issued by institutions regulated by the Bangko Sentral ng Pilipinas (BSP), nor to instruments that are issued exclusively to individuals."[154] This provision enumerates as one of the miscellaneous items, which shall not be included in gross income and shall be exempt from income tax, the following: "Gains realized from the

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[153] Emphasis added.

[154] BIR Ruling [DA-144-01] (Aug. 30, 2001).

sale or exchange or retirement of bonds, debentures or other certificates of indebtedness with a maturity of more than five (5) years."

143. According to the Investment House Association of the Philippines ("IHAP"), the clear scope of the 20% FWT exemption granted to long-term investment instruments of banks as contradistinguished from the scope of the exemption granted in Section 32(B)(7)(g) gives a distinct advantage to banks that is detrimental to all other capital market players. The disadvantage stems from the construction of the scope of the term *gain* in Section 32(B)(7)(g). The legal issue is whether the term *gain* encompasses all forms of income derived from long-term (i.e., with a maturity of more than five (5) years) certificates of indebtedness, including interest income.

144. In response to queries raised by non-bank financial institutions, the BIR issued rulings to the effect that the term *gains* embraces "income, yield or interest, which are all synonymous with gains, whether discounted or at premium."[155] Consequently, the interest income derived from long-term certificates of indebtedness is likewise exempt from the 20% FWT. However, the CTA rejected this BIR interpretation in the leading case of *Nippon Life Insurance Company of the Philippines, Inc. v. Commissioner of Internal Revenue*, C.T.A. Case No. 6142, 04 February 2002.

145. In *Nippon Life*, the CTA, applying the principle that where a provision granting tax exemption is susceptible to a restrictive interpretation then such interpretation must be adopted, held that the term *gains* in Section 32(B)(7)(g) does not include

[155] BIR Ruling No. 16-2000 (Jan. 7, 2000). *See also* BIR Ruling No. 166-1999 (Oct. 25, 1999); BIR Ruling No. 20-2001 (May 31, 2001).

interest. The CTA gave the following reasons: (a) the general rule that the term *gains*, in its general sense, includes or is synonymous to *interest* cannot be applied to Section 32(B)(7)(g) because this provision specifically refers to *gains from the sale* of bonds, debentures and other certificates; (b) Section 32(A) separately classifies as items of gross income “gains derived from dealings in property” and “interest”; (c) Sections 24(B)(1) and 25(A)(2) exempts from income tax the interest derived by citizens, resident aliens and nonresident aliens engaged in trade or business within the Philippines from certain long-term deposit or investment, whereas there is no such exemption from income tax on such interest for domestic or foreign corporations under Section 27 and 28; and (d) if Congress intended to exempt the *interest* derived from long-term bonds, debentures and other certificates of indebtedness under Section 32(B)(7)(g), it would have done so in clear and specific terms.[156] The Court of Appeals affirmed the CTA’s *Nippon Life* holding.[157] In turn, the Supreme Court affirmed the Court of Appeals via a minute resolution denying Nippon Life’s petition for review on certiorari for failure to show that the Court of Appeals committed reversible error.[158] The CTA reiterated *Nippon Life* in a long line of subsequent cases.[159]

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[156] Nippon Life Insurance Company of the Philippines, Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 6142, February 4, 2002.

[157] *See* Nippon Life Insurance Company of the Philippines, Inc. v. Commissioner of Internal Revenue, CA-G.R. SP No. 69224, November 15, 2002

[158] *See* Nippon Life Insurance Company of the Philippines, Inc. v. Commissioner of Internal Revenue, G.R. No. 159162, November 19, 2003. The CTA cited the Supreme Court’s resolution in First Nationwide Assurance Corp. v. Commissioner of Internal Revenue, C.T.A. EB Case No. 1 (C.T.A. Case No. 6473), June 7, 2005, thus: “G.R. No. 159612 (*Nippon Life Insurance Company of the Philippines, Inc. vs. Commissioner of Internal Revenue*) — Acting on the petition for review on *certiorari* of the decision dated November 15, 2002 of the Court of Appeals in CA-G.R. SP No. 69224, the Court

146. IHAP points to the contrasting scope of the tax incentives given to the banking sector from that granted to the non-banking sector as a key reason behind the concentration of savings in long-term bank investment products.

147. For the Life Insurance sector, the tax exemption should equally apply to investments in long-term insurance products such as variable life and deferred annuities.

(2) Trust Accounts

148. As earlier mentioned, the NIRC of 1997 exempts from the 20% FWT the interest income derived by individual citizens, resident aliens and non-resident aliens engaged in trade or business in the Philippines from, among others, common trust funds, individual trust funds or investment management accounts. The BSP essayed its role in implementing the exemption through its *BSP Memorandum To All Banks*

Resolved to DENY the petition for failure of petitioner to show that a reversible error had been committed by the appellate court."

[159] *See* Malayan Reinsurance v. Commissioner of Internal Revenue, C.T.A. Case No. 6252, July 24, 2002; Malayan Zurich Insurance v. Commissioner of Internal Revenue, C.T.A. Case No.6251, September 30, 2002 (affirmed in CA-G.R. SP No. 77070, March 28, 2005; First Nationwide Assurance Corp. v. Commissioner of Internal Revenue, C.T.A. Case No. 6253, October 3, 2002; Rizal Commercial Banking Corp. v. Commissioner of Internal Revenue, C.T.A. Case No. 6228, December 4, 2002, Malayan Insurance Co. v. Commissioner of Internal Revenue, C.T.A. Case No. 6243, December 16, 2002; Tokio Marine Malayan Insurance Co. v. Commissioner of Internal Revenue, C.T.A. Case No. 6254, January 13, 2003 (affirmed in CA-G.R. SP No. 77639, June 29, 2004); RCBC Savings Bank v. Commissioner of Internal Revenue, C.T.A. Case No. 6341, May 5, 2003; Nippon Life Insurance Co. v. Commissioner of Internal Revenue, C.T.A. Case No. 6323, July 24, 2003; Nippon Life Insurance Co. v. Commissioner of Internal Revenue, C.T.A. Case No. 6348, September 12, 2003; Tokio Marine Malayan Insurance Co. v. Commissioner of Internal Revenue, C.T.A. Case No. 6472, December 1, 2003; First Nationwide Assurance Corp. v. Commissioner of Internal Revenue, C.T.A. Case No. 6473, December 22, 2003; Malayan Insurance Co., Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 6471, January 26, 2004; Great Pacific Life Assurance Corp. v. Commissioner of Internal Revenue, C.T.A. Case No. 6342, May 11, 2004; Malayan Zurich Insurance Co. v. Commissioner of Internal Revenue, C.T.A. Case No. 6474, September 2, 2004.

Performing Trust, Other Fiduciary Business and Investment Management Activities dated 03 January 2000. This memorandum amended the Manual of Regulations for Banks by adding the following provisions: (a) Section X409.8 on tax-exempt individual trust accounts; (b) Section X410.7 on tax-exempt common trust funds; and (c) Section X411.9 on tax-exempt individual investment management accounts. These provisions respectively enumerate the features/requirements of the aforesaid long-term investment products in order to qualify for the tax exemption.

149. One such feature/requirement pertains to the transacting parties. For individual trust accounts, the "trust indenture/agreement shall only be between individuals who are Filipino citizens or resident aliens and banks acting as trustee."[160] For common trust funds, the "CTF indenture or plan as well as evidences of participation shall clearly indicate that participants shall be limited to individual trustors/investors who are Filipino citizens or resident aliens."[161] For individual investment management accounts, the "investment management agreement shall only be between individuals who are Filipino citizens or resident aliens and investment manager-banks."[162] Notwithstanding the restrictive language limiting the qualified individual investor to citizens and resident aliens, it should be noted that the BIR clarified that while "BSP Memorandum dated January 3, 2000 allows only individual resident citizens and individual resident aliens to invest in a [Common Trust

[160] MORB, *supra* note 27, at § X409.8(b).

[161] MORB, *supra* note 27, Appendix 60. Prior to the introduction of the Unit Investment Trust Fund, this feature/requirement is denominated as Section X410.7(b).

[162] MORB, *supra* note 27, at § X411.9(b).

Fund, Individual Trust Account, or Investment Management Account], the same principles on exemption of investment in long-term deposit or investment certificates apply to non-resident alien individuals engaged in trade or business in the Philippines" as per Section 25(A)(2) of the NIRC of 1997.[163]

150. Investment houses authorized by the Monetary Board to engage in trust and other fiduciary business do not enjoy the exemption. Thus, the interest income derived from CTFs, where the trustee is an investment house, is subject to the 20% FWT.

151. As previously mentioned, pre-need companies are required to put up a Trust Fund that it may invest in long-term investment certificates. The interest income derived by a pre-need company's Trust Fund from long-term investments is not exempt from the 20% FWT.[164] For example, under the former Section X410.7(b) of the Manual of Regulations for Banks the CTF "shall be limited to individual trustors/investors who are Filipino citizens or resident aliens." The sector, through the Philippine Federation of Pre-Need Plan Companies ("Pre-Need Federation") pushes for the inclusion of the clause "pre-need companies and their medium term

[163] BIR Ruling No. 03-2005 (Jul. 22, 2005).

[164] *But see* BIR Ruling No. 003-05 (Jul. 22, 2005): "Accordingly, since, for tax purposes, a trust is treated as an individual, interest/discount earned by the Funds may be exempt from the 20% final withholding tax if the conditions set forth in Sec. 24(B)(1) in relation to Sec. 22(FF) of the Tax Code on long term deposits or investments are complied with. …Otherwise stated, the interest income of a trust may be exempt from the 20% final withholding tax only if the underlying investment is a long term investment or deposit as defined in Section 22(FF), and the trust holds on to that deposit or investment for at least 5 years."

investments through their trustee banks" in the permitted parties of the trust agreements such that these shall be covered by the tax exemption.

(3) Preferential Tax Treatment to Expanded Foreign Currency Deposit System

152. Section 24(B)(1) of the NIRC of 1997 provides in part that the interest income derived by individual citizens and resident aliens "from a depository bank under the expanded foreign currency deposit system shall be subject to a final income tax at the rate of seven and one-half percent (7 1/2%)." The same final income tax applies to the interest income derived from a depository bank under the expanded foreign currency deposit system by a domestic corporation under Section 27(D)(1) and by a resident foreign corporation as per Section 28(A)(7)(a). In contrast, the final income tax rate for interest income derived from peso-denominated bank deposits is twenty percent (20%).

153. In addition, Section 27(D)(3) for domestic corporations and Section 28(A)(7)(b) for resident foreign corporations uniformly provide that: (a) the interest income from foreign currency loans granted by depository banks under the expanded foreign currency deposit system to residents (other than offshore units in the Philippines or other depository banks under the expanded system) shall be subject to a final tax at the rate of ten percent (10%); and (b) any income of nonresidents, whether individuals or corporations, from transactions with depository banks under said expanded system shall be exempt from income tax.

154. IHAP stresses that the preferential income tax rate accorded to foreign currency deposits spurs the migration of funds away from peso-denominated investment products.

(4) Retirement Plan

155. Retirement plans administered or managed by the trust department of banks enjoy income tax exemption under Section 32(B)(6)(a) of the NIRC of 1997, which provides that the benefits received by retirees from retirement plans approved by the BIR are exempt from tax. In addition, Section 60(B) of the NIRC of 1997 exempts from tax the income of an employee trust fund, i.e., covered by a trust agreement with a trust entity, such as a bank.

156. Under RR No. 1-68, life insurance companies may administer retirement funds as insurers under a Deposit Administration Contract or Group Deferred Annuity Contract. However, income generated from these funds is subject to income tax. The distinction lies in the fact that banks manage these funds as *trustees*, while life insurance companies do so as *insurers*. The life insurance sector, through the Philippine Life Insurance Association ("PLIA"), therefore proposes that insurance companies be permitted to act as trustees of private benefit retirement or other plans in order for such plans to enjoy the income tax exemption granted under Section 60(B).

157. The Pre-Need Federation advocates a similar position for pension plans offered by pre-need companies.

(5) Educational Plan

158. Given that the VAT covers pre-need companies, the premiums pertaining to pre-need educational plans are subject to the 12% VAT. In contrast, educational plans offered by life insurance companies are not subject to the VAT. Instead, the premium tax of 5% is imposed.

4.2 Shifting Interpretation of Tax Law

(1) 19-Lender Rule

159. The so-called "19-lender rule" is material in definition of the terms *public* and *deposit substitutes*. The interpretation of this rule vis-à-vis government debt instruments and securities became the subject of recent administrative interpretation.

160. BIR Ruling No. 020-01 concerned the issuance of the 10-year zero-coupon PEACe bonds (Treasury notes).[165] The bonds were originally issued to a single non-government entity, Code NGO. Code NGO thereafter resold the bonds at a premium to certain investors on a fully underwritten basis. The BIR confirmed that the ***original*** issuance of the bonds to a single entity does not amount to borrowing of funds from the public, such that these bonds would not be treated as falling under the term *deposit substitutes*. Hence, the FWT imposed on deposit substitutes does not apply to the bonds. This ruling effectively concluded that the number of lenders/investors should be determined at the time of the ***original*** issuance of the bonds.

[165] BIR Ruling No. 020-01 (May 31, 2001).

161. Subsequently on 16 July 2004, the BIR modified the interpretation of the 19-lender rule through BIR Ruling No. 007-04. The BIR now took the position that since the object of the issuance of government bonds or notes is to obtain the required government funding, both the issuance (origination) and the subsequent distribution (exchange and trading) of government debt instruments and securities in the secondary market to other market participants, specifically, the investors, constitute a public borrowing of the government. The financial assets (i.e., debt instrument and securities) in the hands of the investors represent a claim to future cash for which the borrowing entity, at maturity date, will have to pay. It is however in the secondary market that the investing public makes the indirect investment in the borrowing entity, in this case, the government. Thus, it was ruled that the "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."[166] In other words, since the actual number of bondholders or investors may, at maturity date of the financial instrument, exceed twenty (20) individuals or corporations, the said direct lenders (origination) and indirect investors (secondary market) are deemed to constitute "public" borrowing.

162. As a consequence of this interpretation, the BIR ruled that interest income derived from such government debt instruments and securities is subject to the following taxes under the NIRC of 1997: (a) 20% final withholding tax imposed under Section 24(B)(1) and 25(A)(2) if the bondholder is an individual citizen or resident

[166] BIR Ruling No. 007-04 (Jul. 16, 2004).

alien or non-resident alien engaged in trade or business in the Philippines; (b) 25% tax imposed under Section 25(B) if the bondholder is a non-resident alien individual not engaged in trade or business within the Philippines; (c) 20% final tax imposed under Section 27(D)(1) and 28(A)(7)(a) if the bondholder is a domestic or resident foreign corporation, respectively; and (d) 32% final withholding tax for non-resident foreign corporations pursuant to Section 28(B)(1).

(2) Determining the tax base for GRT

163. The term *gross receipts* is statutorily defined in Section 108(A) of the NIRC of 1997 as "the total amount of money or its equivalent representing the contract price, compensation, service fee, rental or royalty, including the amount charged for materials supplied with the services and deposits and advanced payments actually or constructively received during the taxable quarter for the services performed or to be performed for another person, excluding the value-added tax." Over the years, the determination of taxable gross receipts has conformed to the shifts in legislation, administrative interpretation and judicial construction.

164. From the enactment of RA No. 39 on October 1946, interest income of banks, without any deduction, formed part of their gross taxable receipts. From October 1946 to June 1977, there was no withholding tax on interest income from bank deposits.

165. On 03 June 1977, PD No. 1156 imposed a 15% *creditable* withholding tax at source on interest income from bank deposits. Despite being subjected to a withholding tax, the entire interest income, without any deduction, still formed part of

a bank's taxable gross receipts. The treatment changed with the advent of PD No. 1739 on 17 September 1980, which made the withholding tax on interest from bank deposits a *final* tax*,* in lieu of a creditable tax. RR No. 12-80, which was issued to implement PD No. 1793, provided that "the rates of taxes to be imposed on the gross receipts of financial institutions shall be based on all items of income **actually received**."[167]

166. Subsequently on 10 October 1984, PD No. 1959 amended PD No. 1739. To implement this amending statute, RR No. 17-84 provided that: (a) interest income subjected to withholding tax need not be included in gross income for purposes of computing taxable income, (b) interest paid on bank deposits are allowed as deductible interest expense, and (c) if the recipient of interest income is a financial institution, the interest income will be included as part of the tax base upon which gross receipt tax is imposed.[168]

167. The relevant judicial construction began four years after the passage of RA No. 39 with the defunct Board of Tax Appeals' (the predecessor of the present CTA) decision in *National City Bank v. Collector of Internal Revenue*, BTA Case No. 52, 12 July 1952. The Board construed the term *gross receipts* as the whole amount received as interest without deductions. The *National City Bank* ruling remained unchallenged until 1996.

