

FINAL REPORT

FINANCIAL SECTOR TAXATION POLICY DISCUSSION AND RECOMMENDATIONS (SECOND MODULE)

Submitted to:

**Economic Modernization Through Efficient Reforms And Governance Enhancement
(EMERGE) Project**

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FINANCIAL SECTOR TAXATION II ACHIEVING TAX NEUTRALITY POLICY DISCUSSION AND RECOMMENDATIONS

PART I: INTRODUCTION

All taxes change behavior. Taxes affect people's portfolio choices and their decision to work, save and take risks. These changes in behavior may be a good thing if the change is for the better. To illustrate, governments seek to reduce "negative externalities" by taxing the production and sale of cigarettes and liquor. In this respect, taxes can generate two positive effects on the economy: they finance public goods and discourage anti-social behavior.

Not all economic activities can be taxed, however, and where untaxed activities are inevitably encouraged relative to taxed activities, virtually all taxes are distortive and non-neutral. The exception is the head or poll tax. These reduce personal or household income and therefore reduce private savings and consumption. This reduction does not make poll taxes distortive since the very objective and unavoidable consequence of taxation is to reduce private use of scarce resources to free them up for public or collective use. When the public funds generated are, in turn, efficiently spent, the reallocation of resources from private to public use makes the economy more efficient. Moreover, explicit taxation is generally considered a better way to reallocate resources from private to public use than other methods of doing so (such as excessive money creation to finance government or the repression of the financial sector to make cheap credit available for financing public or quasi-public investments). Despite the neutrality of poll taxes, they are not imposed because they are considered to be very inequitable and politically unacceptable, which means that governments must resort to distortive or non-neutral taxes.

Of all the sectors, the financial sector is perhaps the most sensitive to distortive taxation. What may appear to be a small tax on financial transactions may actually be a very high relative to the value added generated by the sector. This point is best illustrated by the effects of the documentary stamp taxes (DST) that used to be imposed¹ on secondary markets for government securities. Since the DST rate of PhP.30 for every PhP200 is large compared to the interest income per peso of government securities held for one week, which is just the annualized yield divided by 52. While the fraction of a percent (0.15%) may look small relative to the face or market value of the securities being traded, it is a

¹ The NIRC as amended by Republic Act No. 9243.

huge tax relative to the interest income of a securities trader who holds the securities for a few days or weeks.

To make matters worse for the financial sector, virtually identical economic activities in the sector are taxed differently, resulting in an unjustified bias for or against instruments that have equivalent financial effects but offered by different financial institutions.

The object of a neutral tax system is ensuring that identical economic activities are similarly taxed.

PART II: ASSESSING NEUTRALITY

Poll tax aside, the most neutral tax is a single rate consumption tax. Consumption taxes not only encourage the consumption of leisure, but also of untaxed goods that are home-produced or produced in the informal sector. Also, since income that is not consumed is not taxed, consumption taxes encourage savings. Equivalently, if all income is eventually consumed, it is taxed only when it is eventually spent on consumption. The only distortions the consumption tax causes are (i) its negative effect on labor supply and effort (work is less rewarding since each hour of work could buy less goods because of the consumption tax); and (ii) its unintended bias in favor of smuggled and informal sector goods.

Consumption taxes are generally more neutral than income taxes. This is so since a tax system which taxes consumption rather than income encourages savings by allowing people to postpone partially the payment of taxes by postponing consumption.

However, despite the fact that consumption tax is the most neutral tax, no government has eliminated the income tax in favor of the consumption tax. For one thing, income taxes on wage and salary workers in government and large corporations are probably one of the easiest taxes to collect, accounting for more than 90% of individual income tax payments. This applies as well to the many taxes on “passive” income (*e.g.*, FWT on interest income) that are easy to collect and are perceived to fall on the higher income groups. For another thing, in spite of its unfairness to wage and salary workers, the income tax is still perceived to be more progressive than the VAT and to be at least as efficient as the VAT provided the highest marginal income tax rate is not too high.

These reasons for favoring income taxes ignore its disadvantages: (a) Income taxes favor hard-to-tax occupations (*e.g.*, tax revenue per wage and salary earners is higher than on the self employed), resulting in the unequal taxation of two taxpayers with the same income, with the person who saves more for retirement ending up paying more taxes over his lifetime because of the taxes that fall on the income arising from savings; and (b) It discourages savings to the extent that it reaches passive income arising from savings (*e.g.*, interest income and dividends).

By comparing the advantages and distortions of consumption and income taxes, one sees that each have separate strengths and weaknesses that can compliment one another. First, income taxes reach income that consumption taxes cannot reach, such as the portion of income not covered by the withholding system that is spent on smuggled and informal sector goods. Second, the VAT complements the income tax since it covers expenditures of consumers who

manage to avoid paying income taxes (and is mildly progressive to the extent that basic goods and services are exempt from indirect taxes). Third, since most people have few sources of income yet buy goods and services from many sellers and providers, consumption taxes have to have a linear proportional relationship with total consumption that is exempt from indirect taxes and cannot increase progressively as total consumption increases (unlike income taxes where the marginal tax rates rise as total income rises). In all, consumption taxes and income taxes are like two blades of a pair of scissors that cut much better when used together rather than separately. As a result, tax systems in all countries rely heavily on both income and consumption taxes.

Income taxes, however, can achieve better tax neutrality and mimic the advantages of consumption taxes by simply excluding from the income tax base the additional income that arises from additional savings (*e.g.*, dividends and interest income), thus removing the bias against savings.

A Simple Example:

- Two periods (working period and retirement period with zero work income in the retirement period). In the absence of taxes, income in working period is Y , consumption in working period is C , and consumption in retirement period is the part of Y that is not consumed prior to retirement plus interest income $(Y-C)(1+r)$.
- Tax paid under income tax: tY in period 1 and $tr[Y(1-t) - C]$ in period 2 (assuming interest income is taxable in period 2)
- Tax under consumption tax regime: tC in period 1 and $t(Y-C)(1+r)$ in period 2.
- NPV of taxes under consumption tax regime = $tC + t(Y-C)(1+r)/(1+r) = tY$
- NPV of taxes under income tax regime = $tY + tr[Y(1-t)-C]/(1+r)$

Thus, a “life-time” tax under the two tax regimes would be equivalent if $tr[Y(1-t)-C]$ were set to zero. Consumption taxes and income taxes that yield the same NPV of revenue over the life time of the income earner would be equivalent if additional income arising from savings were exempt from income taxes.

From this discussion, determining or assessing the neutrality (or degree of non-neutrality) of Philippine financial taxes can be done through two equivalent tests:

Test 1: comparing financial sector taxes with consumption taxes; or

Test 2: comparing financial sector taxes with income taxes that mimic consumption taxes by excluding from the tax base the additional income that arise from savings.

To further simplify, achieving neutrality means:

- (1) similarly taxing similar financial activities;
- (2) encouraging savings; and
- (3) discouraging transaction taxes, including those that are not so named but have the same effect.