[167] Revenue Regulations No. 12-1980 § 4 (Nov. 7, 1980) (emphasis added).

[168] Revenue Regulations No. 17-1984 § 7 (Oct. 12, 1984).

168. When a withholding tax on interest income was introduced, the question arose on whether the withholding tax portion on the interest income should be excluded in determining the GRT. In *Asian Bank Corporation v. Commissioner of Internal Revenue*, CTA Case No. 4720, 30 January 1996*,* the CTA ruled that the final withholding tax on a bank's passive interest income does not form part of its taxable gross receipts. The *Asian Bank* ruling was based on RR No. 12-80, which stated that gross receipts tax on financial institutions shall be based on all items of income **actually received**. The final withholding tax on interest income not having been received by a bank since the tax was remitted directly to the National Government, the tax portion was thus excluded from determining gross receipts.

169. The Court of Appeals reversed the *Asian Bank* ruling in *Commissioner of Internal Revenue v. Asian Bank Corporation*, CA-G.R. SP No. 51248, 22 November 1999, holding that gross interest income earned, without any deductions, should be the appropriate tax base for purposes of computing the GRT. On 16 November 2001, the Court of Tax Appeals also issued two (2) decisions *(Far East Bank and Trust Co. v. Commissioner of Internal Revenue, CTA Case no. 5763; Standard Chartered Bank v. Commissioner of Internal Revenue, CTA Case no. 5679)* contradicting the *Asian Bank* ruling.

170. The Supreme Court settled the issue when it recently ruled that the withholding tax portion on interest income forms part of gross receipts in computing GRT on banks. The Court reasoned thus: (a) removing the withholding tax portion in computing the gross receipts tax will effectively create a tax exemption—a tax exemption which the law does not provide; (b) the gross interest income earned by

the bank, inclusive of the withholding tax portion, is money that is actually earned, owned, and constructively received by the bank before such withholding tax is paid to the National Government in order to extinguish a tax liability; and (c) the term *interest* means the gross amount paid by the borrower to the lender as consideration for the use of the lender's money.[169]

5 Sector-Specific Tax Issues

5.1 Banks

Rationalize various tax treatment and tax administration

171. The banking sector, through the Bankers Association of the Philippines ("BAP"), observes that the NIRC of 1997 prescribes various tax treatment based on: (a) type of investor – corporations, individuals, retirement funds including SSS, GSIS; (b) instrument used – traditional loans, deposit substitutes, and their tenor – below and equal or greater than 5 years; (c) issuer/guarantor – FCDUs, HIGC, trust departments of banks; (d) type of income – income and capital gains, coupons against discounts. This, in turn, affects the applicable tax rate—whether 32% income tax, 20% FWT or tax exempt—and the manner of collecting the tax—discounts are paid upon issuance, coupons upon payment, income upon filing of the return.

172. These factors spawn uncertainties in the interpretation of tax rules and impact on the operation of the financial and capital markets, increase risk of tax assessments and affect the government's tax administration and cashflow. Thus, the

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[169] China Banking Corporation v. Court of Appeals, G.R. Nos. 146749 & 147938, June 10, 2003, 403 SCRA 634. *See also* Commissioner of Internal Revenue v. Solidbank Corporation, G.R. No. 148191, November 25, 2003, 416 SCRA 436.

sector pushes for the rationalization of the tax treatment and tax administration of the above factors for clarity, simplicity and consistency.

Deposit Substitutes

173. The BAP notes that the definition of the term *deposit substitutes* found in Section 22(Y) of the NIRC of 1997 was adopted from the definition formulated by monetary authorities to regulate the money supply.

(a) Imposition of FWT

174. Under Section 27(D)(1), the income of banks and non-bank financial institutions from deposit substitutes is treated as passive income subject to 20% FWT, although both institutions are active, and not passive, income earners with respect to income from deposit substitutes. The BAP proposes that the income of banks and non-bank financial institutions be subject to the normal income tax which is paid at the end of each fiscal year, instead of being subject to an upfront FWT.

175. It is observed however that interest income from deposit substitutes, by its nature, is earned passively whether or not the holder of the instrument is an active or passive player in the capital market.

(b) Definition of *public*

176. Debt instruments are deemed as deposit substitutes when the funds are obtained from twenty or more individual or corporate lenders at any one time.[170] The

[170] National Internal Revenue Code of 1997, as amended, § 22(Y) (1997)

BAP proposes that the definition of *public* be further substantiated by confining the term to investor and lenders who are passive income earners for purposes of applying the 20% FWT. Under this proposal, entities that are active lenders/investors, such as banks and other financial institutions, would be considered as non-public entities.

(c) BSP instruments

177. The sector contends that BSP instruments (i.e., reverse repurchase between banks and BSP), which are essentially used for monetary policy and regulatory purposes, but which are not instruments required by the capital market, should not be included in the definition of deposit substitutes.

178. As a background, reverse repurchase agreements were only subjected to DST on 01 January 1998 when the Tax Reform Act of 1997 (RA No. 8424) took effect. Prior to 01 January 1998, the NIRC defined the term *deposit substitutes* to include *repurchase agreements*[171] but did not include the term *reverse repurchase agreements*. RA No. 8424 subsequently included the term *reverse repurchase agreements* in the definition of deposit substitutes. Prior to this amendment, the BIR

[171] Section 20(y) of the old NIRC defines a ***deposit substitute*** as "an alternative form of obtaining funds from the public, 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 of receivables and other obligations, or financing their own needs or the needs of their agent or dealer. These instruments may include but need not be limited to promissory notes, ***repurchase agreements*,** certificates of assignments or participation and similar instruments with recourse as may be authorized by the Central Bank of the Philippines, for banks and non-bank financial intermediaries or by the Securities and Exchange Commission of the Philippines for commercial, industrial, finance companies and other non-financial companies: provided, however, that only debt instruments issued for interbank call loans to cover deficiency in reserves against deposit liabilities including those between and aong banks and quasi-banks shall not be considered as deposit substitute debt instruments."

issued RR No. 03-1997 on 02 February 1997 (Taxation of Certain Income Derived from Banking Activities). This issue thus arose: can the BIR, by way of administrative issuance of RR No. 03-1997, subject reverse repurchase agreements to DST by including these in the definition of the term *deposit substitutes*? This issue was eventually resolved by the CTA when it ruled that reverse repurchase agreements can only be subject to DST effective 01 January 1998 when the 1997 Tax Code expanded the definition of the term *deposit substitutes*.[172]

Creditable Withholding Tax

179. RR Nos. 17-2003 and 30-2003 imposed a 2% CWT on income from services including financial transactions. This imposes substantial operational/administrative costs and difficulties for the BIR, the service provider and their clients. Another concern is that banks and other similarly affected entities are unable to use the CWT because of continuing negative tax base situation—effectively, an interest-free loan without a fixed maturity is being extended to the government, which raises issues of equity. Finally, the credit risk of the BIR is effectively shifted from the taxpayers (i.e., banks) to their clients in the latter's capacity as withholding agents, who, in most instances, have a higher credit risk than the taxpayers.

180. The BAP recommends the review of this imposition of CWT, considering its costs and benefits.

[172] China Banking Corporation v. Commissioner of Internal Revenue, C.T.A. Case No. 6400, October 14, 2004.

Documentary Stamp Tax

(a) On electronic documents

181. Section 10 of RR No. 09-2004 applies DST on “all documents not otherwise exempted by law, notwithstanding the fact that they are in electronic form.” The BIR reasons out that since the Electronic Commerce Act recognizes electronic documents as the functional equivalent of written documents then the issuance of electronic documents is equivalent to the issuance of written documents.

182. The BAP argues that this interpretation by the BIR discourages the use of electronic means of doing financial transactions, specifically for purposes of making payments/remittances. This results in inefficiencies, retrogression to archaic modes of payment/remittance, and increased costs to the banking public.

(b) On bills of exchange and others

183. Section 181 of the NIRC of 1997 imposes DST upon “any acceptance or payment of any bill of exchange or order for the payment of money purporting to be drawn in a foreign country but payable in the Philippines.”

184. The BAP sees this provision as discouraging investments in the Philippines and, thus, proposes for its reconsideration.

5.2 Insurance Companies

(1) Life Insurance

Documentary Stamp Tax

(a) On the tax base for life insurance policies

185. On March 20, 2004, RA No. 9243 took effect and amended Title VII of the NIRC of 1997 pertaining to DST. Under the amended Section 183, the basis of computation of the DST on life insurance policies was changed from the "amount insured" to "amount of premium collected." The BIR, through RR No. 13-2004, interprets this amendment to mean that DST "shall be due and collected every time there is an insurance premium collection on such policy, including premiums paid/collected beyond the year the policy was taken out."

186. The PLIA contends that this interpretation effectively negates the legislative intent behind the amendment, i.e., to grant a tax relief on the life insurance industry. Also, the interpretation is inconsistent with the nature of DST, which is tax on documents and should be paid only once. Finally, the BIR's position unduly discriminates against life insurance policies since other documents are subjected to DST only once, that is, upon their issuance—for instance, non-life insurance policies are taxed with DST upon their issuance, but since these are re-issued or renewed annually, it is proper that the DST is based on the premium collected annually.

187. In BIR Ruling DA-182-05, the BIR addressed the position put forth by PLIA and confirmed its interpretation in RR No. 13-2004. The BIR argues that RA No. 9243 is clear in providing that the tax base is the "amount of premium collected." Thus, "the 'amount of premium collected' is in fact the actual price/consideration paid for the insurance coverage upon which the DST should be based" such that "for purposes of insurance, the collection of premium in installments is merely a mode of

collecting the price agreed to be paid by the policyholder."[173] Further, "the imposition of DST each time the installment amount is collected is called for considering that the actual premium price (full amount of consideration) is not certain at the time the policy is issued."[174] This, the BIR contends is in itself a relief: "While other provisions of the DST law require payment of DST only once and upfront, in the case of life insurance, the full payment of DST is effectively spread over certain period of time, depending on the number of installments the premium is expected to be paid or upon the happening of the risk insured."[175] The other relief is the change in the tax base considering that the amount of the insurance coverage is much higher than the amount of premium.

188. Since the BIR had indicated that it would implement its position unless the law is amended, the PLIA proposes that a law be enacted that would impose DST on life insurance policies on the basis of only one annualized premium (i.e., the first year), to be paid only once (i.e., when the policy is issued). Concretely, the tax base should be the "amount of premium due within the first year of the policy, said tax to be payable in full upon issuance of the policy." Essentially, this proposal seeks the imposition of the DST upon the premium payments only for the first year of the life insurance policy. Accordingly, subsequent premiums collected upon the same policy should no longer by subject to the DST.

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[173] BIR Ruling [DA-182-05] (April 20, 2005).

[174] *Id.*

[175] *Id.*

(b) Assessment of deficiency DST

189. The PLIA questions the BIR assessment of deficiency DST on life insurance policies issued prior to RA No. 9234. The BIR alleges that the additional DST is due to discrepancies between the DST due on direct business/sums assured (as reflected in the insurance companies' annual statement submitted to the Insurance Commission) and the amount of DST pertaining to life insurance paid per the DST return of the taxpayer. These discrepancies are traced to (a) increases in the coverage or sum assured under certain insurance policies issued in previous years for which the corresponding DST based on the original coverage had already been paid, and (b) amounts covered by certain riders attached to the insurance policies. The BIR cites *Commissioner of Internal Revenue v. Lincoln Philippine Life Insurance Co.*, G.R. No. 119176, 19 March 2002, which relevantly ruled that "to claim that the increase in the amount insured (by virtue of the automatic increase clause incorporated into the policy at the time of issuance) should not be included in the computation of the documentary stamp tax due on the policy would be a clear evasion of the law requiring that the tax be computed on the basis of the amount of the policy."

190. It is the PLIA's position that for policies issued prior to the effectivity date of RA No. 9243 (i.e., 20 March 2004), the DST should be computed based on the amount insured at the time when the policy was issued. The *Lincoln Life* ruling applies to a specific situation: where the amount of the increase is already definite at the time of the issuance of the policy. In contrast, the assessment pertains to increases in coverage brought about by changes in the coverage of various group life policies

based on factors that are not known and could not have been known by anyone at the time of the issuance of the policy. Neither should *Lincoln Life* be used as basis for assessing DST on riders because although riders may stipulate an increase in benefit, such increase is not automatic but is instead contingent upon the happening of a certain event or condition, i.e., that the insured dies before the lapse of a certain period and/or that death was due to an accident. Furthermore, in the case of riders, while there may be some instrument attached to the policy, no corresponding actual insurance upon any life is made because the coverage only becomes effective when certain conditions are fulfilled.

(2) Non-life Insurance

Imposition of VAT on Reinsurance Transactions

191. Under RA No. 9337, as implemented by Section 4.103-8(i) of RR No. 16-2005, non-life reinsurance premiums and reinsurance commissions, whether life or non-life, are subject to VAT. The non-life insurance sector, through the Philippine Insurers and Reinsurers Association ("PIRA"), however, contest such imposition based on the following grounds:

(a) In reinsurance transactions, there is no taxable sale of goods or services since it merely involves the sharing or distribution of risks arising from an already existing insurance policy;

(b) Reinsurance commissions received are not commissions in its ordinary sense but actually represents mere reimbursement by the reinsurers of their respective proportionate share in the original insurer's costs for acquiring the said insurance policy; and

(c) The amount of tax that the BIR stands to collect would be the same regardless of whether or not VAT is imposed on reinsurance premiums. The exercise would just be imposing a heavier work load for both the BIR and the insurers and reinsurers in effecting the collection of the same amount of tax.

Documentary Stamp Tax

192. On the imposition of the DST, the PIRA raises the following issues:

(a) High DST rate

193. The non-life insurance industry is struggling with stiff competition from its foreign counterparts, particularly in the field of marine insurance, mainly because of the comparatively high DST imposed on the insurance policies, i.e., 12.5%. Thus, there is currently a pending appeal for support from the BIR and the DOF for the lowering of such DST rate to at least five percent (5%).

(b) Tax base in RMO 48-99

194. RMO No. 48-99 prescribed that the tax base for DST on insurance policies should be *gross premiums*. The PIRA is requesting for a reversion to the old rule, as stated under RMO No. 66-98, of having *net premiums* (i.e., less premium returns and adjustments) as the tax base for purposes of computing DST.

(c) Imprinting of DST

195. In order to achieve uniformity with existing industry practice of allowing a 90-day cycle to agents and brokers for the consummation and payment of premiums on insurance transactions/policies, the PIRA is appealing for the amendment of RR Nos. 9-2000 and 15-2001 in order to extend or lengthen the existing period for DST imprinting to a similar period of ninety (90) days.

Minimum Corporate Income Tax

196. According to the sector, RMC No. 04-2003 (on the minimum corporate income tax) failed to specify the appropriate account classifications (i.e., "revenue" and "cost of services") relevant to the non-life insurance business. Consequently, the sector proposes that the BIR issue a separate RMC specifically to address this lacuna.

5.3 Investment Houses

20% FWT exemption of long-term bank investment products

197. This concern is treated as a cross-sectoral issue under paragraph 141 above. For IHAP, the distinct advantage afforded to banks must be equalized. This may be achieved by applying the 20% FWT exemption to the securities side or the non-bank sector. However, if extending the exemption would prove to be unacceptable in view of lost revenues for government, the alternative option is to remove the exemption granted to the banking sector.

Preferential Tax Treatment of Expanded Foreign Currency Deposit System

198. This issue is likewise treated as a cross-sectoral issue under paragraph 150 above.

Double Taxation on Repurchase Agreements/Facilities

199. A key ingredient for successful capital market is a strong secondary market. This requires secondary market tools including securities borrowing and lending and repurchase facilities. Unfortunately, the Philippines has no securities borrowing and lending facility and repurchase facility both on the debt security side and equity side.

200. Further compounding the situation is the BIR's treatment of repurchase transactions as collateralized borrowing transactions. Under pertinent provisions of the NIRC of 1997,[176] a repurchase agreement is deemed a deposit substitute subject to a FWT of twenty percent (20%) on any yield or other monetary benefit realized therefrom. However, with the passage of RA Act No. 9238 and its implementation through RR No. 09-04, IHAP points out that there is now effectively a "double taxation" of repurchase agreements because a five percent (5%) gross receipts tax is imposed on net trading gains realized on debt instruments, which include repurchase agreements. Section 16 of RA No. 9337 in amending Section 121 of the NIRC of 1997 increased this GRT rate to seven percent (7%).

[176] National Internal Revenue Code of 1997, as amended § 22(Y) (1997). It provides that deposit substitutes are an alternative from of obtaining funds from the public other than deposits, through the issuance, endorsement, or acceptance of debt instruments which include repurchase agreements.

5.4 Pre-Need

VAT Base

201. The pre-need sector's issue on the VAT centers on whether contributions to the trust fund may be deducted from the tax base applicable to it. In the VAT regime under RA No. 7716, trust fund contributions are deductible. RR No. 07-95 relevantly provides in its Section 4.102.1(g): "In the case of pre-need companies, they shall be considered as dealers in securities and their gross receipts shall mean actual receipts on contract price **minus contributions to the trust funds** to be set up independently as mandated by the Securities and Exchange Commission."[177] This provision is echoed in RMC No. 13-96.[178]

202. The advent of RA No. 9337 obfuscates the treatment of trust fund contributions. In Section 4.108-3(g) of RR No. 14-05, dealers in securities are subject to VAT on the basis of the gross income received from their sale or exchange of securities. Its last paragraph further provides that: "In the case of pre-need companies, including HMOs, they shall be considered as dealers in securities and their gross receipts shall mean actual receipts on contract price **without allowing for**

[177] Consolidated Value Added Tax Regulations, Revenue Regulations No. 07-95 (Dec. 9, 1995) (emphasis added).

[178] Revenue Memorandum Circular No. 13-96 (Jan 15, 1996). The answer to question no. 10 states that pre-need companies "shall be considered as dealers in securities and shall be subject to VAT based on their gross income" and gross income "shall mean actual receipts on contract price minus contributions to the trust fund to be set up independently as mandated by the Securities & Exchange Commission."

any deduction from the gross receipts."[179] From this, it is clear that trust fund contributions are disallowed deductions.

203. As previously noted, RR No. 14-05 never went into force and was subsequently superseded by RR No. 16-05. The present version of Section 4.108-3(g) in RR No. 16-05 notably deleted the afore-cited last paragraph contained in RR No. 14-05. As such, there is now no express proscription against the deduction of trust fund contributions from a pre-need company's gross receipts. In lieu of the aforesaid paragraph, RR No. 16-05 separately treated pre-need companies in its Section 4.108-3(j). This provision relevantly states that as service providers the compensation of pre-need companies for their services "is the premiums or payments received from plan holders." The taxable base for VAT purposes therefore is the said premiums or payments. It does not expressly say that trust fund contributions may be deducted. Such silence may, by implication, be taken to mean that deductions are disallowed. Moreover, since allowable deductions are akin to a tax exemption, these are construed strictly against the taxpayer.

204. The non-deduction of the trust fund contributions effectively amounts to imposing the VAT on such contributions. Since VAT may be passed on, the burden of the tax will eventually be shouldered by the pre-need plan holders.

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[179] Emphasis added.

5.5 Securities Dealers and Brokers

Reducing the High Transaction Cost

205. For the past two years, Wilshire Consulting has evaluated the Philippine Stock Exchange as having a high transaction cost.[180] Taxes contribute to this high transaction cost.

(a) Stock Transaction Tax

206. The STT of 0.5% serves to increase the transaction cost in the local stock market. The PSE pushes for the re-examination of the basis for the imposition of the STT or a re-computation of the formula currently in use.

(b) VAT on stockbrokering services

207. At present, stockbrokering services are subject to VAT. As such, it increases the incidental cost of investing in the Philippine stock market for both foreign investors and domestic retail investors since the stockbrokers pass on or shift the tax burden to these investors. Another related concern is the absence of any industry standard by which claims of input VAT for foreign and domestic retail investors may be validated.

208. The PSE suggests that stockbrokering services be treated similarly as services rendered by banks, non-bank financial intermediaries and finance companies, which are exempt from the coverage of VAT. Alternatively, it is proposed

[180] WHILSIRE CONSULTING, PERMISSIBLE EQUITY MARKETS INVESTMENT ANALYSIS 50 (April 2005).

that stockbroker services be subjected to a lower GRT rate than the 10% VAT, as was previously imposed.

(c) DST

209. Under Section 199(e) of the NIRC of 1997, as amended through RA No. 9243, the sale, barter or exchange of shares of stock listed and traded through the local stock exchange is exempt from DST for a period of five (5) years from 20 March 2004, which is the effectivity date of RA No. 9243.

210. The PSE proposes that this so-called “sunset provision” be removed such that the exemption is made permanent. By doing so, the high transaction costs in the Philippine stock market would be reduced.

211. Also, Section 174 of the NIRC of 1997 imposes DST on the original issuance of shares of stock. The PSE takes exception to this imposition insofar as it covers initial public offerings. The exemption under Section 199(e) exclusively pertains to the secondary trading of the shares. As such, this additional cost contributes adversely to decisions of companies to go public.

Assessment of Deficiency STT

212. There are cases where the BIR assessed brokers for deficiency STT even for dealer or house accounts. As far as the PSE is concerned, such assessment is inconsistent with the exemption from the STT granted by Section 127(A) of the NIRC of 1997 in favor of the sale of listed shares by dealers in securities.

IPO Tax

213. Section 127(B) of the NIRC of 1997 imposes tax at graduated rates of one percent (1%) to four percent (4%) on the disposition of shares of stock in closely held corporations through initial public offering ("IPO").

214. The PSE advocates for a temporary suspension, if not an outright abolition, of the IPO tax until the volume of transactions in the local stock market has improved. PSE contends that the tax adversely affects the decision of corporations to go public.

Shifting of DST Liability

215. Section 173 of the NIRC of 1997 provides that "whenever one party to the taxable document enjoys exemption from the [DST], the other party thereto who is not exempt shall be the one directly liable for the tax."

216. Brokers and dealers are being assessed deficiency DST for sales transactions where the counter-party is an entity exempt from DST, such as the GSIS and SSS. In a transaction, it is industry practice for the buyer to shoulder the liability for DST. However, the trading facility of the PSE, the Maktrade System, operates on an automatic order matching set-up whereby orders are matched based on the prices quoted by the parties whose identities are not disclosed in the Maktrade System. As a result, since the seller does not know the identity of the buyer, the transaction can be consummated without the seller being aware that it should have paid the DST thereon because the counter-party is an entity exempt from DST.

217. The PSE proposes the amendment of Section 173 to exclude from the tax-liability-shifting rule cases where the GSIS or SSS is a party to a stock market

transaction. The shifting of tax liability should not apply because the trading facility does not disclose or allow the identities of the parties to be revealed. Market forces dictate what orders will be matched and executed, without regard to the identity of the parties to the transaction.

Establishment of REIT

218. A Real Estate Investment Trust ("REIT") is usually a closed-end investment trust that trades on an exchange and uses the pooled capital of investors to purchase and manage income properties or commercial real estate, such as shopping centers, apartments and industrial buildings. The shares of most REITs are traded in the stock exchange. REITs do not pay tax on income and capital gains provided that they distribute a high proportion of net cash flow to investors. REITs exist in such countries as the US, Australia, Japan, South Korea, Singapore, Hong Kong and Taiwan.[181]

219. REIT is alien in the Philippines. The key deterrent to its establishment is the absence of laws that provide for tax exemptions to pass-through entities. Thus, the PSE proposes the enactment of enabling legislation. Alternatively, the establishment of REITs could be done in conjunction with RA No. 9182 or the Special Purpose Vehicle Act. REITs so established could utilize the non-performing assets portfolio of banks, including non-performing loans ("NPL") and real and other properties owned or acquired ("ROPOA").

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[181] *See* Ruby Anne M. Rubio, *Tax efficient REITs have yet to debut in RP*, BUSINESS WORLD GUIDE TO MUTUAL FUNDS, HEDGE FUNDS AND TRUST FUNDS, Jul. 28, 2005, at 15.

5.6 Financing Companies

Uniform Tax Treatment of Leases

220. Presently, a GRT of 5% is imposed on (a) the interest income alone in cases of financial leasing, or (b) the gross rental in case of operating lease.

221. The sector, through the Philippine Financing Association ("PFA"), proposes that financial leasing and operating lease be excluded from the coverage of GRT. Instead, both types of leasing should be subjected to VAT. The purpose of this proposal is (a) to place financial leasing on equal footing with loans, where the borrower is allowed to take the input VAT credit upon purchase of the asset, and (b) to place operating lease on equal footing with lease by non-financing company-lessors which is subject to VAT.

Exclusion from CWT coverage

222. Under RR No. 14-2002, the gross rental income of financing companies from the operating lease of real and personal property is subject to CWT of 5%.

223. The PFA proposes that financing companies and their rental company subsidiaries be excluded from the coverage of the said regulations, reasoning that the inclusion of financing companies is disadvantageous to the BIR because leasing and financing companies are generally more reliable tax payors than most of their clients. Further, in view of the small spreads of financing companies, the 5% CWT on operating lease results in a situation where the leasing companies with a negative tax base will never avail of the CWT.

224. The foregoing rationale for the proposed exclusion equally applies to the 2% CWT imposed on financial lease of equipment where the lessee is a top 10,000 corporation as per RR No. 17-03.

Amendments to Financing Company Act of 1998

(a) Definition of *financial leasing*

225. The PFA contends that the definition of finance lease (or financial lease) found in the Financing Company Act of 1998 and RR No. 09-2004 diverges from generally accepted accounting principles. It proposes that the definition under International Accounting Standards (IAS) No. 17 should be used in order to be consistent with global practice or standards. IAS 17.4 classifies a lease as a finance lease "if it transfers substantially all the risks and rewards incident to ownership."[182]

(b) Equal incentives and exemptions

226. Section 10 of the Financing Company Act of 1998 provides that:

> SEC. 10. *Applicability of incentives and exemptions to financial leases.* — Any incentive, exemption or benefit, including tax credits and investment incentives granted by law or regulation to any purchaser, importer, borrower or other eligible person in connection with any purchase, importation, acquisition, or other transaction shall not be lost, diminished or impaired when the associated financing is through a financial lease rather than through borrowing or other conventional method of financing. Financing companies providing the financial lease in such cases shall be entitled to any incentive, exemption, benefit or privilege available to lenders, importers, purchasers or other eligible person in such transactions under the applicable law or regulation.[183]

[182] IAS PLUS http://www.iasplus.com/standard/ias17.htm (last accessed Sept. 29, 2005).

[183] Emphasis added.

The PFA contends that the language of the law clearly provides equal incentives. However, due to the absence of specific implementing guidelines on the matter finance companies are forced to re-apply to the DTI/BOI for specific exemptions. This situation is exemplified in a financial lease where the lessee is exempt from customs duties and the personal property subject of the lease is imported. Under section 10, the financing company is permitted to directly import the item duty-free. In practice, however, the arrangement is circuitous: the exempt lessee imports the item and a sale-lease back agreement is executed with the financing company.

227. The PFA further proposes that Section 10 incentives should be extended to apply to the operating lease provided by financing companies for the lessor's purchase of the leased asset.

(c) Option to purchase leased asset

228. The definition of the term *financial lease* in the Finance Company Act of 1998 directly traces its provenance to Section 1(j) of the *New Rules and Regulations to Implement the Provisions of Republic Act No. 5980 (The Financing Company Act), As Amended* issued by the SEC and dated 16 October 1991.[184] This provision read:

> "LEASING" shall refer to financial leasing which is a mode of extending credit through a non-cancellable contract under which the lessor purchases or acquires at the instance of the lessee heavy equipment, motor vehicles, industrial machinery, appliances, business and office machines, and other movable property in consideration of the periodic payment by the lessee of a fixed amount of money sufficient to amortize at

[184] Cebu Contractors Consortium Co. v. Court of Appeals, G.R. No. 107199, July 22, 2003, 407 SCRA 154, 160.

> least 70% of the purchase price or acquisition cost, including any incidental expenses and a margin of profit, over the lease period. The contract shall extend over an obligatory period during which the lessee has the right to hold and use the leased property and shall bear the cost of repairs, maintenance, insurance and preservation thereof, **but with no obligation or option on the part of the lessee to purchase the leased property at the end of the lease contract.**[185]

This definition was incorporated with minor modification in Section 3(d) of RA No. 8556, which retained a similar verbiage on the lessee having no obligation or option to purchase the leased property.

229. Even prior to the issuance of the aforesaid rules, a definition of *finance lease* can be found RR No. 19-86, which the BIR issued to "prescribe the rules to govern the tax treatment of lease agreements and provide guidelines for determining whether certain transactions purporting to be leases of tangible personal property are in reality conditional sales contracts."[186] Section 2.01/2 of RR No. 19-86 defined *finance lease* thus:

> "Finance lease" or full payout lease is a contract involving payment over an obligatory period (also called primary or basic period) of specified rental amounts for the use of a lessor's property, sufficient in total to amortize the capital outlay of the lessor and to provide for the lessor's borrowing costs and profits. The obligatory period refers to the primary or basic non-cancellable period of the lease which in no case shall be less than 730 days. The lessee, not the lessor, exercises the choice of the asset and is normally responsible for maintenance, insurance and such other expenses pertinent to the use, preservation and operation of the asset. Finance leases may be extended, after the expiration of the primary period, by non-cancellable secondary or subsequent periods

[185] Emphasis added.

[186] Revenue Regulations No. 19-86, as amended, § 1 (Nov. 10, 1986) (effective beginning 01 January 1987 pursuant to Revenue Regulations No. 22-86 (Dec. 16, 1986)). *See also* Beltran v. PAIC Finance Corporation, G.R. Nos. 83113 & 83256, May 19, 1992, 209 SCRA 105, 117 (referring to Revenue Regulations No. 19-86 as governing the tax treatment of lease agreements, as distinguished from conditional sales contracts).

> with the rentals significantly reduced. The residual value shall in no instance be less than five per centum (5%) of the lessor's acquisition cost of the leased asset.

230. This definition clearly excludes any reference to the obligation or option to purchase the asset. However, in the guidelines to determine whether a lease is in fact a conditional sales contract, the BIR first lays the statutory basis of the distinction by citing the Civil Code:

> A lease is a contract whereby one of the parties (lessor) binds himself to give to another (lessee) the enjoyment or use of a thing for a price certain, and for a period which may be definite or indefinite (Article 1643, Civil Code). In other words, a lease is an agreement between a lessor and a lessee giving the lessee possession and use of a specific property upon payment of rentals over a period of time. The lessor retains ownership of the asset so that it shall not become the property of the lessee or any related third party during the term of the lease. On the other hand, a sale is a contract whereby one of the contracting parties (seller or vendor) obligates himself to transfer ownership of and to deliver a determinate thing while the other party (buyer or vendee) obligates himself to pay for said thing a price certain in money or its equivalent. (Article 1458, Civil Code.)

231. The BIR also enumerates as one of the four "compelling persuasive factors" warranting the treatment of a lease agreement as a conditional sales contract: "**the lessee is given the option to purchase the asset at anytime during the obligatory period of the lease**, notwithstanding that the option price is equivalent to or higher than the current fair market value of the asset."[187] In the absence of any of the compelling persuasive factors, the presence of any of these conditions leads to the same conclusion: (a) "portions of the periodic payments are made specifically

[187] Revenue Regulations No. 19-86, as amended, § 4.03/2 (a) (Nov. 10, 1986). The other "compelling persuasive factors" are: (a) the lessee acquires automatic ownership of the asset upon payment of the stated amount of "rentals" which under the contract he is required to make; (b) portions of the periodic rental payments are credited to the purchase price of the asset; (c) The receipts of payment indicate that the payment made were partial or full payments of the asset

applicable to an equity to be acquired by the lessee"; (b) "the property may be acquired under a purchase option, at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made."[188] The BIR applied these guidelines in several rulings;[189] while the CTA, Court of Appeals and the Supreme Court mentioned RR No. 19-86 under varying circumstances without touching on the guidelines.[190] RR No. 19-86 remains in force today.