**PART III: ANALYZING THE NEUTRALITY OF
CURRENT FINANCIAL SECTOR TAXES**

***A. FINAL WITHHOLDING TAX
ON INTEREST INCOME***

The present Final Withholding Tax (FWT) system fails both tests – it neither acts as a consumption tax nor as a pure income tax since it may be, if the inflation rate is much higher than real interest rate, a tax on the principal. Not only is it a bias against savings, it also imposes different taxes on income arising from the same or equivalent acts of saving depending on the currency denomination, maturity, and issuer of the financial instrument or asset in which the savings are invested. To make matters worse, a 20% final tax on nominal interest income is actually a very high tax on real interest income if inflation is large relative to nominal interest. This is the case even for modest rates of inflation (*e.g.*, 5%).

During working group discussions, we were reminded that, aside from raising billions of pesos for the government, FWTs were created out of necessity. Previously, when the Philippines practiced global income taxation, income arising from interest and other passive income were effectively tax exempt because taxpayers simply did not declare them in their tax returns. There was very little that tax collectors could do in this regard since they were hampered by bank secrecy laws from cross-checking reported interest income with bank records. To allow the government to collect taxes without violating bank secrecy laws, banks were deputized as withholding agents on taxes on interest income. Since the banks had no way of knowing what income tax brackets their clients belong to, the only workable solution was to impose a uniform tax rate on all depositors for each type of deposit or financial instrument.

The first part of this financial sector taxation study² revealed that one of the greater causes of perceived financial distortion was the zero-rated tax rate advantage given to interest arising from long-term instruments, trust accounts, etc. issued by banks.³ If the goal is to encourage savings, there is no real justification for exempting long-term deposits in banks from the FWT. All this does is to encourage households to put their money in long-term instruments of

² Policy Review of Financial Sector Taxation (First Module), Submitted to Economic Modernization Through Efficient Reforms and Government Enhancement (EMERGE), 30 June 2006 [Fintax 1].

³ The local government units have also expressed their concern at the unequal treatment with which bonds issued by local governments are treated vis-à-vis banks. It is proposed that the uniform taxation on all financial instruments would also address this concern.

banks, without necessarily affecting total household savings. Likewise, if long-term instruments are effectively bearer instruments and are therefore tradable or negotiable, these instruments in the hands of constant traders are effectively short-term instruments that are exempt from the FWT. Ironically, short term instruments (with maturity dates of less than five years) that are not traded and held until maturity are instead taxed at a higher rate. In short, exempting long-term instruments issued by banks simply result in taxing very similar savings activities at very different rates.

If savings are to be encouraged, all savings should be taxed similarly regardless of the issuer of the financial instrument. An individual should be able to save as much by leaving his money in a trust account administered by a trust company as with a bank.

In addition, having a final withholding tax of 20% is hard to justify if the goal is to remove the bias of the tax system against savings. As illustrated below, a 20% tax on interest income results in a very high tax on real interest income even at modest rates of inflation.

Consider a nominal interest rate of 7% where the inflation rate is 5%, the nominal after-tax interest income is only 5.6%. This leaves the saver a net interest income (after taxes) of only 0.6%, which is only 30% of the real interest rate. The result is that the effective tax rate on real interest is 70% (1 minus the ratio of .6% to 2%) since part of nominal interest is compensation for the erosion of the principal due to inflation. A saver would, in the long run, invest his money in another country or asset (e.g., jewelry) that at least allows him to be ahead of inflation. In effect, part of the interest payments are effectively amortization on the principal, which ends up being taxed as income.

As show in Figures 1 and 2 below, it is also important to point out that the ratio of the inflation rate to the real interest rate have, in the past, reached levels that were so high that the 20% withholding tax on nominal interest income actually exceeded the real interest income, *i.e.*, the effective tax on real interest income exceeded 100%. During such times, the 20% tax was effectively a tax on the principal. The effective tax rate on real interest income is of course usually less than 100%. But as shown in the charts below, it was generally higher than the corporate income tax and higher marginal income tax rate.

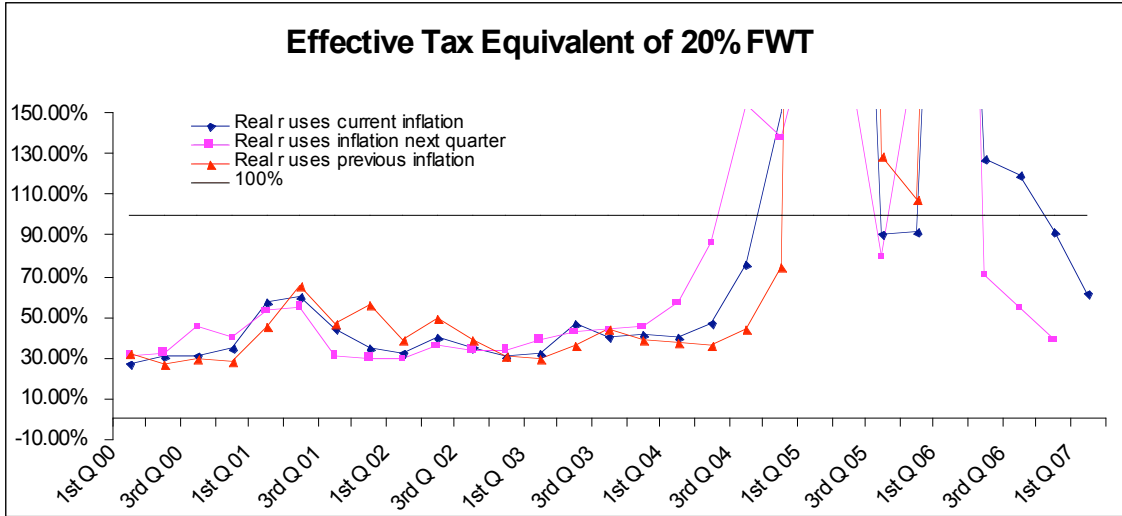


Figure 1

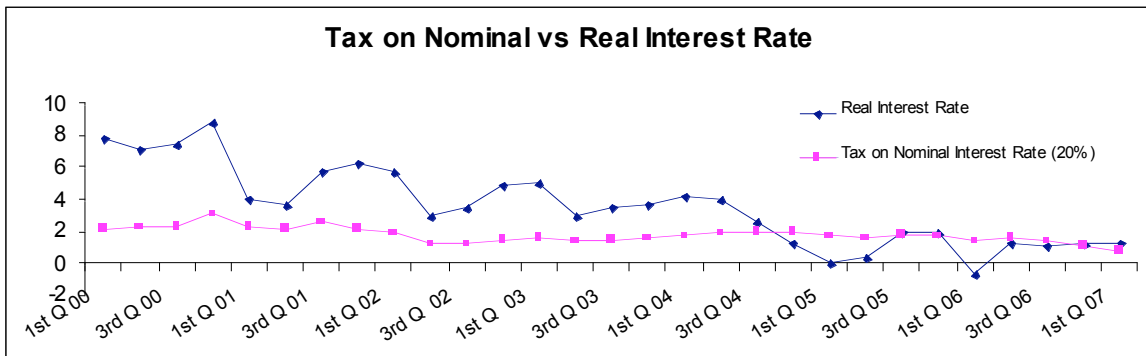


Figure 2

There is therefore a strong rationale for both lowering and making the interest income tax rate a uniform or a single rate. First, it does not make any economic sense to give banks better treatment than other financial intermediaries and institutions. Second, there is neither empirical nor theoretical basis for saying that zero-rated taxes on interest from longer-term financial instruments promotes savings (it is the composition of the savings will change but not total savings). Finally, the only reason that interest on foreign currency deposits cannot be taxed as the same rate as interest on peso deposit is that the 20% tax on interest on peso deposits is high enough to induce many Filipinos (especially those with large deposits) to deposit their foreign currency holding in banks in countries that do not impose the same tax. Making the final withholding tax on interest uniform and independent of currency denomination would not cause the same problem if the tax rate is uniform at 10% rather than at 20%. The difference between the current rate of 7.5% on FCDUs and the proposed uniform rate of 10% is not large enough to induce flight of foreign currency deposits to other countries.