232. The PFA proposes the amendment of RA No. 8556 to allow the lessees the option to purchase the leased asset under both finance lease and operating lease without the lease transaction being construed as a conditional/installment sale. It is argued that the exercise of a purchase option in a lease is not being precluded under IAS 17.

233. IAS 17.10 enumerates the following situations that would normally lead to classifying a lease as a finance lease: (a) **the lease transfers ownership of the asset to the lessee by the end of the lease term**; (b) **the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than**

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[188] *Id.* at § 4.03/3.

[189] *See* BIR Ruling Nos. 283-87 (Sept. 10, 1987), 129-90 (Sept. 4, 1990), 241-93 (Jan. 10, 1993), 054-95 (Mar. 16, 1995) and VAT Ruling No. 051-91 (May 5, 1991).

[190] *See e.g.* Consolidated Orient Leasing and Finance Corporation v. Commissioner of Internal Revenue, C.T.A. Case No. 4463, October 25, 1995; Makati Leasing and Finance Corporation v. Commissioner of Internal Revenue, CA-GR SP No. 23578 (C.T.A. No. 3354), November 25, 1992; Beltran v. PAIC Finance Corporation, G.R. Nos. 83113 & 83256, May 19, 1992, 209 SCRA 105; BPI Leasing Corporation v. Court of Appeals, G.R. No. 127624, November 18, 2003, 416 SCRA 4.

fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised; (c) the lease term is for the major part of the economic life of the asset, even if title is not transferred; (d) at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and (e) the lease assets are of a specialized nature such that only the lessee can use them without major modifications being made. [191]

5.7 Mutual Funds

Tax Treatment of Unit Investment Trust Funds

234. Pursuant to BSP Circular No. 447, series of 2004, which took effect on 01 October 2004, unit investment trust funds ("UITF" or "UIT Funds") were introduced in the Philippines. UIT Funds "are open-ended pooled trust funds denominated in pesos or any acceptable currency, which are operated and administered by a trust entity and made available by participation."[192] In this definition, the term *trust entity* refers to any "bank, investment house or a stock corporation duly authorized by the Monetary Board to engage in trust, investment management and fiduciary business."[193] The term *UIT Fund* is expressly characterized as synonymous to

[191] IAS PLUS http://www.iasplus.com/standard/ias17.htm (last accessed Sept. 29, 2005) (emphasis added).

[192] MORB, *supra* note 25, at § X410.1(a) *and* Manual of Regulations for Non-Bank Financial Institutions § 4410Q.1(a) (Dec. 2004) [hereinafter MORNBFI].

[193] MORB, *supra* note 25, at § X410.1(b) *and* MORNBFI, *supra* note 186, at § 4410Q.1(b).

common trust funds ("CTF"), but the UIT Fund is considered to be an improved version of the CTF, with the latter poised for phase out by 30 September 2006.[194]

235. Under BSP regulations, UIT Funds may only be invested (a) in bank deposits and (b) in the following financial instruments: (i) securities issued by or guaranteed by the Philippine government, or the BSP; (ii) tradable securities issued by the government of a foreign country, any political subdivision of a foreign country or any supranational entity; (iii) exchange-listed securities; (iv) marketable instruments that are traded in an organized exchange; (v) loans traded in an organized market; and (vi) such other tradable investments outlets/categories as the BSP may allow.[195]

236. UIT Funds are similar to mutual funds in that both pool clients' funds together for investment purposes. They differ in the following: (a) UIT Fund is created via a Declaration of Trust executed by a trust entity, while a mutual fund has a corporate existence; (b) UITF is supervised by the BSP, mutual funds by the SEC; (c) UIT Fund clients get participating units of investment for their placements, while mutual fund clients invest in shares of stock of the fund; (d) UIT Fund clients are charged a fixed annual trust fee, while mutual fund clients are charged entry and exit fees.[196]

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[194] MORB, *supra* note 25, at § X410.1(a); Philippine National Bank, Unit Investment Trust Funds Primer at 1; EastWest Bank, Unit Investment Trust Fund Frequently Asked Questions *available at* http://www.eastwestbanker.com/info/pi_faqs.asp. (last accessed Sept. 29, 2005).

[195] MORB, *supra* note 25, at § X410.9 *and* MORNBFI, *supra* note 186, at § 4410Q.9.

[196] Ehden Llave-Pelaez, *UITF: improved version of the CTF*, BUSINESS WORLD GUIDE TO MUTUAL FUNDS, HEDGE FUNDS AND TRUST FUNDS, Jul. 28, 2005, at 13-14.

237. According to the BSP Circular Letter of 19 August 2004, "UIT [Funds] created under Circular No. 447 shall not include long term funds designed for the primary purpose of availing tax incentives/exemption under Section 24(B)(1) of R.A. No 8424 (The Tax Reform Act of 1997)." Consequently, gain or yield from UIT Funds is subject to the 20% FWT regardless of the length of the holding period. In contrast, the interest income of individuals from the CTF is expressly granted exemption under Section 24(B)(1) provided it is held for at least five years.[197]

Documentary Stamp Tax

238. According to the sector, DST is a recurring tax burden that slightly erodes the funds' yields when the holding period is short, i.e., less than one year. The proposal is that the DST be made into a one-time payment based on the authorized capital stock.

6 Unresolved or Ambiguous Rulings, Guidelines and Policies

239. Based on the major tax issues or concerns surfaced in the preceding section, the unresolved or ambiguous tax rulings, guidelines and policies impacting on the financial sector are enumerated below. The ambiguity stems from changes in the interpretation of the law by the BIR or where the BIR's interpretation is overturned by the courts:

[197] *See also* BIR Ruling Nos. 063-00 (Nov. 20, 2000), 030-01 (Jul. 24, 2001), DA-414-00 (Nov. 29, 2000), DA-156-01 (Sept. 5, 2001), DA-064-02 (Apr. 3, 2002), DA-144-02 (Sept. 3, 2002).

- In interpreting the scope of the income tax exemption granted to long-term bonds, debentures and other certificates of indebtedness under Section 32(B)(7)(g) of the NIRC of 1997, the BIR ruled the term *gains* encompasses interest income. The CTA, as subsequently affirmed by the Court of Appeals and the Supreme Court, overturned the BIR's view by holding that *gains* does not include interest income.

- The definition of the "19-lender rule" vis-à-vis government debt instruments and securities. BIR Ruling No. 020-01 reckoned the number of lenders/investors at the time of the original issuance of the government debt instruments and securities. This was modified in BIR Ruling No. 007-04 where it was ruled that the mere issuance of government debt instruments and securities is covered by the term *deposit substitute* irrespective of the number of lenders/investors at the time of origination.

- The VAT base for pre-need plans is ambiguous. While RR No. 07-95 expressly says that the gross receipts of pre-need companies excludes their mandatory contributions to the required trust funds, the present regulations (RR No. 16-05) implementing RA No. 9337 is silent on whether trust fund contributions may be deducted. This could be construed as disallowing such deduction.

- The tax exemption of UIT Funds. UIT Funds was designed to replace the CTF. However, according to the BSP, UIT Funds shall not include long term funds designed for availing of the tax exemption under Section 24(B)(1) of the NIRC of 1997.

PART III – REGIONAL PRACTICE OVERVIEW

240. This section of the report presents a comparative overview of the financial sector taxation prevailing in the following jurisdictions: Philippines, Hong Kong, Thailand and Singapore. These three foreign jurisdictions represent both the developed and emerging global equity markets in the Asian region. Hong Kong, along with Japan, is considered a developed market of East Asia, while Singapore is the sole developed market of Southeast Asia. Thailand is considered an emerging market of Southeast Asia in the company of Indonesia, Malaysia and the Philippines.[198]

241. For this purpose, a comparative matrix is presented showing the taxes applicable to key financial transactions or products in each of these jurisdictions. A discussion of the salient features of the financial sector taxation in these three foreign jurisdictions is annexed to this report.

7 Cross Country Comparison of Tax Treatment

242. In the succeeding sections, the tax treatment implemented in the aforesaid four jurisdictions on key products, transactions or undertakings of their respective financial sectors are tabulated for comparison. Where appropriate, significant distinctions or patterns are highlighted.

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[198] WHILSIRE CONSULTING, PERMISSIBLE EQUITY MARKETS INVESTMENT ANALYSIS (EXPOSURE DRAFT) 2-3 (January 2006). In this report for the California Public Employees' Retirement System (CalPERS), twenty-seven nations are listed under emerging markets and Thailand (ranked 12th) is the highest ranking Southeast Asian emerging market, followed by the Philippines (ranked 14th), Indonesia (ranked 15th) and Malaysia (19th). *See id.* at 13.

Table 1: Bank Deposits

Philippines	Hong Kong	Thailand	Singapore
Income Tax Rate: 20% (peso-denominated) or 7.5% (foreign currency-denominated) (FWT) Base: interest income	**Profits Tax** Rate: 17.5% Base: interest income accruing to a financial institution from the carrying on of its business in HK Exempt: interest income derived by person (including corporation) from any deposit placed in HK, unless deposit secures a borrowing the interest expense on which is deductible	**Personal Income Tax** Rate: 15% (withholding) Base: interest income from demand deposit not exceeding Baht20,000 or time deposit not exceeding Baht30,000 Exempt: interest income exceeding Baht20,000 or Baht30,000 **Corporate Income Tax** Rate: 1% (domestic juristic) or 15% (foreign juristic) (withholding) Base: interest paid to juristic person	**Individual Income Tax** Exempt **Corporate Income Tax** Rate: 20% Base: interest income
Gross Receipts Tax Rate: 5% if maturity is 5 years or less or 1% if maturity is more than 5 years Base: interest		**Specific Business Tax** Rate: 3% Base: gross revenue	**Goods & Services Tax** Exempt
Documentary Stamp Tax Rate: 0.5% for time deposit Base: face value Exempt: regular savings or demand deposit	**Stamp Duty** Exempt	**Stamp Duty** Rate: Baht5.00 Base: each receipt of interest bearing bank deposit	**Stamp Duty** Exempt

243. The Philippines make a distinction between peso-denominated and foreign currency-denominated bank deposits in imposing income tax on interest income, with the latter enjoying a concessionary rate. In the three foreign jurisdictions, a uniform income tax treatment applies to bank deposits, regardless of the currency in which

these are held. Also, in these foreign jurisdictions, income tax exemption, at varying degrees, is afforded the taxpayer-depositor.

244. The narrow scope of the Stamp Duty in both Singapore and Hong Kong further reduces the tax exposure of the transaction. In contrast, ad valorem DST is imposed on time deposits in the Philippines, while a fixed Stamp Duty applies to all kinds of interest-bearing bank deposits in Thailand.

Table 2: Debt Instrument, Bonds, Debentures, Certificates of Indebtedness

Philippines	Hong Kong	Thailand	Singapore
Income Tax *Issued by Banks* Rate: issued to (a) individuals, exempt if long term or at 5%, 12% or 20% (FWT) if pre-terminated, (b) to corporations, at 20% (FWT) Base: interest income *Issued by Non-Banks* Rate: 20% (FWT) Base: interest income *Regardless of issuer* Rate: Exempt if maturity exceeds 5 years or at 20% if maturity does not exceed 5 years Base: gains from sale, exchange or retirement	Profits Tax Rate: (a) for long term debt instrument – exempt; (b) for medium term debt instrument - 8.75% for corporations or 8% for unincorporated businesses Base: interest paid or payable and any gain or profit on sale or redemption or presentment	Personal Income Tax Rate: choose (a) withholding tax at 15% and exclude the gains or interest from assessable income; or (b) include such gains or interest in assessable income Base: gains from sale or interest income Corporate Income Tax Rate: 1% (withholding) Base: interest	Individual Income Tax Exempt Corporate Income Tax Rate: 10% Base: interest or discount income (excluding discount arising from secondary trading) earned by financial institution corporations and bodies of persons in SG from debt securities substantially arranged by financial institutions in SG Exempt: income derived by primary dealers from trading in SG government securities
Documentary Stamp Tax Rate: 0.5% Base: issue price or face value	Stamp Duty Exempt	Stamp Duty (a) *Promissory Note and the like* Rate: Baht3.00 Base: each instrument	Stamp Duty Exempt

		(b) Debenture certificate or certificate of indebtedness issued by any company Rate: Baht5.00 Base: each certificate *(c)Transfer of debenture, bond, certificate of indebtedness* Rate: 0.1% Base: nominal value of instrument	

245. In the Philippines, the treatment of interest income derived by individuals from debt instruments varies depending on the maturity period and whether the issuer is a bank or a non-bank financial institution—i.e., long-term instruments issued by banks are eligible for income tax exemption, which entitlement does not equally apply where the issuer is a non-bank entity. In the foreign jurisdictions, no similar distinction prevails.

246. In Hong Kong, exemption from Profits Tax or a concessionary Profits Tax rate applies to interest and gains derived from debt instruments depending on the maturity and holding period. In Singapore, outright Individual Income Tax exemption is given while a concessionary Corporate Income Tax rate is applied. No DST or Stamp Duty is imposed in Singapore and Hong Kong.

Table 3: Collective Investment Schemes

Philippines	Hong Kong	Thailand	Singapore
Income Tax *Common trust funds* Rate: (a) banks as trustee - exempt (if long term) or at 5%, 12% or 20% (if pre-terminated); (b) Non-banks as trustee – 20% Base: interest income *Unit Investment Trust Fund* Rate: 20% Base: gains *Mutual Funds* Exempt: gains	Profits Tax Exempt	Personal Income Tax Exempt	Individual Income Tax Exempt: distributions from designated or approved unit trusts Corporate Income Tax *CPF Approved Unit Trust* Exempt: gains on disposal of securities; if remitted, overseas interest and dividend income *Designated Unit Trust* Exempt: gains on disposal of securities; interest income, overseas dividend income; rental and other income derived from immovable property outside SG (if remitted); discount/interest from short-term qualifying debt securities; distributions from foreign unit trusts (if remitted); fees and compensatory payments from securities lending and repurchase agreements; gains on disposal of securities issued by supranational bodies; income from foreign exchange and derivatives transactions

247. The Philippine tax system distinguishes the income tax treatment of common trust funds depending on the character of the trustee, with favorable treatment afforded to bank-trustees over non-bank trustees. In all jurisdictions, exemption from

income tax or profits tax is generally granted to income derived from collective investment schemes. In Singapore, interest and gains of qualifying unit trusts are entitled to income tax exemption.

Table 4: Life Insurance

Philippines	Hong Kong	Thailand	Singapore
Income Tax Rate: 35% Base: taxable income	Profits Tax Rate: 17.5% Base: assessable profits Assessable profits shall be: (a) deemed to be 5% of onshore premium less corresponding reinsurance premium, or (b) on election, based on adjusted surplus calculated by reference to actuarial-based statutory accounts	Corporate Income Tax Rate: 30% Base: net profit Rate: 1% (withholding) Base: premiums	Corporate Income Tax Rate: 20% Base: chargeable income Concessionary rate of 10% on income arising from insuring or reinsuring offshore risks Income allocated to policyholders taxable at 10%
Premium Tax Rate: 5% Base: premium collected		Specific Business Tax Rate: 2.5% Base: Gross revenue (monthly gross receipts)	Goods & Services Tax Exempt supply: insurance and reinsurance premiums Zero-rated: if insurer "belongs" outside of SG
Documentary Stamp Tax *(a) Policy of life insurance* Rate: 0.25% Base: premium collected *(b) Policy of Annuity* Rate: 0.25% Base: premium, or installment payment or contract price collected	Stamp Duty Exempt	Stamp Duty *(a) Policy of life insurance* Rate: 0.05% Base: sum insured *(b) Policy of insurance where reinsurance is effected* Rate: Baht1.00 Base: each policy *(c) Renewal of Policy of Insurance* Rate: half the rate of the original policy	Stamp Duty Exempt

248. Among the four jurisdictions, premium tax is imposed only in the Philippines. In Hong Kong, life insurance companies are given the choice on how assessable profit is to be computed for purposes of the Profits Tax. In Thailand, life insurance is subject to Specific Business Tax. Singapore treats life insurance and reinsurance premiums as either Goods and Services Tax-exempt or zero-rated.