The questions for reform become whether to (a) uniformly exempt all interest income from taxes following the notion that income taxes can mimic consumption taxes if income arising from savings is exempt from tax; or (b) impose a single rate tax that is much lower than the highest rate by reducing the FWT rate and raising the lowest rates the highest something lower than 20% but greater than zero (*e.g.*, 10%).

If the FWT on interest income is zero, the revenue loss from eliminating interest income tax should be replaced by increasing consumption taxes or reducing fiscal incentives, which would likewise improve the economic efficiency of the tax system. (As to the latter, it has been found that over 90% of Board of Investment income tax holidays and other tax incentives go to firms that would have invested anyway even in the absence of the fiscal incentives). It should be noted, however, that as long as there is so much redundant fiscal incentives and tax holidays are being granted, FWT on interest and dividends should remain, given the large public debt and the low public spending on infrastructure, education and basic social services.

Even if it is politically feasible to raise consumption taxes or reduce fiscal incentives significantly, it may not be equitable to eliminate taxes on interest income completely since the share of interest income in total income tends to rise with income and wealth. Thus, while it could be argued that FWT on interest of 20% is too high, it could also be argued that the ideal tax rate should not be zero on both revenue and equity grounds.

In addition, the effect of zero-rated interest income tax rates is that the incentive for tax arbitrage increases when the tax rate on interest income is lowered. For instance, there would be strong incentive for firms to give employees interest-free loans in lieu of salary increases. On one hand, the company can borrow money to relend to employees and claim the interest as tax deductions as they would the salary expense. On the other hand, the interest income of the employees would be tax exempt. This arbitrage opportunity will of course still be there for as long as the tax rate on interest income is lower than the tax rate on salary income. In the extreme, a zero rate might make the friction cost worthwhile and significantly expand the use of the tax arbitrage (which we do not want). In short, promoting savings should also mean minimizing arbitrage opportunities. While it may be hard to make a case of zero tax on interest income, it may be possible if interest income is part of a savings fund that qualifies for special treatment under a special law that explicitly encourages savings for retirement (*e.g.*, the PERA Bill. See below).

In all, even a 10% interest income tax rate could be effectively viewed as a progressive rate that does not really give a tax break on savings. But it must be remembered that a zero rate may be less equitable and lead to the reduction of

expenditures on public goods and services. That is, unless the zero-rated interest income tax is accompanied by either (i) an increase in consumption taxes or (ii) the prospective reduction of fiscal incentives.

Recommendation:

Impose a uniform final withholding tax rate of 10% on all interest income regardless of issuer, currency, or maturity.

Legislation affected:

NIRC, Secs. 24 (B), 27 (D), 28 (7)(a), and 34 (B)(1).

**B. EFFECT OF CHARGING FINANCIAL INSTITUTIONS
WITH PASSIVE INCOME TAX**

An alternative way of looking at the bias of the FWT on interest income in the financial sector is to compare it to taxes on profits. As is well known in the tax literature, taxes on profits are non-distortive *if the computation of taxable profits allows for the deduction of all economic costs*. This is so since the tax on profits would be a tax on pure surplus if all true economic costs are tax deductible. In this regard, the FWT on interest income can be seen as a possible arbitrage or distortion in relation to the taxation of profits. Unless deductibility of interest is limited, corporations can avoid being taxed at the corporate income tax rate through “back-to-back” financing arrangements, the tax-deductible interest on which could be calibrated to wipe out taxable profits. The reduction of taxable profits via the back-to-back arrangement of course increases interest income but the taxpayer gains from it since the FWT rate on interest income is lower than the corporate income tax rate. For this reason, our tax laws now limit the deductibility of interest expense.

For banks and non-bank financial intermediaries, however, taxing their interest income as “passive” income through a final withholding tax may result in higher tax burden than if the interest income was treated like normal business revenue or receipts for tax purposes. This is so since, unlike other sectors of the economy, interest is a substantial part of both the revenue and costs of firms in the financial sector. It could very well be that the gap between interest income and interest expense of firms in the sector is small relative to interest income so that a FWT on gross interest income can be a large percentage of net interest income (as in the case of reverse repurchase agreements). Thus, one way to reduce the bias of the tax system against the financial sector is to treat interest income of banks as normal

revenue from which interest expense and other operating costs can be deducted for tax purposes.

The banking sector first sought to change the definition of 'deposit substitutes' by changing the word 'public.' This change would create a confusing discrepancy between the application of term 'deposit substitutes' in the tax code and in the banking code from which the term 'deposit substitutes' is actually derived.⁴ Legislatively then, a change in taxation could simply mean exempting banks and financial institutions from FWT on interest income derived from deposit substitutes.⁵ This then brings all interest income of banks and financial institutions within the realm of gross income and made subject to corporate income tax of 35%.⁶

Exempting banks and financial institutions from FWT but subjecting other holders of deposit substitutes (*e.g.* T-bills) to passive income tax means the BIR must now track two kinds of interest earners paying different taxes. In bank-to-bank trading or individual-to-individual deposit substitute transactions, the tax consequences would be clearer. But a situation would likely arise where a bank buys a T-bill from an individual or corporation who already pays the FWT, and the bank, in purchasing the T-Bill, absorbs the cost of the FWT.

A Simple Example:

Suppose Mr. X bought a 364-day T-Bill with a face and maturity value of ₱1,000 issued by the Treasury at ₱940. The purchase price inclusive of the FWT would be ₱952 (940 + the 20% tax on the difference between purchase and maturity values). If for any reason, Mr. X sells the T-bill to a bank three months later for say P967, which covers the acquisition cost plus accrued interest, it is important to ask how the bank would be taxed when it receives ₱1,000 pesos from the Treasury on the T-bill's maturity date. Ideally, the bank should include the difference between its acquisition cost and maturity value in its taxable corporate income and be allowed to deduct expenses such as the interest it paid on deposits that were used to buy the asset. If that is the case, however, it should get a refund equal to $\frac{3}{4}$ of the FWT already paid by Mr. X since the bank held the T-bill for $\frac{3}{4}$ of its life. A second best way to tax is to exempt the difference between acquisition cost and maturity from any new taxes. This would effectively mean that the bank is treated as a passive income earner (even if the law has been amended to make all interest income of banks non-passive income). The worst way to tax is to tax the difference between acquisition cost and maturity value as interest income and/or trading gains. This would result in double taxation since the tax on the interest income had already been fully paid in advance when the T-Bill was purchased by the original buyer.

⁴ The term "deposit substitutes" under Sec. 95 of Republic Act 7653, The New Central Bank Act, is substantially the same as the term "deposit substitutes" defined under Sec. 22 (Y) of the National Internal Revenue Code (NIRC) of 1997, except that under the NIRC, reverse repurchase agreements entered into by and between the Bangko Sentral ng Pilipinas (BSP) and any authorized agent bank are expressly included as deposit substitutes.

⁵ Secs 27 (D) (1) and Sec. 28 (7)(a), NIRC.