249. While Singapore and Hong Kong do not impose Stamp Duty on life insurance policies, the Philippines imposes DST on life insurance policies at an ad valorem rate significantly higher (by 0.20%) than the Stamp Duty rate imposed by Thailand. However, Thailand also imposes a fixed rate Stamp Duty on reinsurance policies.

Table 5: Non-Life Insurance

Philippines	Hong Kong	Thailand	Singapore
Income Tax Rate: 35% Base: taxable income	Profits Tax Rate: 17.5% Base: assessable profit (includes gross premiums from insurance business in HK) Concessionary rate of 8.75% on reinsurance of offshore risk	Corporate Income Tax Rate: 30% Base: net profit Rate: 1% (withholding) Base: premiums	Corporate Income Tax Rate: 20% Base: chargeable income Concessionary rate of 10% on income derived from insuring and reinsuring offshore risks Exempt: income derived from approved marine hull and liability insurance business
Value Added Tax Rate: 12% Base: total premiums collected; insurance commissions *Reinsurance* Rate: 12% Base: reinsurance		Value Added Tax Rate: 7% Base: premiums	Goods & Services Tax Rate: 5% Base: premiums Zero-rated: insurance premiums of international marine and aviation insurance, travel insurance and export credit insurance

premiums (non-life); reinsurance commissions (life and non-life)			*Reinsurance premiums* are exempt or zero-rated (when insured belongs "outside" of SG)
Documentary Stamp Tax Rate: 12.5% Base: premium charged	Stamp Duty Exempt	Stamp Duty *(a) Policy of insurance against loss* Rate: 0.5% Base: premium *(b) Policy of any other non-life insurance* Rate: 0.05% Base: sum insured *(c) Policy of insurance where reinsurance is effected* Rate: Baht1.00 Base: each policy *(d) Renewal of Policy of Insurance* Rate: half the rate of the original policy	Stamp Duty Exempt

250. In Singapore, a concessionary Corporate Income Tax rate is applied to the income derived by non-life insurance companies from insuring and reinsuring offshore risks. In Hong Kong, a concessionary Profits Tax rate apples to reinsurance of offshore risks.

251. In the Philippines, Thailand and Singapore, non-life insurance is subject to VAT or GST. In addition to having the highest VAT rate, the Philippines imposes VAT on both non-life insurance premiums and commissions and on non-life reinsurance premiums and commissions. In Singapore, the insurance premiums of international marine and aviation insurance, travel insurance and export credit insurance are deemed zero-rated for GST purposes. Again, no DST is imposed by both Singapore

and Hong Kong on non-life insurance. As between the other two jurisdictions, the Philippines' DST rate is 12% higher than the Stamp Duty rate imposed by Thailand.

Table 6: Leasing

Philippines	Hong Kong	Thailand	Singapore
Income Tax *Finance lease* Rate: 2% (withholding) Base: interest *Operating lease* Rate: 5% (withholding) Base: gross rental	Profits Tax Rate: 17.5% Base: lease rentals included in assessable profit	Corporate Income Tax Rate: 5% (withholding) Base: rental payments	
Gross Receipts Tax *Finance Lease* Rate: 5% Base: interest *Operating lease* Rate: 5% Base: gross rental		Value Added Tax Rate: 7% Base: leasing fees	Goods & Services Tax Rate: deemed as exempt supply of financial service; if treated as hire purchase agreement, 5%

Table 7: Factoring, Discounting

Philippines	Hong Kong	Thailand	Singapore
	Profits Tax Rate: 17.5% Base: assessable profits		
Gross Receipts Tax Rate: 5% Base: interest		Specific Business Tax Rate: 3% Base: interest, discounts, service fees	Good & Services Tax Exempt

Table 8: Share Transfers

Philippines	Hong Kong	Thailand	Singapore
Capital Gains Tax Rate: 5% if gains is not over Php100,000.00 or 10% of any amount in excess of Php100,000.00 (if unlisted) Base: net capital gains	Profits Tax Rate: 17.5% Base: gains included in assessable profits	Personal Income Tax Rate Rate: 0% to 37% Base: gains on transfer of shares (as a category of assessable income) Exempt: if shares listed and sale made in the Stock Exchange Corporate Income Tax Rate: 15%, 20%, 25% or 30% depending on type of taxpayer Base: gains included in net profit	Individual Income Tax Rate: 0% to 21% Base: gains from transfer of shares included in chargeable income Corporate Income Tax Rate: (a) normal rate of 20%; (b) concessionary rate or exemption for qualifying entities Base: gains
Stock Transaction Tax Rate: 0.5% (if listed) Base: gross selling price or gross value in money of shares Initial Public Offering Tax Rate: 4%, 2% or 1% Base: gross selling price or gross value in money of shares disposed in accordance with proportion of shares disposed to the total outstanding shares after listing			
Documentary Stamp Tax *Secondary transfer* Rate: 0.375% if unlisted Base: par value of stock or, if without par value, 25% of DST paid upon original issuance Exempt: if listed	Stamp Duty *Contract note for sale or purchase of any HK stock* Rate: 0.1% Base: amount of consideration *Transfer operating as voluntary disposition inter vivos*	Stamp Duty Rate 0.1% Base: paid up value of shares or nominal value of the instrument, whichever is higher	Stamp Duty Rate: 0.2% Base: purchase price or net asset value, whichever is higher

Original issuance Rate: 0.5% Base: par value or actual consideration for issuance if without par value or actual value if in stock dividends	Rate: HK$5 + 0.2% Base: value of the stock *Transfer of any kind* Rate: HK$5		

252. By virtue of the Stock Transaction Tax, the Initial Public Offering tax and the DST, the Philippines has the highest transaction cost for the transfer of shares among the four jurisdictions. Thailand notably exempts from Personal Income Tax the gains derived by individuals from the transfer of share listed and transferred in its local stock exchange.

253. In all four jurisdictions, Stamp Duty or DST is imposed. In addition to having the highest ad valorem DST rate, the Philippines further imposes DST on both the secondary transfer of unlisted shares—while, imposing a temporary exemption for listed shares—and the original issuance of shares.

PART IV – RECOMMENDATIONS

254. This final section of the study offers recommendation on addressing the instances of tax arbitrage, citing, where apt, regional experience and best practices. These recommendations are given from a purely legal standpoint and, as such, will require validation by the appropriate economic analysis. It also classifies whether the specific tax issues or concerns raised by the various sub-sectors of the Philippine financial sector can be addressed at the administrative level or would require legislation.

8 Addressing Tax Arbitrage

Long-term investment products

255. The interest income derived by individuals (i.e., natural persons) from Bank-issued long-term deposit or investment certificates enjoy exemption from the 20% FWT. The income tax exemption granted in favor of gains realized from the sale or exchange or retirement of long-term bonds, debentures or other certificates of indebtedness applies to such instruments issued by non-banks and issued even to non-individuals. However, since the term *gains* has been interpreted to exclude interest income, interest earned by individuals from long-term bonds, debentures or other certificates of indebtedness issued by non-bank financial institutions will be subject to the 20% FWT.

256. In Singapore, interest income derived by individuals from bank deposits and debt securities (which means bonds, notes, commercial papers, treasury bills and certificates of deposits) is exempt from individual income tax. In Hong Kong, interest

income derived by corporations (except financial institutions) or persons from bank deposits is exempt from Profits Tax; and, interest paid or payable on long tem deposit instruments and any gain or profit on the sale or disposal or on redemption on maturity or presentment of a long term deposit instruments are likewise exempt from Profits Tax.

Trust accounts

257. Interest income derived by individuals from common trust funds, individual trust funds or investment management accounts where banks act as trustee or investment manager is exempt from the 20% FWT. Such exemption is inapplicable where the trustee is a non-bank financial institution, licensed to engage in trust and other fiduciary business.

258. The interest income derived by the mandatory trust fund of pre-need companies from long-term investments is not exempt from the 20% FWT. In order to be entitled to the exemption, the NIRC must be amended to include juridical entities such as pre-need companies.

Preferential treatment of the Expanded Foreign Currency Deposit System

259. The interest income derived by individual-depositors and corporate-depositors under the expanded foreign currency deposit is subject to a concessionary final income tax rate of 7½% as opposed to the 20% imposed on interest income from peso-denominated deposits. The rationale behind the preferential treatment is, as

stated in the enabling statute of the system, to encourage the inflow of foreign currency deposits into Philippine banks.

260. In Thailand, there is no difference in the tax treatment of interest income derived from local currency deposits or foreign currency deposits. In Hong Kong, interest income from bank deposits, irrespective of currency, is exempt from Profits Tax. Singapore similarly affords exemption from Personal Income Tax

Retirement Plan

261. Trusteed Retirement plans administered by banks, in their capacity as trustees, enjoy income tax exemption. Those plans administered by life insurance companies under a Deposit Administration Contract or a Deferred Annuity Contract are not similarly exempt. Pension plans offered by pre-need companies are not also covered by the exemption.

262. In order for life insurance companies and pre-need companies to qualify for the exemption, these entities must secure a trust license from the Monetary Board, under the Section 79 of the General Banking Law of 2000, which does not limit the conduct of trust operations to banks. However, to date, no guidelines have been prescribed to apply to non-bank trust license applicants.

Educational Plan

263. Educational plans offered by pre-need companies are subject to the VAT. Similar products offered by life insurance companies are not subject to VAT. In

Singapore and Thailand, where the VAT (or GST) system operates, life insurance is exempted from its coverage.

264. A recent paper observed that this treatment is common to jurisdictions that have adopted the VAT. This is so because, albeit all types of insurance are explicit fee-based financial services, "a significant part of the premium represents savings of the insured and, therefore, should not be taxed under a consumption-type VAT."[199] Such exemption does not lead to cascading because the purchaser of the life insurance is typically the final consumer; but, "to the extent that the bulk of the premium of a life insurance policy should not be taxed, simply exempting it from the VAT would still allow some VAT elements to remain in the premium."[200] Considering that "life insurance premiums include the value of the intermediation services rendered by insurance companies," the exemption approach is a compromise which allows the government to collect some revenue on this service so provided.[201]

9 Addressing the Sector-Specific Concerns

265. In this section, the sector-specific tax concerns or issues surfaced earlier are scrutinized in order to determine whether addressing these will require action on the administrative level or the legislative level.

[199] Alan Schenk & Howell H. Zee, *Financial Services and the Value-Added Tax, in* TAXING THE FINANCIAL SECTOR: CONCEPTS, ISSUES, AND PRACTICES 60, 72 (Howell H. Zee, ed., 2004).

[200] *Id.* at 73.

[201] *Id.*

266. BANKS.

- *Excluding reverse repurchase agreements from deposit substitutes* – This requires amendment of Section 22(y) of the NIRC of 1997.

- *CWT on financial transactions* – Administrative action would suffice given that the items of income subject to CWT is dependent on the discretion of the Secretary of Finance as per Section 57(B) of the NIRC of 1997.

- *DST on electronic documents* – Excluding electronic documents from DST coverage can be achieved by administrative issuance since the coverage is stated in RR No. 09-04. However, in Hong Kong, Thailand and Singapore, Stamp Duty applies to electronic documents. It is noteworthy that the regional practice treats DST or Stamp Duty as a tax on documents, not on the transactions. This is echoed in the Philippines where DST is described as being "levied on the exercise by persons of certain privileges conferred by law for the creation, revision, or termination of specific legal relationships through the execution of specific instruments."[202]

[202] Philippine Home Assurance Corporation v. Court of Appeals, G.R. No. 119446, January 21, 1999, 301 SCRA 443, 447.

- *DST on bills of exchange drawn in a foreign country but payable in the Philippines* – Legislation is required to amend Section 181 of the NIRC of 1997.

267. LIFE INSURANCE.

- *DST base for life insurance policies* – In order to avoid ambiguity and preclude adverse administrative interpretation, legislation is required to amend Section 183 of the NIRC of 1997. At the administrative level, BIR has interpreted the law adverse to the PLIA's position, such construction enjoys a high presumption of validity before the courts. It is noteworthy that in Hong Kong and Singapore, no DST is due on life insurance policies; while in Thailand, the DST base for life insurance policies is the sum insured, which was the case in the Philippines prior to the advent of RA No. 9234.

- *Assessment of deficiency DST on life insurance policies prior to RA No. 9234* – This can be addressed at the administrative level.

268. NON-LIFE INSURANCE.

- *VAT on non-life reinsurance premiums and commissions* – This can be addressed administratively given that the title on VAT of the NIRC of 1997, as last amended by RA No. 9337, does not mention reinsurance premiums nor commissions. In other words, the specification of the

VAT coverage of non-life insurance premiums and non-life reinsurance commissions is enunciated in RR No. 16-2005.

- *Reduction of DST rate on non-life insurance policies* – This requires amendment of Section 184 of the NIRC of 1997.

- *Tax base for DST* – Administrative action is sufficient since the determination of the tax base is founded upon the BIR's interpretation of the tax base stated in Section 184, which is *the amount of premium charged*.

- *Extension of DST imprinting* – This can be addressed sufficiently at the administrative level because Section 200 of the NIRC of 1997 gives wide latitude to the Secretary of Finance in prescribing the manner of payment of the DST.

- *MCIT account classification* – This can be dealt with administratively.

269. INVESTMENT HOUSES.

- *Double taxation on repurchase agreements/facilities* – Technically, there is no double taxation considering that jurisprudence defines double taxation as "taxing for the same tax period the same thing or activity twice, when it should be taxed but once, for the same purpose and with the same kind of character of tax."[203] In any event, addressing

[203] VITUG & ACOSTA, *supra* note 4, at 41 (2nd ed. 2000).

this concern would require legislative amendment of the provisions on deposit substitutes or the gross receipts tax on net trading gains realized from debt instruments.

270. PRE NEED.

- *VAT Base* – The issue on whether trust fund contributions can be deducted from the tax base for VAT can be addressed at the administrative level through a clarification of RR No. 16-05.

271. SECURITIES DEALERS & BROKERS.

- *Reduction of high transaction cost in the PSE*: (a) STT – This will require legislation by removing the imposition of the tax under Section 127(A) of the NIRC of 1997. It is noteworthy that in Hong Kong and Singapore, there is no percentage tax similar to the stock transaction tax. In these jurisdictions, the Stamp Duty on the transfer of shares listed in the local exchange functions as the securities transaction tax. (b) VAT on stock brokering services – Removing stock brokering services from the coverage of VAT and subjecting the same to GRT requires legislation. In Singapore, stock brokering service is subject to GST; in Thailand, it is subject to VAT. (c) DST on transfer of listed shares – The proposed perpetual DST exemption of the transfer of shares of stock listed and traded through the PSE requires legislation. In Singapore and Hong Kong, Stamp Duty is imposed on shares of stock irrespective whether these are listed in the local stock exchange or not. In Thailand, a similar exemption from Stamp Duty applies. (d) DST on original issuance of shares – Excluding initial public offerings from the coverage of the DST requires legislation.

- *Assessment of deficiency STT on dealer accounts* – This can be addressed administratively given the exemption from STT granted to the sale of listed shares by dealers in securities under Section 127(A) of the NIRC of 1997.

- *Suspension or abolition of the IPO tax* – This will require legislation to amend or repeal Section 127(B) of the NIRC of 1997.

- *Shifting of DST Liability vis-à-vis PSE's Marktrade System* – Legislation may be required to make Section 173 of the NIRC of 1997 on the shifting of the DST conform with the technology used by the PSE. At the very least, appropriate regulation should be issued to clarify its application in this context.

- *Establishment of REITs* – Enabling legislation is necessary. REIT is present in Hong Kong, Singapore and Thailand.

272. FINANCING COMPANIES.

- *Uniform treatment of leasing* – Making finance lease subject to VAT instead of GRT will require legislation.

- *Exclusion from the coverage of CWT* – This may be addressed administratively since Section 57(B) of the NIRC of 1997 gives discretion to the Secretary of Finance in specifying items of income that will be subject to CWT.