⁶ The tax rate is reduced to 30% in 2009 (Sec. 27[A], NIRC as amended by Republic Act No. 9337).

Thus, in declaring interest income, both the banks and individuals should be able to prove the portions of interest income for which each holder of the T-Bill is liable,⁷ or provide a certification system, the presentation of which tells the Bureau of Internal Revenue how long a bank or individual has held a financial instrument. A tracking and certification system upon which the BIR can rely therefore becomes indispensable. On this point, the banking sector represents that the existing computerized system of registering deposit substitutes, e.g. numbers on the certificates or coupons recorded by custodians, should be sufficient to track the holders of each deposit substitute. With technology as it is, it seems plausible to apply the system to all such instruments.

Without an efficient tracking system that allows sufficient refunding or crediting, the exemption of banks and financial institutions from FWT would mean a dead-letter provision. The banks' interest income from secondary purchases of government and other securities, which are already covered by the FWT, would inevitably be taxed as passive income anyway. If taxing some types of interest income of banks as passive income cannot be avoided for administrative reasons, the tax law and its implementing rules and regulation can still be designed to avoid the double taxation by ensuring that the interest income already covered by the FWT is not subjected to a second FWT or subject to a tax on trading gain.

Clarification:

For purposes of this section, the interest income shall be included as part of "gain" as opposed to its jurisprudential definition in *Nippon Life Insurance Company of the Philippines, Inc. v. Commissioner of Internal Revenue* (G.R. No. 159162, 19 November 2003).

Gain shall therefore be computed as follows: Selling price (SP) of the instrument minus the cost of acquiring the instrument (AP) [including accrued interest, or the carrying cost net of unearned discount, i.e. the cost of a loan incurred to obtain the instrument]. Simply:

$$\text{Gain} = \text{SP} - \text{AP}$$

In this way, a bank's cost of purchasing or issuing deposit substitutes would be properly recognized as its ordinary business, and the gains derived would be properly taxed actively to deduct the effective cost of the instruments.

At this juncture, it should be noted that regardless of whether banks and financial institutions exercising quasi-banking functions are excluded from FWT on interest income, reducing the FWT tax rate to 10% already reduces

⁷ Note: This situation would not arise in bank-to-bank transactions.

significantly the losses suffered by these institutions that result from the fact that part of their interest income would still be taxed as if it were passive income.

Recommendation:

Only if a proper tracking and certification system is in place, exempt banks and quasi-banks from paying FWT and subject their interest income to regular corporate income tax.

If no tracking or certification is in place, then the alternative recommendation is to exempt banks and quasi-banks from paying additional FWT on interest income already covered by FWT, and ensure that accrued interest, interest already covered by FWT and other costs of obtaining the instrument are deducted in computing trading gains.

Legislation affected:

Sec. 22 (Y), Sec. 27 (D)(1), Sec. 34 (B)(1) and Sec. 121(d).

For the alternative recommendation, a Sec. 37.1 will be added under the chapter on "allowable deductions" entitled "Special Provisions Regarding Income and Deductions of Banks and Quasi-Banks."

A provision should also be added in the amendatory law that ensures the prospectivity of this provision.

C. REPURCHASE AGREEMENTS

Repurchase Agreements (REPOs) serve a very useful purpose: they deepen financial markets by articulating the yield curve to the extent that the REPO actually creates new instruments.

As it stands, however, gains of REPOs are generally taxed twice: the first time when interest is earned as a holder of the REPO (the present 20% FWT is imposed), and the second time when the holder sells the REPO (a 7% GRT on net trading gains is imposed). This is considered a "double tax"⁸ because of the great

⁸ This term is not here used in the legal sense, which is "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."

reduction of any gain that can be realized from REPOs as financial instruments. A simple algebraic example can be used to illustrate this:

A Simple Example:

Suppose a bank pays X for a T-Bill with a face (maturity) value of Y . Clearly, the interest income is Y minus X . Suppose that the bank does a REPO using the instrument with another bank and sells it at A with a buy back price of B . Clearly the interest income of the second bank is A minus B . But obviously, total interest income is not Y minus X plus A minus B , which involves double counting. The *consolidated net* interest income of the two banks is still Y minus X , the difference between the face or maturity value and the original purchase price. This is so since the net interest income of the first bank is the difference between Y minus X and A minus B , i.e., $[(Y - X) - (A - B)]$ which is equal to the sum of Y minus X and B minus A , i.e., $(Y - X + B - A)$. This plus the interest income of the second bank is still $Y - X$, i.e., $(Y - X + B - A + A - B = Y - X)$. In short a REPO splits the interest income on the T-Bill between the two banks and does not increase total net interest income. This means that taxing the interest in a REPO transaction would be double taxation if the interest income on the original or underlying instrument is already subject to a final withholding tax.

The reason for the double taxation is that it is *gross* - not *net* - interest income that is subject to the FWT. This double taxation would clearly discourage REPOs, and it is no surprise that REPOs are not at all used in Philippine financial markets.

Where, however, the difference between Y and B is an implicit forecast of future short (shorter than the original tenor of the original instrument) term interest rates, it is in the interest of government that such markets develop. In short, there should be no tax - either on FWTs or on trading gains - on the REPO.

This discrepancy is already addressed by the recommendation above that deposit substitutes, of which REPOs are part, are removed from FWT on interest income. To equalize further, the net trading gains of financial institutions should also be removed from gross income subject to GRT.

Recommendations:

1. Along with banks and Remove REPOs from FWT specifically to emphasize its special function under the NIRC as providing two instruments; and
2. Remove from GRT the net trading gains of banks and non-bank financial intermediaries, and allow refund or credit on the accrued interest to ensure that only the net gain is subject to corporate income tax.

Legislation Affected:

NIRC, Sec. 121(d), as amended, with an explanatory provision written into the amendatory law itself.

D. REVERSE REPURCHASE AGREEMENTS:

Reverse repurchase agreements were inexplicably included within the definition of “deposit substitutes” in the Tax Code, where reverse repurchase agreements are not found in the Banking Law. Insofar as reverse repurchase agreements are not necessary for the capital market, and essentially used for monetary policy,⁹ these reverse repurchase agreements should again be excluded from the term “deposit substitutes.”

Recommendation:

Revert to the old NIRC by removing the phrase “including reverse repurchase agreements entered into by and between the Bangko Sentral ng Pilipinas (BSP) and any authorized agent bank” from the definition of deposit substitutes under the NIRC.

Legislation affected:

NIRC, Sec. 22 (Y).

E. ROP BONDS

According to our inquiries with banks and government agencies, interest income from long-term, foreign currency ROP bonds is exempt from tax. Nevertheless, where it was found that short-term foreign currency bonds sometimes were also tax exempt, it was posited (on a no-names basis) that these were purchased by foreigners covered by income tax treaties.

This gives rise to another inequity is in the taxation of interest income from foreign denominated ROP bonds sold to foreign investors under tax treaty that are exempt from interest income under tax treaty regardless of the maturity of these bonds. These bonds are then resold to individuals who can take

⁹ Par. 177, page 95-96, Fintax 1.

advantage of the preferred tax treatment of these foreign banks. Thus, Filipinos or residents who purchase short-term bonds from tax treaty exempt institutions are not taxed on their interest income, while interest income tax of Filipinos and residents who purchase ROP bonds through foreign currency deposit units/OBUs is likely withheld. This discrepancy is made even more apparent when compared to the tax rates on REPOS mentioned above. Again, this violates the most basic principle of taxation: identical economic activities must not be taxed differently.

Where, however, the FWT on REPOs may be removed by excluding REPOs from applicable FWT provisions of the Tax Code, the tax treaties cannot be amended to reduce the tax benefits to other countries. Arbitrage arises from the favor given to long-term investments where local sellers of short-term ROP bonds are taxed while foreign sellers of short-term foreign currency bonds are exempt. This drives home the point of reducing or zero-rating interest income of both foreign and local currency short-term deposits.

F. DOCUMENTARY STAMP TAXES

Documentary stamp taxes (DST) also fail both tests, as it is neither an income nor a consumption tax. Instead, it taxes transactions. To the extent that transactions taxes reduce the volume of transactions, which in turn may reduce GDP growth, DSTs reduce both income and consumption tax revenue in the long run. The only argument in its favor is that if sufficiently small, DST won't discourage transactions

The counter argument is if indeed DST is small, the cost of administration and compliance may actually exceed the social benefit from the revenue that they generate. For example, some state universities have not adjusted their tuition for at least 35 years. Their tuition have become so low that they can save money by not collecting tuition and instead laying-off personnel who collect and administer the tuition.

Setting maximum limits on DST would therefore have been ideal. The extent to which DST can be reduced across all transactions - and the resulting revenue loss - depends on unavailable data on the amount of DST collected per transaction. At minimum, life insurance premiums, along with fixed term deposits of banks and premiums of pre-need companies should be exempt the same way deposits without fixed terms are DST exempt as all are equivalent savings instruments. But in the course of this study, it was found that to remove only these transactions from DST may cause some difficulty if other transactions are not treated similarly, and of course, an across-the-board reduction of DST

may cause significant revenue loss. It is for this reason that no deductions or limits on DST are recommended.

G. GRT v. VAT ON FINANCIAL INSTITUTIONS

The tax system has other non-neutral effects on financial intermediation, savings, and investment decisions. For one, the VAT as implemented in the Philippines is merely an approximation of a true consumption tax because of deviations of the VAT tax base from true value added. As already mentioned, nominal interest includes compensation for the effects of inflation on the real value of the principal.

This is not to say that it is impossible to approximate the true value added. For instance, the net cash inflow of the financial intermediary (*e.g.*, interest income minus interest expense) is value added. Such a system, however, may be rather complicated to administer such as when the tax on gross would vary as spreads vary. It is for this reason most countries exempt financial institutions from VAT. In the Philippines, the tax that takes the place of VAT is the gross receipts tax (GRT). In some sense it is inferior to VAT because it cannot be credited against output VAT, and therefore does not reward borrowers who honestly pay the output VAT relative to those who don't. It also imposes the same tax on consumption and investment loans because it cannot be credited against output VAT. Nevertheless, there is strong preference for the GRT among many firms in the sector because of its administrative advantages. In short, most banks and financial intermediaries would probably not want to replace the non-creditable GRT with a creditable VAT.

1. GRT of Financial Leasing Companies

The notable exception to the application of GRT to all financial institutions are firms in the financial sector that are engaged in leasing, a sector worth encouraging as separate from banks since it finances small businesses. On one hand, the present GRT is biased against leasing of capital goods and equipment by firms in the financial sector both relative to loan financing and leasing from firms that are not part of the financial sector. In the case of loan-financed capital goods or equipment, the VAT on the capital equipment, unlike the GRT on the lease payments, can be credited against the output VAT of the firm that purchased the equipment. On the other hand, lease payments to companies that are not part of the financial sector are subject to VAT and can therefore also be credited against the output VAT. Leasing firms in the sector can of course solve this problem by getting out of the sector, but that is almost like throwing the

baby out with the bathwater since that would reduce their access to funds that firms in the sector are in a better position to mobilize. Thus, it is recommended that financial and operating leases by firms in the financial sector, whether or not engaged in quasi-banking activities, be subject to VAT and not to GRT.

Recommendation:

Financial and operating leases by firms in the financial sector, whether engaged in quasi-banking activities, will be made subject to VAT and not to GRT. At the same time proper guidelines be put in place to determine the proper VAT credits to determine the limitation on capital goods under lease.

Legislation Affected:

NIRC, Sec. 108 (A), Sec. 122.

2. Percentage Tax on Life Insurance Premiums

Also problematic is measuring the value added of life insurance. A big part of the insurance premium is very similar to a bank deposit that the insurance company eventually returns the premium payments to the insured person or his or her beneficiary. Life insurance premiums should therefore be treated as a savings or investment, and not as a purchase or consumption. As it is, the five percent life insurance premium tax not only taxes the income arising from savings but also taxes the savings itself. The savings can be spared only if the portion of the premium payment which the insurance companies will eventually return to life insurance purchasers is exempt from the premium tax.

Even if it assumed that life insurance is a sale of service that should be subject to VAT, the 5% tax on the premium is a much heavier tax burden the 12% VAT. For instance, it is quite unlikely that the present value of what insurance companies return to the insured represents only 7/12 of the present value of the premium payments. More likely, if insurance companies eventually return 10/12 of premium payments to the insured, a 2% tax on premium, less than half the actual tax rate, *already approximates the 12% VAT* (since 2% divided by 1 minus 10/12 equal 12%). In sum, there is a strong case in favor of reducing significantly if not eliminating totally the tax on life-insurance premiums.

Recommendation:

Reduce percentage tax of life insurance from 5% to 2% based on total premium collected.

Legislation Affected:
NIRC, Sec. 123

3. VAT on Non-Life Insurance

Contrary to life insurance premium VAT, the VAT on non-life insurance premium is non-distortive. That is, if the buyers of non-life insurance are themselves subject to VAT, are honestly declaring their sales, and can therefore credit the VAT on premium against their output VAT. Given that insurance companies must return a significant portion of the premium that they collect (albeit actuarially) to their customers, the distortion appears when the buyers are households who pay premium VAT, cannot credit their output VAT, and do not receive any value-added. Unless of course one can give a good argument why non-life insurance services provided to households, like the beer and cigarettes that they consume, deserve to be taxed at a higher rate than ordinary consumer goods and services.

The only means of distortion would arise in the event of any ambiguity on whether gross receipts payments made by insurance companies to its reserve fund are made part of its VAT base. This would increase the company's gross receipts subject to VAT and raise the after tax price of non-life insurance paid by households, which would therefore discourage them from buying non-life insurance. The present law, however, already excludes from the VAT base the contributions during the year to the reserve fund.

4. VAT on Pre-Need

Pre-need plans act very much like savings, as do life insurance policies. Their treatment should therefore be similar to that of life-insurance premiums and should be subject therefore to percentage tax on pre-need collections.

Recommendation:

Exclude pre-need policies from VAT, and instead subject them to 2% GRT.

Legislation Affected:

NIRC, Sec. 123 by the addition of a new provision Sec. 123[A]; Sec. 108.3(j) of RR 06-05

H. RELATED RECOMMENDATIONS

1. Stock Exchange Related Taxes

Initial public offerings should be encouraged since greater public stock interest in a corporation means greater scrutiny of corporate affairs resulting in greater corporate responsibility. A tax on IPOs, however, acts more as a deterrent to IPOs because it is a tax on capital and not income.