- *Amendments to the Financing Company Act of 1998* – Legislation is needed to update the definition of finance lease, to extend the incentives in Section 10 to operating lease of finance companies, and to permit the lessee the option to purchase the leased asset under both finance and operating leases without the transaction deemed as a conditional or installment sale.

- Administrative issuance will suffice to address the implementation of Section 10 of the Financing Company Act of 1998.

273. MUTUAL FUNDS.

- The application of the tax exemption granted to CTFs to UIT Funds can be addressed administratively through coordination between the BIR and BSP.

Annex: Salient Features of Financial Sector Taxation in Hong Kong, Thailand & Singapore

1 Hong Kong

274. The Hong Kong tax regime is relatively simple. There are three types of direct taxes provided in Hong Kong's Inland Revenue Ordinance, namely: (a) Profits Tax; (b) Salaries Tax; and (c) Property Tax.[204] Miscellaneous levies include Stamp Duty. There is no withholding tax system. The Profits Tax and the Stamp Duty are the significant impositions on the financial sector in Hong Kong.

1.1 Profits Tax

275. Under the Profits Tax, "[p]ersons, including corporations, partnerships, trustees and bodies of persons carrying on any trade, profession or business in Hong Kong are chargeable to tax on all profits (excluding profits arising from the sale of capital assets) arising in or derived from Hong Kong from such trade, profession or business."[205] No distinction is made between residents and non-residents. The Profits Tax is charged on the assessable profits for a year of assessment. *Assessable profits* are the net profits (other than profits arising from the sale of capital assets) for the basis period, arising in or derived from Hong Kong.[206]

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[204] INLAND REVENUE DEPARTMENT, A BRIEF GUIDE TO TAXES ADMINISTERED BY THE INLAND REVENUE DEPARTMENT 2005-2006 1 (June 2005) [hereinafter HONG KONG GUIDE TO TAXES]. Information on Hong Kong financial sector taxation was also based on the memorandum by Christine M. Koo & Ip.

[205] *Id.* at 1.

[206] Inland Revenue Department of Hong Kong, "Tax Information: Profits Tax" *available at* http://www.ird.gov.hk/eng/tax/bus_pft.htm (last accessed Feb. 6, 2006).

276. There are three conditions that must be satisfied in order for a person to be chargeable to Profits Tax. These are: (a) the person must carry on a trade, profession or business in Hong Kong; (b) the profits to be charged must be from such trade, profession or business carried on by the person in Hong Kong; and (c) the profits must be profits arising in or derived from Hong Kong.[207]

277. Effective year of assessment 2003-2004, the Profits Tax rate for corporations is increased from sixteen percent (16%) to seventeen-and-a-half percent (17 ½%). For unincorporated businesses, the rate is sixteen percent (16%) beginning year of assessment 2004-2005.[208]

278. The following income and profits are excluded from assessable profits, and thus exempt from Profits Tax:

(1) dividends received from a corporation which is subject to Hong Kong Profits Tax;

(2) amounts already included in the assessable profits of other persons chargeable to Profits Tax;

(3) interest on Tax Reserve Certificates;

(4) interest on, and any profit made in respect of:

(a) a bond issued under the Loans Ordinance or the Loans (Government Bonds) Ordinance or

(b) an Exchange Fund debt instrument or

(c) a Hong Kong dollar-denominated multilateral agency debt instrument

(5) interest income and trading profits derived from long term debt instruments; and

(6) sums received or accrued in respect of a specified investment scheme by or to the person as: -

(a) a person chargeable to Profits Tax in respect of a mutual fund, unit trust or similar investment scheme that is authorized as a collective investment scheme under section 104 of the Securities and Futures Ordinance; or

[207] Inland Revenue Department of Hong Kong, Departmental Interpretation and Practice Notes No. 21 (Revised), "Locality of Profits" para. 4 (March 1998).

[208] HONG KONG GUIDE TO TAXES, *supra* note 199, at 2.

> (b) a person chargeable to Profits Tax in respect of a mutual fund, unit trust or similar investment scheme where the Commissioner is satisfied that the mutual fund, unit trust or investment scheme is a bona fide widely held investment scheme which complies with the requirements of a supervisory authority within an acceptable regulatory regime.

279. Tax incentives relating to the financial sector include the following: (a) tax concessions for gains derived from qualified debt instruments; (b) concessionary tax rate for offshore business of reinsurance companies; and (c) exemption from payment of tax on interest derived from any deposit placed in Hong Kong with an authorized institution, which exemption is inapplicable to interest received or accrued to a financial institution.[209]

Qualified Debt Instruments

280. Qualified debt instruments issued in Hong Kong are entitled to either a concessionary Profits Tax rate or outright exemption depending on whether these debt instruments are medium term or long term. As defined in Schedule 6 of the Inland Revenue Ordinance, the term *debt instrument* means any of the following instruments: (a) a bill of exchange; (b) a promissory note; (c) any other instrument which evidences an obligation to pay a stated or determinable amount to bearer or to order, on or before a fixed time, with or without interest, being an instrument by the delivery of which, with or without endorsement, the right to receive that stated or determinate amount, with or without interest, is transferable.

[209] HONG KONG TAX GUIDE, *supra* note 199, at 5.

281. Under Section 14(A)(1) of the Inland Revenue Ordinance, the concessionary rate of one-half (1/2) of the normal Profits Tax rate—i.e., 8.75% for corporations and 8% for unincorporated businesses—is chargeable on (a) the interest paid or payable on a medium term debt instrument and (b) any gain or profit on the sale or other disposal or on the redemption on maturity or presentment of the medium term debt instrument. Beginning assessment year 2003-2004, *medium term debt instrument* means a debt instrument that (a) is issued on or after 05 March 2003, (b) has an original maturity of less than seven (7) years but not less than three (3) years or is undated, and (c) cannot be redeemed within seven (7) years from the date of its issue but not within the first three (3) years.[210]

282. Further, pursuant to Section 26A(1)(h) and (i) of the Inland Revenue Ordinance, the following are excluded in the profits of any corporation or person chargeable to, and thus exempt from, Profits Tax: (a) the interest paid or payable on a long term debt instrument; and (b) any gain or profit on the sale or other disposal or on the redemption on maturity or presentment of a long term debt instrument. Section 26(A)(2) defines a *long term debt instrument* as one that (a) is issued on or after 05 March 2003, (b) has an original maturity of not less than seven (7) years or is undated, and (c) cannot be redeemed within seven (7) years from the date of its issue.

[210] Prior to 2003-2004, as per Section 14(A)(5) of the Inland Revenue Ordinance, the term *medium term debt instrument* means a debt instrument that (a) is issued before 05 March 2003, (b) has an original maturity of not less than five (5) years or is undated, and (c) cannot be redeemed within five (5) years from the date of its issue.

Qualifying Offshore Reinsurance Business

283. The concessionary rate of fifty percent (50%) of the normal Profits Tax rate is applied to offshore business of reinsurance companies.

Interest Income From Deposit Exempt

284. Interest income derived from any deposit placed with an authorized institution—i.e., a bank, a restricted license bank or a deposit taking company—in Hong Kong by the following taxpayers are exempt from the Profits Tax: (a) corporations carrying on a trade, profession or business in Hong Kong; and (b) persons, other than corporations, carrying on a trade, profession or business in Hong Kong where the interest income is in respect of funds of the trade, profession or business. The exemption does not apply to interest income received by financial institutions. The term *financial institution* refers to: (a) an authorized institution within the meaning of section 2 of the Banking Ordinance, i.e., a bank, restricted license bank or deposit taking company; and (b) any associated corporation of such an authorized institution which, being exempt by virtue of section 3(2)(a) or (b) or (c) of the Banking Ordinance, would have been liable to be authorized as a deposit-taking company or restricted license bank under that Ordinance had it not been so exempt."[211]

[211] Inland Revenue Authority of Hong Kong, Departmental Interpretation and Practice Notes No. 34 (Revised), "Exemption From Profits Tax (Interest Income) Order 1998" paras. 3-4 (December 2004).

Computing Assessable Profit for Life Insurance

285. Under Section 23 of the Inland Revenue Ordinance, the assessable profits of life insurance corporations shall be deemed to be five percent (5%) of the premiums from its life insurance business in Hong Kong during the basis period for a particular year. Alternatively, life insurance corporations may choose that their assessable profits shall be that part of the adjusted surplus deemed to arise in the basis period for that year less any dividend received.

1.2 Stamp Duty

286. Stamp Duty is chargeable on certain documents specified in the Stamp Duty Ordinance "which imposes fixed duty on some documents and an ad valorem duty on others."[212] Under said Ordinance, Stamp Duty is imposed on the following types of documents: (a) conveyance on sale (i.e., assignment); (b) agreement for sale of residential property; (c) lease of immovable property (i.e., tenancy agreement); (d) and transfer of Hong Kong stock.[213]

287. The term *stock* means any of the following investments: (a) any shares, stocks, debentures, loan stocks, funds, bonds or notes of or issued by any body, whether corporate or unincorporate, or any government or local government authority, or any other similar investment of any description; (b) any units under a unit trust scheme; (c) any right, option or interest in or in respect of any stock referred to

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[212] HONG KONG TAX GUIDE, *supra* note 199, at 27.

[213] Inland Revenue Department of Hong Kong, "Tax Information: Stamp Duty" *available at* http://www.ird.gov.hk/eng/tax/sdu.htm (last accessed Feb. 10, 2006).

in items (a) or (b), other than any such right, option or interest under an employees' share purchase or share option scheme.

288. Pursuant to section 2 of the Stamp Duty Ordinance, in general, the term *stock* does **not** include the following: (a) any loan capital, or (b) any bill of exchange or promissory note, or (b) any certificate of deposit (as defined in section 2 of the Inland Revenue Ordinance) or (c) any Exchange Fund debt instrument or Hong Kong dollar denominated multilateral agency debt instrument within the meaning of that Ordinance, or (d) any bond issued under the Loans Ordinance, or (e) any debentures, loan stocks, funds, bonds or notes denominated otherwise than in the currency of Hong Kong except to the extent that the same shall be redeemable, or may at the option of any person be redeemed, in the currency of Hong Kong. As such, these instruments are not subject to Stamp Duty. The term *stock* includes these investments—thus, subject to Stamp Duty—where the consideration or any part of the consideration for a conveyance on sale (in respect of immovable property) consists of any stock or any security not being stock.

289. Stamp Duty on the sale of immovable property in Hong Kong is charged at rates that vary with amount or value of the consideration as follows:[214]

[214] Source of table: Inland Revenue Department of Hong Kong, "Tax Information: Stamp Duty" *available in* http:// www.ird.gov.hk/eng/tax/sdu.htm (last accessed on Feb. 10, 2006).

Amount or value of the consideration		Stamp Duty Rate
Exceeds	Does not exceed	
.	HK$1,000,000	HK$100
HK$1,000,000	HK$1,080,000	HK$100 + 10% of excess over HK$1,000,000
HK$1,080,000	HK$2,000,000	0.75%
HK$2,000,000	HK$2,176,470	HK$15,000 + 10% of excess over HK$2,000,000
HK$2,176,470	HK$3,000,000	1.5%
HK$3,000,000	HK$3,290,320	HK$45,000 + 10% of excess over HK$3,000,000
HK$3,290,320	HK$4,000,000	2.25%
HK$4,000,000	HK$4,428,570	HK$90,000 + 10% of excess over HK$4,000,000
HK$4,428,570	HK$6,000,000	3%
HK$6,000,000	HK$6,720,000	HK$180,000 + 10% of excess over HK$6,000,000
HK$6,720,000	.	3.75%

290. The Stamp Duty for the lease of immovable property in Hong Kong is calculated at rates which vary with the term of the lease as follows:[215]

Term		Stamp Duty Rate
Not defined or is uncertain		0.25% x of the yearly or average yearly rent
Exceeds	Does not exceed	
.	1 year	0.25% x of the total rent payable over the term of the lease
1 year	3 years	0.5% x of the yearly or average yearly rent
3 years	.	1% x of the yearly or average yearly rent
key money, construction fee etc. mentioned in the lease		3.75% of the consideration if rent is also payable under the lease. Otherwise, same duty as for a sale of immovable property
duplicate or counterpart		HK$5 each

291. The rate of Stamp Duty for the transfer of Hong Kong stock vary with the amount or value of the consideration as follows:[216]

[215] Source of table: Inland Revenue Department of Hong Kong, "Tax Information: Stamp Duty" *available at* http:// www.ird.gov.hk/eng/tax/sdu.htm (last accessed Feb. 10, 2006).

Nature of Document	Rate
Contract Note for sale or purchase of any Hong Kong stock	0.1% of the amount of the consideration or of its value on every sold note and every bought note
Transfer operating as a voluntary disposition inter vivos	$5 + 0.2% of the value of the stock
Transfer of any other kind	$5

2 Thailand

292. The following taxes under the Thai Revenue Code impact on the financial sector of Thailand: (a) Personal Income Tax; (b) Corporate Income Tax; (c) Value-Added Tax; (d) Specific Business Tax; and (e) Stamp Duty.[217]

2.1 Personal Income Tax

293. Personal Income Tax ("PIT") is a direct tax levied on the income of a person. The term *person* means an individual, an ordinary partnership, a non-juristic body of persons, a deceased person and an undivided estate. In general, a person liable to PIT has to compute his tax liability, file tax returns and pay tax, if any, accordingly on a calendar year basis.[218]

294. Taxpayers are classified as "resident" and "non-resident". A resident of Thailand is liable to pay tax on income from sources in Thailand on a cash basis,

[216] Source of table: Inland Revenue Department of Hong Kong, "Tax Information: Stamp Duty" *available at* http:// www.ird.gov.hk/eng/tax/sdu.htm (last accessed Feb. 10, 2006).

[217] The discussion of these taxes are primarily based on information available in the Revenue Department of Thailand website and furnished by Kamthorn Surachet & Somsak, Ltd.

[218] Paras. 258 to 266 are based on Revenue Department of Thailand, "Tax Structures: Personal Income Tax" *available at* http://www.rd.go.th/publish/6000.0.html (last accessed Feb. 2, 2006).

regardless of where the money is paid, as well as on the portion of income from foreign sources that is brought into Thailand. A non-resident is, however, subject to tax only on income from sources in Thailand.

295. Income chargeable to the PIT is called "assessable income". The term covers income both in cash and in kind. Assessable income is divided into eight (8) categories, which includes, among others, “income in the nature of dividends, interest on deposits with banks in Thailand, shares of profits or other benefits from a juristic company, juristic partnership, or mutual fund, payments received as a result of the reduction of capital, a bonus, an increased capital holdings, gains from amalgamation, acquisition or dissolution of juristic companies or partnerships, and gains from transferring of shares or partnership holdings.” The tax rate is progressive, ranging from five percent (5%) to thirty-seven percent (37%).

Exclusions From Assessable Income

296. There are types of income that the taxpayer shall not include or may choose not to include in the assessable income in calculating their PIT liability. These include income from sale of immovable property, interest income and dividends. A taxpayer shall not include income from sales of immovable property acquired by bequest or by way of gift to the assessable income when calculating PIT. However, if the sale is made for a commercial purpose, then such income must be included as the assessable income.

297. At the taxpayer’s option, interest income may be excluded from the computation of PIT provided that a tax of fifteen percent (15%) is withheld at source.

However, the following forms of an individual's interest income are exempt from the 15% withholding tax:

(a) interest on bonds or debentures issued by a government organization;

(b) interest on savings deposits in commercial banks if the aggregate amount of interest received is not more than 20,000 Baht during a taxable year;

(c) interest on loans paid by a finance company; and

(d) interest received from any financial institution organized by a specific law of Thailand for the purpose of lending money to promote agriculture, commerce or industry

298. Another type of income covered is dividend income. A resident taxpayer who received dividends or shares of profits from a registered company or a mutual fund, which tax has been withheld at source at the rate of ten percent (10%), may choose to exclude such dividends from the assessable income when calculating PIT. In availing of this option, the taxpayer will be unable to claim any refund or credit available to such dividends.

Withholding Tax

299. The withholding tax system applies to certain categories of income. Under this system, the payer of income has to withheld tax at source, file tax return and submit the amount of tax withheld. The tax so withheld is credited against the tax liability of a taxpayer at the time of filing the PIT return. This creditable withholding tax applies to banking services and financing arrangement services, as follows: [219]

[219] Source of tables: Kamthorn memorandum.