It has been observed that the Philippines has the highest transaction cost for transfers of shares as compared to Hong Kong, Thailand, and Singapore.¹⁰ It is also represented that because of the high transaction costs, *i.e.* the initial public offering tax, the volume of transactions in the Philippine stock exchange has not improved. The conclusion is therefore that in the absence of any movement in stock exchange transactions, any suspension or abolition of IPO taxes would improve stock exchange conditions at little revenue loss.

The sale of shares through IPO should therefore be revoked. Alternatively, the IPO tax may be suspended until stock exchange trading listing and trading improve, but in any event, the lowest possible tax rates should be imposed.

Recommendation:

- 1) Revocation of the IPO tax. In the alternative, impose the lowest possible tax rates, but suspend implementation until stock exchange listing and trading improves.
- 2) Make permanent the exemption in Sec. 199, NIRC as amended so that the sale, barter or exchange of stocks listed in the stock exchange are exempt from DST.

Legislation Affected:

NIRC, Sec. 127(B); Sec. 199 (e).

2. The Fire Code

Within P.D. 1185, otherwise known as the Fire Code, is an appropriation to the Fire Service of 2% of all premiums from certain non-life policies. Although tagged as an appropriation, however, this appropriation is a tax hidden within a

¹⁰ See generally Fintax 1.

non-tax law. If ever there was need for an appropriation, it should mirror the provisions of the insurance code and Sec. 286 of the NIRC, which merely allocates a certain portion of insurance premiums *already collected* to the Insurance Fund, instead of imposing a separate and direct tax on non-life insurance premiums. Although an alternative recommendation was to set-aside a percentage of certain non-life policy collections to the Fire Service, it was a consensus that, for simplicity, this tax provision should merely be deleted from the P.D. 1185.

Recommendation:

Delete the provisions on the 2% tax on all premium, excluding re-insurance premiums for the sale of fire, earthquake and explosion hazard insurance collected by companies, persons or agents licensed to sell such insurance in the Philippines.

Legislation Affected:

Sec. 13(b) of P.D. 1185

3. *The PERA Bill*

Where neutrality is best achieved by encouraging savings regardless of instrument, issuer, currency, or other factors, the latest draft of the Personal Equity and Retirement Account (PERA) (SB 2233) is legislation with the following advantages:

- (i) allows different institutions to act as administrators,
- (ii) encourages savings by exempting from tax the interest income from an individual's PERA account regardless of where the money is invested; and
- (iii) grants a 5% income tax credit when salary is contributed to the PERA account, which applies to contributions that do not exceed PhP50,000 *per year*.

Since the bill allows PERA investments in all kinds of approved financial instruments, the PERA neutralizes the arbitrage across these financial instruments while providing the same advantages as a zero-rated FWT on interest income.

The disadvantage of SB 2233 was the limit on the amount of savings that can be put into the PERA account. Further, the bill ensured that this limit could not be increased by allowing the Secretary of Finance the authority to raise the limit only to reflect the cost of money. This means that an individual would be

forced to have two savings accounts, with the second one subject to the same taxes that discourage savings.

Since, as of this writing, SB 2233, which should have been passed by this Congress, could not get the approval of Congress for lack of quorum, certain amendments may still be recommended. If the purpose of PERA is to encourage savings, the ideal amendment to the PERA bill would be to allow an individual to increase the PERA contribution ceiling to more than P50,000 to up to P100,000, and impose the following features:

- (i) the fruits of the PERA account are exempt from tax, regardless of where the account is invested (*i.e.*, income is exempt from tax regardless of whether it is corporate dividend, interest or capital gains); and
- (ii) The removal of the 5% tax credit.

Raising the ceiling on annual contribution from P50,000 to P100,000 will increase the amount of savings that will be mobilized by the PERA law but will also increase government's foregone revenue. However, removing the 5% income tax credit will more than offset the revenue loss from the doubling of the ceiling. On the other hand, a ceiling of P100,000 on annual contributions would be high enough to encourage savings except for very rich whose savings decisions would probably not be very sensitive to the incentives being granted by the law anyway.

Since, SB 2233 allows other members of the financial sector to qualify as account administrators, the bill alone would reduce significantly the present advantage of the banks as the only institutions that can issue instruments exempt from the FWT. If the PERA bill becomes law, the urgency of removing the special tax treatment of banks is reduced. Still, the fact remains that the special tax treatment of banks cannot be justified.

Even without further revisions, the latest version is superior to an earlier version where the applicable rate of tax credit is effectively the highest marginal tax rate that is applicable to the taxpayer. This would have been inequitable, since it would give higher tax breaks to individuals who have higher income, and it also would have increased the size of government's revenue loss.

Recommendation:

- 1) Change the PERA contribution from P50,000 to up to P100,000,
- 2) Exempt from income tax, whether passive or active, the fruits of the PERA account; and

- 3) Remove the 5% tax credit.

PERA Provisions Affected:
SB 2233, Secs. 5 and 8.

4. THE REIT BILL

The proposed Real Estate Investment Company Act of 2007 (REIT Bill) seeks to promote the development of the capital market by supporting securitization. As proposed, the means of promoting this market is to provide a pass-through provision that exempts Real Estate Investment Companies from income tax, thereby relying for revenues the dividends to be distributed to its shareholders. The same problem arises, however, with respect to the over abundance of enterprises enjoying tax holidays. A pass-through provision would therefore create the same arbitrage on tax collection on enterprises that would have formed anyway regardless of the income tax incentives. Further, no dividend tax rate is provided, such that a domestic shareholder of a REIT would still be exempt from taxes on dividends under our present tax laws.

Recommendation:

1. Ensure that REIT should not be subject to transaction taxes (*i.e.*, VAT, DST) as requested in the REIT draft bill.
2. Nevertheless, recommend that REITs be subject to ordinary corporate income taxes and make them instead subject to BOI incentives.
3. Ensure that the rentals from property should still subject to VAT

PART IV: EFFECTS ON TAX REVENUE

A. Revenue Loss from a Shift to a Uniform Withholding Tax of Ten Percent on Interest Income

The adoption of a uniform ten percent withholding tax on interest income will result to a projected loss of PhP4.99 billion. The revenue loss from this uniform tax is already low since interest rates have been on a decline during the past years. On the other hand, for FWT from long-term deposits and FCDO, a revenue gain will be realized. The revenue gain amounts to ₱ 779 million. The net revenue loss from a uniform withholding tax on interest income is ₱4.22 billion.

Amount as of December 2006						
Values in thousand pesos						
	Amount	Interest Rate (Dec 2006)	Interest Earnings	Revenue Gain	Revenue loss	Net Revenue Gain
Demand	477,097,642.00	0.05	238,548.82		23,854.88	(23,854.88)
Savings	1,400,953,698.00	2.36	33,062,507.27		3,306,250.73	(3,306,250.73)
Time	689,414,361	2.31/3.01	20,751,372	318,509.43	1,660,109.78	(1,341,600.35)
FCDO	920,633,672.00	2.00	18,412,673.44	460,316.84		460,316.84
			72,465,101.80	778,826.27	4,990,215.39	(4,211,389.12)

Data Source: PDIC; BSP

Figure 3

B. Revenue Loss from a Reduction/Elimination of 5% tax on Life-Insurance Premium

The reduction/elimination of the five percent premium tax on life-insurance will result to a revenue loss. From the 2004 data from the Insurance Commission, per capital expenditure for life insurance is ₱505. Total premiums from life and non-life insurance is 1.27% of GDP. Basing on the total assets and per-capita expenditure information from the Insurance Commission, premiums from life-insurance is 0.78% of GDP, resulting to ₱36.75 Billion. On the other hand, based from the premiums of the top 37 life-insurance companies, total premium was ₱46 billion in 2004. Using the data from the top 37 companies, a reduction of the premium tax to 2% will result to a revenue loss of ₱1.41 billion. It should be noted that this computation is based on the assumption that the quantity of life-insurance purchased will not change due to the reduction of the premium tax.