Banking services

Payer	Receiver	W/T rate for the payer
Juristic person	Juristic person	1%
Juristic person	Individual	15%
Individual	Juristic person	N/A
Individual	Individual	N/A

Financing arrangement services

Payer	Receiver	W/T rate for the payer
Juristic person	Juristic person	1%
Juristic person	Individual	Progressive rate
Individual	Juristic person	N/A
Individual	Individual	N/A

Interest Income from Bank Deposits and Bank-Issued Investment Certificates

300. The interest income of person-depositors from bank deposits—which includes deposits in banks under the law governing commercial banking, and a company under the law governing the undertaking of finance, securities, and *credít foncier* businesses, and asset management companies under the law governing asset management companies—is treated for PIT purposes thus:[220]

[220] The table is based on the Kamthorn memorandum. The term *credit foncier* means " 'landed credit'; loan on mortgage, repaid in annual installments." *See* http://www.tiscali.co.uk/reference/dictionaries/difficultwords/data/d0004008.html.

Type of interest income	PIT Treatment
(1) Interest on deposit with bank in Thailand that is repayable on demand in the savings where the total amount of interest received by a taxpayer throughout the tax year	
- does not exceed 20,000 Baht	exempt from PIT computation
- that exceeding 20,000 Baht	subject to withholding tax at the rate of 15% of the interest
(2) Interest on deposits with banks in Thailand that are fixed for a period exceeding one year gathered from all fixed accounts throughout the tax year	
- not exceeding 30,000 Baht	exempt from PIT computation
- that exceeding 30,000 Baht	subject to withholding tax at the rate of 15% of the interest
(3) Interest on savings deposits with the Bank of Agriculture and Agricultural Cooperatives	exempt from PIT computation
(4) Interest, received from depositing with a bank in Thailand and/or a saving cooperative under the law governing co-operatives in Thailand - that originates from monthly deposits for an uninterrupted period of not less than 24 months beginning from the date of the first deposit - with each deposit being equal in amount but not exceeding 25,000 Baht per month and not exceeding 600,000 Baht in total	exempt from PIT computation
(5) Interest on bonds or debentures issued by a government organization	exempt from 15% withholding tax.
(6) Interest on loans paid by a finance company	exempt from 15% withholding tax

301. The tax treatment of interest income derived by person-investors from bank-issued investment certificates—i.e., bonds, debentures, promissory notes, and certificates of deposits—varies depending on whether the investor is a resident or not. Thus, (a) if resident investor, interest on bank-issued investment certificates will be subject to withholding tax at the rate of 15% and the investor may exclude such income from the PIT computation at the year end; and (b) if non-resident investor,

interest on banks-issued investment certificates will be subject to withholding tax at the rate of 15%.[221]

2.2 Corporate Income Tax

302. Corporate Income Tax ("CIT") is a direct tax levied on a juristic company or partnership which is established under Thai or foreign law and carries on business in Thailand or derives certain types of income from Thailand. The term *juristic company or partnership* ("company") means a limited company, a limited partnership or a registered ordinary partnership incorporated under Thai or foreign law as well as an association and a foundation engaged in business producing revenue. The term also includes any joint venture and any trading or profit-seeking activity carried on by a foreign government or its agency or by any other juristic body incorporated under a foreign law.[222]

303. The CIT is levied on both Thai and foreign companies. A Thai company is subject to tax in Thailand on its worldwide net profit at the end of each accounting period (i.e., 12 months). Generally, a foreign company is treated as carrying on business in Thailand if it has an office, a branch or any other place of business in Thailand or has an employee, agent, representative or go-between for carrying on business in Thailand. A foreign company carrying on business in Thailand is subject to CIT only for net profit arising from or in consequence of business carried on in

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[221] Kamthorn Memorandum.

[222] Paras. 267 to 270 are based on Revenue Department of Thailand, "Tax Structures: Corporate Income Tax" *available at* http://www.rd.go.th/publish/6044.0.html (last accessed on Feb. 7, 2006).

Thailand, at the end of each accounting period. When a foreign company disposes of its profit out of Thailand, such profit will be subject to tax on the sum disposed of. Profit also means any sum set aside out of profits as well as any sum which may be regarded as profit.

304. The CIT rate is thirty percent (30%) on net profit. However, the rates vary depending on types of taxpayers, as follows:[223]

Tax Payer	Tax Base	CIT Rate
1. Small company	- Net profit not exceeding 1 million Baht	15%
	- Net profit over 1 million Baht but not exceeding 3 million Baht	25%
	- Net profit exceeding 3 million Baht	30%
2. Companies listed in Stock Exchange of Thailand (SET)	- Net profit for first 300 million Baht	25%
	- Net profit for the amount exceeding 300 million Baht	30%
3. Companies newly listed in Stock Exchange of Thailand (SET)	Net Profit	25%
4. Company newly listed in Market for Alternative Investment (MAI)	- Net Profit for first 5 accounting periods after listing	20 %
	- Net Profit after first 5 accounting periods	30 %
5. Bank deriving profits from International Banking Facilities (IBF)	Net Profit	10 %
6. Foreign company engaging in international transportation	Gross receipts	3%
7. Foreign company not carrying on business in Thailand receiving dividends from Thailand	Gross receipts	10%
8. Foreign company not carrying on business in Thailand receiving other types of income apart from dividend from Thailand	Gross receipts	15%
9. Foreign company disposing profit out of Thailand	Amount disposed	10%
10. Profitable association and foundation	Gross receipts	2% or 10%
11. Regional Operating Headquaters (ROH)	Net Profit	10%

[223] Source of the table: Revenue Department of Thailand, "Tax Structures: Corporate Income Tax" *available at* http://www.rd.go.th/publish/6044.0.html (last accessed on Feb. 7, 2006).

Withholding Tax

305. Certain types of income paid to companies are subject to withholding tax at source. The withholding tax rates depend on the types of income and the tax status of the recipient. The tax withheld will be credited against the final tax liability of the taxpayer. Government agencies are required to withhold tax at the rate of one percent (1%) on all types of income paid to companies. The following are the withholding tax rates on some important types of income:

Types of income	Withholding tax rate
1. Dividends	10 %
2. Interest	10 % if paid to associations or foundations 1 % in other case
3. Royalties	10 % if paid to associations or foundations 3 % in other case
4. Advertising Fees	2 %
5. Service and professional fees	3 % if paid to Thai company or foreign company having permanent branch in Thailand 5% if paid to foreign company not having permanent branch in Thailand
6. Prizes	5 %

Interest Income from Bank Deposits and Bank-issued Investment Certificates

306. The interest income derived by juristic person-depositors from bank deposits—which includes deposits in banks under the law governing commercial banking, and a company under the law governing the undertaking of finance, securities, and *credít foncier* businesses, and asset management companies under the law governing asset management companies—is treated for CIT purposes as follows:

- Interest on deposits with banks in Thailand will be subject to withholding tax at the rate of 1% if the depositor is a Thai juristic person. The depositor shall include the interest income for its CIT computation at the year end.

- Interest on deposits with banks in Thailand will be subject to withholding tax at the rate of 15% if the depositor is a foreign juristic person.[224]

307. For juristic person-investors, their interest income from bank-issued investment certificates (i.e., bonds, debentures, promissory notes, and certificates of deposits) the CIT treatment is the same as that of interest from bank deposits.[225]

2.3 Valued Added Tax

308. Value Added Tax ("VAT') is an indirect tax imposed on the value added of each stage of production and distribution. Any person or entity who regularly supplies goods or provides services in Thailand and has an annual turnover exceeding 1.8 million Baht is subject to VAT in Thailand. Service is deemed to be provided in Thailand if the service is performed in Thailand regardless of where it is utilized or if it is performed elsewhere and utilized in Thailand.[226]

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[224] Kamthorn Memorandum.

[225] Kamthorn Memorandum.

[226] Paras. 273 to 276 are based on Revenue Department of Thailand, "Tax Structures: Value Added Tax" *available at* http://www.rd.go.th/publish/6043.0.html (last accessed on Feb. 7, 2006)

309. An importer is also subject to VAT in Thailand no matter whether one is a registered person or not. VAT will be collected by the Customs Department at the time goods are imported. Certain businesses are excluded from VAT and will instead be subjected to Specific Business Tax.

310. Under VAT, taxable goods mean all types of property, tangible or intangible, whether they are available for sales, for own use, or for any other purposes. It also includes any types of articles imported into Thailand. Services refer to any activities conducted for the benefits of a person or an entity, which are not the supply in terms of goods. The VAT rate is seven percent (7%).

311. The tax base of VAT is the total value received or receivable from the supply of goods or services. Value means money, property, consideration, service fees, or any other benefits which is ascertainable in terms of money. The VAT tax base will also include any excise tax arising in connection with such supply; but it is exclusive of the VAT itself and any discounts or allowances (but only if discounts or allowances are clearly shown in the tax invoices).

2.4 Specific Business Tax

312. Aside from the VAT, the Specific Business Tax ("SBT") is the other kind of indirect tax introduced to replace the Business Tax. It is imposed on certain businesses that are excluded from VAT coverage. These businesses include: (a) Banking, Financial and similar businesses; (b) Life Insurance; (c) Pawn Brokerage;

(d) Real Estate; and (e) any other business specified by the Royal Decree, i.e., business engaged in repurchasing agreement (REPO) and factoring.[227]

313. The activities of the following entities are exempt from SBT: (a) activities of Bank of Thailand, Government Savings Bank, Government Housing Bank and Bank for Agriculture and Agricultural Cooperatives; (b) Activities of the Export-Import Bank of Thailand, the Industrial Finance Corporation of Thailand, Asset Management Corporation, Small Industrial Finance Cooperation and Secondary Mortgage Corporation; (c) activities of National Housing Authority, Government Pawn Brokerage and Pension Fund; and (e) activities of selling securities listed in the Stock Exchange of Thailand.

314. The SBT tax base and rate are tabulated as follows (local tax at the rate of 10% is imposed on top of SBT):

Business	Tax Base	Tax Rate
Banking, Finance and similar business	Interest, discounts, service fees, other fees, profits from foreign exchange	3.0%
Life Insurance	Interest, service fees and other fees	2.5%
Pawn Brokerage	Interest, fees, remuneration from selling overdue property	2.5%
Real Estate	Gross receipts	3.0%
Repurchase Agreement	The difference between selling price and repurchasing price	3.0%
Factoring	Interest, discounts, service fees and other fees	3.0%

[227] Paras. 277 to 279 are based on Revenue Department of Thailand, "Tax Structures: Specific Business Tax" *available at* http://www.rd.go.th/publish/6042.0.html (last accessed on Feb. 7, 2006).

2.5 Stamp Duty

315. Stamp duties are taxes on instruments and not on transactions or persons. For the purposes of stamp duty, an instrument is defined as any document chargeable with duty under the Revenue Code.[228]

316. Only instruments listed in the stamp duty schedule under the Revenue Code are subject to the stamp duty. The schedule also lists the persons liable to pay stamp duty, e.g., the persons executing the instrument, the holders of the instrument or the beneficiary.

317. The instruments liable to stamp duty include, *inter alia*, transfers of land, leases, stock transfers, debentures, mortgages, life assurance policies, annuities, power of attorney, promissory notes, letters of credit, and traveler's checks. Exemptions are specified under the Revenue Code, Royal Decrees, the order of the chairman of the National Executive Council, and Thai laws. Significantly, under Royal Decrees, the following are exempt from Stamp Duties: (a) a transferor, only in respect of the transfer of registered or approved securities for which the Stock Exchange of Thailand acts as registrar; (b) a transferor, only in respect of the transfer of bonds issued by the Bank of Government Housing Welfare, if the Bank of Thailand acts as registrar for such transfer; (c) a transferor, only in respect of the transfer of bonds issued by the Bank of Thailand; and (d) a transferor of bond issued by government enterprises.

[228] Paras. 280 to 283 are based on Revenue Department of Thailand, "Tax Structures: Stamp Duty" *available at* http://www.rd.go.th/publish/21986.0.html (last accessed on Feb. 7, 2006).

318. The rate of stamp duty on instruments relevant to the financial sector are tabulated below:

Nature of Instrument/Transaction	Stamp Duty
(1) Lease of land, building, or other construction or floating house - For every 1,000 Baht or fraction thereof of the rent or key money or both for the entire lease period	1 Baht
(2) Transfer of share, debenture, bond, and certificate of indebtedness issued by any company, association, body of persons or organizations - For every 1,000 Baht or fraction thereof of the paid-up value of the share, or of the nominal value of the instrument, whichever is greater	1 Baht
(3) Hire-purchase of property - For every 1,000 Baht or fraction thereof of the total value	1 Baht
(4) Loan of money or agreement for bank overdraft - For every 1,000 Baht or fraction thereof of the total amount of loan or the maximum amount of overdraft agreed upon	1 Baht
(5) Policy of insurance (a) Policy of insurance against loss – For every 250 Baht or fraction thereof of the premium (b) Policy of life insurance – For every 2,000 Baht or fraction thereof of the sum insured (c) For any other insurance – For every 2,000 Baht or fraction thereof of the sum insured (d) Policy of Annuity – For every 2,000 Baht or fraction thereof of the principal amount, or, if the principal amount is not apparent, for every 2,000 Baht or fraction thereof of 33 1/3 times the yearly income (e) Policy of insurance where reinsurance is effected (f) Renewal of policy of insurance	 1 Baht 1 Baht 1 Baht 1 Baht 1 Baht Half the rate for the original policy
(6) (a) Bill of exchange or similar instrument used like bill of exchange - For each instrument (b) Promissory note or similar instrument used like promissory note - For each instrument	3 Baht
(7) Bond of any government sold in Thailand - For every 100 Baht or fraction thereof	1 Baht
(8) Check or any written order used in lieu of check - For each instrument	3 Baht
(9) Receipt for any interest-bearing deposit	5 Baht
(10) Letter of Credit (a) issued in Thailand - For value less than 10,000 Baht - For value of 10,000 Baht or over (b) Issued abroad and payable in Thailand - For each payment	 20 Baht 30 Baht 20 Baht

(11) Traveler's check (a) issued in Thailand – For each instrument (b) issued abroad but payable in Thailand – For each instrument in Thailand	 3 Baht 3 Baht
(12) Pledge - For every 2,000 Baht or fraction thereof of the debt - If amount of debt secured by pledge is indeterminate	 1 Baht 1 Baht

3 Singapore

319. In Singapore, the taxes imposed that are relevant to the financial sector include: (a) Individual Income Tax; (b) Corporate Income Tax; (c) Goods and Services Tax; (d) Stamp Duty.[229]

3.1 Individual Income Tax

Interest Income Exemption of Individuals

320. The interest income received by tax resident individuals are exempt as follows: (a) interest received from Post Office Savings Bank ("POSB") savings accounts – full amount is tax exempt beginning 01 January 2004; (b) interest received from (i) POSB fixed deposit and current accounts and (ii) other approved banks and licensed finance companies in Singapore – full amount is tax exempt beginning 01 January 2005; (c) interest received from debt securities (excluding such income derived through partnerships in Singapore) derived on or after 01 January 2004 is tax exempt; (d) interest received under the Central Provident Fund Minimum Sum and Investment Scheme.

321. For non-resident individuals, the following interest income received by them are exempt: (a) interest received from approved banks and approved Asian Dollar Bonds; (b) interest received from finance companies – full amount is tax exempt

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[229] The discussion on these taxes is primarily based on the Inland Revenue Authority of Singapore website. *See* http://www.iras.gov.sg/ESVPortal/iit/index.asp (for Individual Income Tax); http://www.iras.gov.sg/ESVPortal/ct/index.asp (for Corporate Income Tax); http://www.iras.gov.sg/ESVPortal/gst/index.asp (for Goods and Services Tax). *See also* the Ministry of Finance of Singapore website at http://www.mof.gov.sg/taxation/index.html.

beginning 01 January 2005; (c) interest received from debt securities (excluding such income derived through partnerships in Singapore) derived on or after 01 January 2004 is tax exempt.

Treatment of Singapore Investment Income

322. The following income derived from Singapore by any individual on or after 01 January 2004 is exempt from income tax:[230]

(a)	any interest from debt securities
(b)	any discount from debt securities which mature within one year from the date of issue of those securities
(c)	any income from any annuity, except income from an annuity (i) purchased by the employer of an individual in lieu of any pension or other benefit payable during his employment or upon his retirement, and (ii) purchased under the Supplementary Retirement Scheme
(d)	any income from any life insurance policy, except any sum realized under any insurance against loss of profits
(e)	any distribution made by any collective investment scheme constituted as a unit trust (including real estate investment trust) authorized under the Securities and Futures Act;
(f)	any fee or compensatory payment from securities lending or repurchase agreements

3.2 Corporate Income Tax

323. A company will be taxed on any income accruing in or derived from Singapore or received in Singapore from outside Singapore, regardless of the company's tax residence status in Singapore. Starting 2005, a company is charged a flat Corporate Income Tax rate of twenty percent (20%) on its chargeable income.

[230] Ministry of Finance of Singapore, "Tax Treatment of Singapore Investment Income" *available at* http://www.mof.gov.sg/taxation/Singapore_investment_income.html.

324. Singapore introduced beginning 01 January 2003 the one-tier corporate taxation to replace the full imputation system. Under the one-tier system, corporate income is taxed at the corporate level and such tax is a final tax. Thus, all dividends paid are exempt from tax in the hands of its shareholders.

Withholding Tax

325. The withholding tax system applies to Singapore-sourced income of non-resident companies. The withholding tax rate varies depending on the nature of the payments made. The types of payment subject to withholding tax are:[231]

Nature of Income	Tax rate
Interest, commission, fee or other payment in connection with any loan or indebtedness	15% (final on gross payment)
Royalty or other lump sum payments for the use of movable properties Payment for the use of or the right to use scientific, technical, industrial or commercial knowledge or information	10% 10%
Technical assistance and service fees	Prevailing Corporate Tax rate (20%)
Management fees	Prevailing Corporate Tax rate (20%)
Rent or other payments for the use of movable properties	15% (final on gross payment)
Time charter fees and voyage charter fees 1. Paid to resident of a country which has a tax treaty with Singapore which provides for: - Full exemption of shipping and aircraft profits - 50% exemption of shipping and aircraft profits 2. Paid to a resident of a country which has no tax treaty with Singapore	 Nil 1% 2%

[231] Inland Revenue Authority of Singapore, "What is withholding tax & types of payments subject to withholding tax" *available in* http://www.iras.gov.sg/ESVPortal/ct/pfv_ct_b.3.1_what+is+withholding+tax.asp (last accessed Feb. 13, 2006) *and* "Withholding Tax Rates" *available in* http://www.iras.gov.sg/ESVPortal/ct/pfv_ct_b.3.3_withholding+tax+rates.asp (last accessed Feb. 11, 2006).

3. Paid to a resident of a tax haven country	3%
Bareboat charter fees 1. Paid to resident of a country which has a tax treaty with Singapore where: (a) treaty specifically covers bareboat charter fees under the 'Shipping & Air Transport' Article and it provides for: - Full exemption of shipping and aircraft profits - 50% exemption of shipping and aircraft profits (b) treaty does not cover bareboat charter fees 2. Paid to a resident of a country which has no tax treaty with Singapore 3. Paid to a resident of a tax haven country	 Nil 1% 2% 2% 3%
Directors' remuneration	Prevailing Corporate Tax rate (20%)
Proceeds from sale of any real property by a non-resident property trader	15%

Financial Sector Investment Scheme

326. Effective 01 January 2004, the Monetary Authority of Singapore ("MAS") implemented the Financial Sector Investment ("FSI") Scheme. Under the FSI scheme, seven tax incentive schemes for financial services existing prior to 2004 are merged into a streamlined scheme for the purpose of simplifying the tax system and developing high-growth and high-valued financial activities in Singapore. The FSI Scheme categorizes the qualifying activities into Standard-tier Qualifying Activities & Awards and Enhanced-tier Qualifying Activities & Awards. The awards may be given initially for five (5), seven (7), or ten (10) years depending on the headcount and scope of the applicant's activities.[232]

[232] Linda L. Ng, "Singapore Unveils Major Reform of Tax Incentives for Financial Services", TAX NOTES INTERNATIONAL 535-36 (May 12, 2003) [hereinafter Ng].

327. Income derived from Standard-tier qualifying activities is taxed at the concessionary tax rate of ten percent (10%). A company with the Standard-tier award will be able to enjoy the 10% tax rate on income from qualifying activities, provided there is at least one (1) professional staff engaged in the category of activities for which the income is derived. A qualifying base is imposed on the income derived from qualifying activities. This qualifying base is not imposed on income derived from the provision of qualifying headquarters services by companies granted the FSI Headquarter Services award.[233]

328. Income derived form Enhanced-tier activities is taxed at the concessionary rate of five percent (5%). No qualifying base is imposed on income derived from these activities.[234] Enhanced-tier awards are granted to high-growth, high value-added activities and come in four (4) types, namely:[235]

(a)	*bond market awards* for arranging, underwriting, and distributing qualifying debt securities;
(b)	*derivative market awards* for intermediary services in connection with transactions relating to qualifying derivatives and trading of qualifying derivatives;
(c)	*equity market awards* for arranging, underwriting, managing, and placing initial public offerings of stocks, shares, bonds, and other securities issued by foreign companies for purposes of listing on the Singapore Exchange, the sale of securities of foreign companies listed on the Singapore Exchange, and services (including brokerage, nominee, and custodian services) in connection with transactions relating to securities of foreign companies listed on the Singapore Exchange; and
(d)	*credit facilities syndication awards* for arranging, underwriting, and participating in syndicated offshore credit facilities or offshore guarantee facilities, if the loans are used outside Singapore and interest is not deducted from income accruing in or deriving from Singapore.

233 Singapore Government, "Financial Sector Incentive Scheme (FSI)" *available in* http://www.business.gov.sg/incentives/fsi.htm

234 *Id.*

235 Ng, *supra* note 227, at 535-36.

3.3 Goods & Services Tax

329. Goods and Services Tax ("GST") is a tax on domestic consumption. The tax is paid when money is spent on goods or services, including imports. It is a multi-stage tax which is collected at every stage of the production and distribution chain.

330. "Output tax" is the GST a registered trader charges on his local supplies of goods and services. "Input tax" is the GST that the trader has paid on purchases of goods and services for the purpose of his business. The input tax is deductible from output tax to arrive at the GST payable by the trader, or amount to be refunded to him.

331. The GST rate was increased from three percent (3%) to four percent (4%) in 2003 and from four percent (4%) to five percent (5%) in 2004. It is levied on: (a) goods and services supplied in Singapore by any taxable person in the course or furtherance of a business; and (b) goods imported into Singapore by any person. In general, a supply is either taxable or exempt. A taxable supply is one that is standard-rated or zero-rated. Only a standard-rated supply is liable to GST at 5%.

332. Zero-rating a supply means applying GST at 0% for the transaction. A GST registered trader need not charge GST on his zero-rated supplies, but he is nevertheless allowed a refund of the tax he has paid on his inputs. In Singapore, only "exports" of goods and "international" services are zero-rated. In contrast, if a supply is exempt from GST, no tax is chargeable on it. A GST registered trader does not charge his customer any GST on his exempt supplies. At the same time, he is not

entitled to claim input tax credits for any GST paid on goods and services supplied to him for the purpose of his business. The "sale and lease of residential properties" and "financial services" are exempt from GST in Singapore.[236]

GST on Financial Institutions

333. Financial institutions have both exempt and taxable supplies. The following financial services are deemed exempt supply under Schedule 4 of the GST Act:[237]

GST Exempt Financial Services
a) The operation of any current, deposit or savings account
b) The exchange or grant of an option for the exchange of currency (whether effected by the exchange of bank notes, currency notes or coin, by crediting or debiting accounts, or otherwise) other than the supply of a note or a coin as a collector's item, investment article or item of numismatic interest
c) Any supply by a person carrying on a credit card, charge card or similar payment card operation made directly in connection with that operation to a person who accepts the card used in the operation when presented to him in payment for goods or services
d) The issue, payment, collection or transfer of ownership of any note or order for payment, check or letter of credit or the notification of the issue of a letter of credit
e) The issue, allotment, transfer of ownership, drawing, acceptance or endorsement of a debt security
f) The issue, allotment or transfer of ownership of an equity security
g) The provision of any loan, advance or credit
h) The provision of the facility of installment credit finance in a hire-purchase, conditional sale or credit sale agreement for which facility a separate charge is made and disclosed to the recipient of the supply of goods
i) The transfer or assignment of the provision of the facility of installment credit finance in a hire-purchase agreement
j) The grant of a right or option relating to an obligation to pay interest or the exchange or grant of an option for the exchange of obligations to pay interest
k) The renewal or variation of a debt security, equity security or contract for the provision of any loan, advance or credit

[236] Paras. 298 to 300 are based on Ministry of Finance of Singapore, "GST Information" *available in* http://www.mas.gov.sg/taxation/gst.html.

[237] The list is accessible in the Inland Revenue Authority of Singapore website, i.e., http://www.iras.gov.sg/ ESVPortal/gst/gst_c.4.9.4.a_ss+of+financial+instns.asp

l) The provision, or transfer of ownership, of a life insurance contract
m) The provision or assignment of any futures contract including a futures option transaction which does not lead to a delivery of any goods from the seller to the buyer
n) The provision or assignment of any option or contract for the sale of any unallocated commodity which does not lead to a delivery of the commodity from the seller to the buyer
o) The grant of a right or option to acquire any unallocated commodity where the right is exercisable at a future date and any sale resulting from the exercise of the right would be a sale which does not lead to a delivery of the commodity from the seller to the buyer
p) The issue or transfer of ownership of a unit under any unit trust
q) The arrangement, provision, or transfer of ownership, of any contract of reinsurance

334. In the foregoing enumeration, the term *credit* includes: (a) The supply of credit by a person, in connection with a supply of goods or services by him, for which a separate charge is made and disclosed to the recipient of the supply of goods or services; (b) The discounting of any bill of exchange, promissory note, invoice or any similar instrument or debt security; and (c) The supply of credit by way of factoring of debts and forfaiting,[238] but excludes the supply of a credit card, charge card or similar payment card made to a cardholder for which a fee for joining or subscription is charged other than the provision of credit for which a separate charge in respect of interest is made and disclosed. The term *debt security* means any interest in or right to be paid money that is, or is to be, owing by any person or any option to acquire any such interest or right but excludes a contract of insurance and an estate or interest in land, other than an estate or interest as mortgagee or chargeholder. The

[238] *Forfaiting* “is the purchase of a series of credit instruments such as drafts drawn under time letters of credit, bills of exchange, promissory notes, or other freely negotiable instruments on a "non- recourse" basis (non-recourse means that there is no comeback on the exporter if the importer does not pay). The Forfaiter deducts interest (in the form of a discount), at an agreed rate for the full credit period covered by the notes. The debt instruments are drawn by the exporter (seller), accepted by the importer (buyer), and will bear an aval, or unconditional guarantee. The guarantee will normally be issued by the importer's bank, but some strong corporates can be accepted without a bank guarantee.” John F. Moran, Jr. *Forfaiting A User’s Guide What It Is, Who Uses It And Why?* 1 (2002).

term *equity security* means any interest in or right to a share in the capital of a body corporate or any option to acquire any such interest or right but excludes a contract of insurance and an estate or interest in land, other than an estate or interest as mortgagee or chargeholder. The term *life insurance contract* means a contract for the provision of a life policy within the meaning of the Insurance Act of Singapore. Finally, the term *unit* means a right or interest (whether described as a unit, a sub-unit or otherwise) which may be acquired under a unit trust.

335. Financial institutions are required to account for GST when they received payments for the arranging, broking, underwriting or advising of financial activities. These services are not exempt from GST and are subject to GST at the standard rate.

GST on Lease and Hire Purchase Transactions

336. In a hire purchase agreement, the financier remains the legal owner of the goods until the hirer exercises the option to purchase the goods or pays the last installment. However the commercial substance of the agreement is such that the parties never intend the goods to be returned to the financier. In this transaction, the financier makes two supplies to the hirer for GST purposes, namely: (a) a taxable supply of goods; and (b) an exempt supply of financial service.

337. For GST purposes, the transfer of possession of the goods to the hirer will give rise to a taxable supply of goods even though legal ownership is not transferred yet. The other supply made by the financier is the provision of the facility of installment credit finance, which is an exempt supply of financial service if a separate

charge is made and disclosed to the hirer in respect of it. This separate charge is exempted from GST.

338. A particular finance lease will be treated as a hire purchase agreement for GST purposes—i.e., the foregoing GST treatment will apply—if these conditions are present: (a) the lease provides an option or right for the lessee to purchase the leased goods prior to or at the end of the lease period; and (b) the leased goods are not recognized as the lessor's assets in his accounting record. As to whether a financing or leasing instrument will be treated as a hire purchase agreement, the substance of the instrument, not its term or name, will determine its GST treatment.

339. The GST Act permits GST-registered traders to charge GST on the excess of the sale price over the purchase price of the goods they sell, under the second-hand goods scheme or the gross margin scheme. This scheme applies only to supply of goods and not of services. It cannot be used for any supply of goods where GST has been charged on the previous supply of these goods. While it is normally applied to the sales of used or second-hand goods, the gross margin scheme is also used for *new* goods provided (a) that these are supplied under a hire and purchase agreement and (b) that the financier in the agreement is a pure financier (such as banks, finance companies or leasing companies), whose business of purchasing goods is not for resale purposes but solely for the purpose of providing financing (i.e., the financier does not add a mark-up to the price of the goods being supplied under hire purchase agreements). If a finance lease or conditional sale agreement satisfies the aforesaid conditions to be treated as hire purchase agreement and the pure financier has obtained prior approval to use the scheme for new goods supplied by

him under hire purchase agreements, the extension of the gross margin scheme to the supply of new goods will also apply to such financing instrument.[239]

3.4 Stamp Duty

340. In Singapore, Stamp Duty is a tax on commercial and legal documents that record and give effect to certain transactions. It is not a tax on transactions such that Stamp Duty is payable on the document even if the transaction is aborted. Since 28 February 1998, Stamp Duty is payable only on documents relating to immovable property, stocks and shares as these are enumerated in the First Schedule to the Stamp Duties Act.[240]

341. The current Stamp Duty rates on the major documents are tabulated below, with the currency in Singapore Dollars:[241]

[239] Paras. 301 to 304 are based on Internal Revenue of Singapore, IRAS Circular: Clarifications on the GST Treatment of Hire Purchase and Other Financing Instruments (Nov. 18, 2003).

[240] Inland Revenue Authority of Singapore, "Introduction to Stamp Duty" *available in* http://www.iras.gov.sg/ESVPortal/others/stamp/stamp+duty-f1.1-intro+to+stamp+duty.asp (last accessed Feb. 14, 2006).

[241] Source: http://www.iras.gov.sg/EVSPortal/ others/stamp/stamp_duty-f1.2-duty_rates-stampduty.asp *and* https://concorde.asianconnect.com/esp/image/SD_RATES.pdf (last accessed Feb. 14, 2006).

Document	Rate of Duty
On Sale & Purchase or Gift of immovable property Purchase price or market value, whichever is higher - every $100 or part thereof of the first $180,000 - every $100 or part thereof of the next $180,000 - thereafter, every $100 or part thereof	 $1.00 $2.00 $3.00
On Mortgage of immovable property or stocks and shares Amount of facilities granted	
- every $1,000 or part thereof	$4.00 (maximum $500)
On Tenancy/Lease of immovable property Contractual rent or market rent, whichever is higher (a) Where average annual rent and other consideration calculated for a whole year does not exceed $1,000	Exempt
(b) Where average annual rent and other consideration calculated for a whole year exceeds $1,000 Lease term not exceeding 1 year - every $250 or part thereof of annual rent Lease term exceeding 1 year but not exceeding 3 years - every $250 or part thereof of annual rent Lease term exceeding 3 years or for any indefinite term - every $250 or part thereof of annual rent	 $1.00 $2.00 $4.00
On Transfer or Gift of shares Purchase price or net asset value of the share, whichever is higher - every $100 or part therof	 $0.20