Values (in 2004, current price)	2004		
	Life	Non-Life	Life/ (Life+Nonlife)
Assets (in million PhP)	240,042.00	66,250.00	78%
Per capita Expenditure	505	322	61%
Premiums (As % of GDP)	1.27%		
Premium (As % of GDP)	0.78%	0.49%	
GDP (current price, in million PhP)	4,739,140.00		
Premium (in million PhP)			
Premium (Based on share in GDP)	36,752.69	23,434.39	
Premium (from top 37 Life/Non-Life Companies)	46,985.32	15,515.57	
Premium Tax (5%)	2,349.27		
Revenue Gain	(1,409.56)		

Figure 4

C. Gains from Financial Tax Reform

From the adoption of the uniform withholding 10% tax on interest income and reduction of premium tax on life insurance premiums, net revenue loss is ₱5.6 billion. However, assuming that the economy grows by 0.1% annually, or one percent after ten years, additional tax collection will be ₱7.5 billion annually. The adoption of tax reforms on the financial sector is expected to result to long-term gains for the economy.

(based on 2004 GNP), Suppose...	Change in GNP (in million)	Additional Tax Collection (in Million)
Assumption 1. GNP Grows by 1% due to finan tax reform	65,596.08	7,492.97
Assumption 2. GNP Grows by 2% due to finan tax reform	131,192.17	14,985.94

Figure 5

PART V: SUMMARY OF RECOMMENDATIONS

1. Shift to a uniform final withholding tax of 10% on interest income.
 - 1.1. Remove the exemption of long-term instruments
 - 1.2. Remove the special treatment of foreign currency deposits
 - 1.3. Remove the exemption available only to banks.
2. Provided a reliable system is in place to track and certify who the holders of financial instruments are at any given time during the life of the instrument, exempt from FWT the interest income earned by banks and financial intermediaries exercising quasi-banking functions from deposit substitutes and securities and subject this instead to corporate income tax.
 - 2.1. Only in the absence of a reliable tracking or certification system acceptable to the BIR, in addition to exemption from FWT, a provision is made for the exclusion of accrued interest from interest income from deposit substitutes for purpose of computing corporate income taxes.
3. Remove net trading gains from GRT.
4. Remove reverse repurchase agreements between the BSP and authorized agent banks from the definition of "deposit substitutes."
5. Remove from GRT and incorporate into VAT income derived by finance companies from financial and operating leases, whether or not they exercise quasi-banking functions.
6. Reduce the 5% GRT on life insurance premium to 2%
7. Exclude Pre-need from VAT and subject them to 2% GRT.
8. Suspend or Abolish IPO taxes
9. Permanently exempt from DST the sale, barter, or exchange of stocks listed in the stock exchange
10. The Fire Code: Delete the provisions on the 2% tax on all premium, excluding re-insurance premiums for the sale of fire, earthquake and explosion hazard insurance collected by companies, persons or agents licensed to sell such insurance in the Philippines.
11. PERA Bill:
 - 11.1. The fruits of the PERA account are exempt from tax, regardless of where the account is invested (*i.e.*, income is exempt from tax regardless of whether it is corporate dividend, interest or capital gains); and

11.2. Remove the 5% tax credit.

12. REIT Bill Comments:

12.1. Ensure that REIT should not be subject to transaction taxes (*I.e.*, VAT, DST) as requested in the REIT draft bill.

12.2. Nevertheless, recommend that REITs be subject to ordinary corporate income taxes and make them instead subject to BOI incentives.

12.3. Ensure that the rentals from property should still subject to VAT

PART VI: AMENDED LEGISLATION AND REGULATIONS*

1. *Shift to a uniform final withholding tax of 10% on interest income.*

SEC. 24. *Income Tax Rates.* -

(B) *Rate of Tax on Certain Passive Income on Individual Citizens and Individual Resident Aliens.*

(1) *Interests, Royalties, Prizes, and Other Winnings.* - A final tax at the rate of [~~DELETE: twenty percent (20%)~~] **TEN PERCENT (10%)** is hereby imposed upon the amount of interest from any currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements; royalties, except on books, as well as other literary works and musical compositions, which shall be imposed a final tax of ten percent (10%); prizes (except prizes amounting to Ten thousand pesos (P10,000) or less which shall be subject to tax under Subsection (A) of Section 24; and other winnings (except Philippine Charity Sweepstakes and Lotto winnings), derived from sources within the Philippines:

[DELETE]: Provided, however, That interest income received by an individual taxpayer (except a nonresident individual) 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%) of such interest income:

[DELETE] Provided, further, 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 tax imposed under this Subsection: Provided, finally, That should the holder of the certificate pre-terminate the deposit or investment before the fifth (5th) year, a final tax shall be imposed on the entire income and shall be deducted and withheld by the depository bank from the proceeds of the long-term deposit or investment certificate based on the remaining maturity thereof:

Four (4) years to less than five (5) years - 5%;

Three (3) years to less than (4) years - 12%; and

Less than three (3) years - 20%]

* Note: References to the National Internal Revenue Code of 1997 is reference to its amendatory laws.

SEC. 27. Rates of Income tax on Domestic Corporations. -

(D) Rates of Tax on Certain Passive Incomes. -

1) Interest from Deposits and Yield or any other Monetary Benefit from Deposit Substitutes and from Trust Funds and Similar Arrangements, and Royalties. - A final tax at the rate of [~~DELETE: twenty percent (20%)~~] **TEN PERCENT (10%)** is hereby imposed upon the amount of interest on currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements received by domestic corporations, and royalties, derived from sources within the Philippines:

[DELETE]: Provided, however, That interest income derived by a domestic corporation 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%) of such interest income.

....

Sec. 28. Rates of Income Tax on Foreign Corporations. -

(7) Tax on Certain Incomes Received by a Resident Foreign Corporation. -

(a) Interest from Deposits and Yield or any other Monetary Benefit from Deposit Substitutes, Trust Funds and Similar Arrangements and Royalties. - Interest from any currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements and royalties derived from sources within the Philippines shall be subject to a final income tax at the rate of [~~DELETE: twenty percent (20%)~~] **TEN PERCENT (10%)** of such interest: [~~DELETE:~~ Provided, however, That interest income derived by a resident foreign corporation from a depository bank under the expanded foreign currency deposit system shall be 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%) of such interest income.

2. ***Provided a reliable system is in place to track and certify who the holders of financial instruments are at any given time during the life of the instrument, exempt from FWT the interest income earned by banks and financial intermediaries exercising quasi-banking functions from deposit substitutes and securities and subject this instead to corporate income tax.***

SEC. 27. Rates of Income tax on Domestic Corporations. -

(D) Rates of Tax on Certain Passive Incomes. -

(1) Interest from Deposits and Yield or any other Monetary Benefit from Deposit Substitutes and from Trust Funds and Similar Arrangements, and Royalties.

(Addition of the following paragraph)

PROVIDED, HOWEVER, THAT INTEREST INCOME OF BANKS AND NON-BANK FINANCIAL INTERMEDIARIES PERFORMING QUASI-BANKING FUNCTIONS DERIVED FROM REPURCHASE AGREEMENTS, DEPOSIT SUBSTITUTES, AND SECURITIES SHALL NOT BE CONSIDERED PASSIVE INCOME UNDER THIS SECTION, AND SHALL INSTEAD FORM PART OF THEIR GROSS CORPORATE INCOME TAX UNDER SEC. 27 (A).

Sec. 28. *Rates of Income Tax on Foreign Corporations.* -

....

(7) *Tax on Certain Incomes Received by a Resident Foreign Corporation.* -

(Addition of the following paragraph)

PROVIDED, HOWEVER, THAT INTEREST INCOME OF BANKS AND NON-BANK FINANCIAL INTERMEDIARIES PERFORMING QUASI-BANKING FUNCTIONS DERIVED FROM REPURCHASE AGREEMENTS, DEPOSIT SUBSTITUTES, AND SECURITIES SHALL NOT BE CONSIDERED PASSIVE INCOME UNDER THIS SECTION, AND SHALL INSTEAD FORM PART OF THEIR GROSS CORPORATE INCOME TAX UNDER SEC. 28 (A)(1).

SEC. 34. *Deductions from Gross Income*

....

(B) *Interest.*-

(1) In General. - The amount of interest paid or incurred within a taxable year on indebtedness in connection with the taxpayer's profession, trade or business shall be allowed as deduction from gross income: Provided, however, That the taxpayer's otherwise allowable deduction for interest expense shall be reduced by an amount equal to the following percentages of the interest income subjected to final tax:

Forty-one percent (41%) beginning January 1, 1998;

Thirty-nine percent (39%) beginning January 1, 1999;

Thirty-eight percent (38%) beginning January 1, 2000;

SEVENTY ONE PERCENT (71%) BEGINNING _____

SIXTY SEVEN PERCENT (67%) BEGINNING JANUARY 1, 2009

Prospectivity Provision in Proposed Amendatory Law

Sec. xxx: Prospectivity - THE TEN PERCENT (10%) FINAL TAX RATE ON INTEREST INCOME PROVIDED IN SECTIONS 27 AND 28 SHALL APPLY TO REPURCHASE AGREEMENTS, DEPOSIT SUBSTITUTES, AND SECURITIES ISSUED AFTER THE EFFECTIVITY OF THIS ACT.

- 2.1. *Alternative: Only in the absence of a reliable refund, tracking and certification system acceptable to the BIR, in addition to exemption from FWT, a provision is made for the exclusion of accrued interest arising from interest income on deposit substitutes for the purpose of computing corporate income taxes.*

Chapter VII: Allowable Deductions.

....

SEC. 37. *Special Provisions Regarding Income and Deductions of Insurance Companies, Whether Domestic or Foreign.* -

....

(Addition of the following paragraph)

SEC. 37.1: SPECIAL PROVISIONS REGARDING INCOME AND DEDUCTIONS OF BANKS AND QUASI-BANKS.

IN THE CASE OF INTEREST INCOME AND TRADING GAINS OF BANKS AND NON-BANK FINANCIAL INSTITUTIONS EXERCISING QUASI-BANKING FUNCTIONS DERIVED FROM REPURCHASE AGREEMENTS, DEPOSIT SUBSTITUTES, AND SECURITIES, ALL WITHHOLDING TAXES PAID ON SUCH INSTRUMENTS, ANY ACCRUED INTEREST, AND OTHER COSTS OF OBTAINING THE INSTRUMENT MAY BE DEDUCTED FROM THEIR GROSS INCOME.

3. *Remove net trading gains from GRT; Subject to corporate income tax*

SEC. 121. *Tax on Banks and Non-Bank Financial Intermediaries.* -

There shall be a collected tax on gross receipts derived from sources within the Philippines by all banks and non-bank financial intermediaries in accordance with the following schedule:

....

<u>DELETE: (d) on net trading gain within the taxable year on foreign currency, debt securities, derivatives and other financial instruments</u>	<u>7%</u>
--	-----------

....

Clarification in Proposed Amendatory Law:

Sec. xxx. "Sec. 121 (d), of the NIRC as amended by Republic Act No. 9238 shall be deleted. Net trading gains derived by banks and non-bank financial intermediaries from foreign currency, debt securities, derivatives, and other financial instruments shall form part of their gross income."

4. ***Remove reverse repurchase agreements between the BSP and authorized agent banks from the definition of "deposit substitutes."***

SEC. 22. *Definitions* - When used in this Title:

....

(Y) The term "*deposit substitutes*" shall mean an alternative form of obtaining funds from the public (the term 'public' means borrowing from twenty (20) or more individual or corporate lenders at any one time) other than deposits, through the issuance, endorsement, or acceptance of debt instruments for the borrowers 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 bankers' acceptances, promissory notes, repurchase agreements, [**DELETE: *Including reverse repurchase agreements entered into by and between the Bangko Sentral ng Pilipinas (BSP) and any authorized agent bank***], certificates of assignment or participation and similar instruments with recourse: Provided, however, That debt instruments issued for interbank call loans with maturity of not more than five (5) days to cover deficiency in reserves against deposit liabilities, including those between or among banks and quasi-banks, shall not be considered as deposit substitute debt instruments.

5. ***Remove from GRT and incorporate into VAT income derived by finance companies from financial and operating leases, whether or not they exercise quasi-banking functions.***

SEC. 122. *Tax on Finance Companies.* -

There shall be collected a tax of five percent (5%) on the gross receipts derived by all finance companies, as well as by other financial intermediaries not performing quasi-banking functions done business in the Philippines, from interest, discounts and all other items treated as gross income under this Code:

PROVIDED, HOWEVER, THAT GROSS RECEIPTS DERIVED FROM FINANCIAL AND OPERATING LEASES BY FINANCE COMPANIES AND FINANCIAL INTERMEDIARIES, WHETHER OR NOT PERFORMING QUASI-BANKING FUNCTIONS, SHALL BE SUBJECT TO VALUE ADDED TAX ACCORDING SEC. 108 (A)(8), AND SHALL CONFORM TO BIR GUIDELINES TO BE ISSUED ON THE PROPER USE OF INPUT VAT CREDITS.

6. *Reduce the 5% GRT on life insurance premium to 2%*

SEC. 123. *Tax on Life Insurance Premiums.* -

There shall be collected from every person, company or corporation (except purely cooperative companies or associations) doing life insurance business of any sort in the Philippines a tax of [~~DELETE: five percent (5%)~~] **TWO PERCENT (2%)** of the total premium collected, whether such premiums are paid in money, notes, credits or any substitute for money;

7. *Exclude Pre-need from VAT and subject them to 2% GRT.*

(Addition of the following provision)

SEC. 123 (A). TAX ON PRE- NEED COMPANIES THERE SHALL BE COLLECTED FROM EVERY PHILIPPINE PRE-NEED COMPANY OR CORPORATION PHILIPPINES A TAX OF TWO PERCENT (2%) OF THE TOTAL PREMIUM OR TOTAL CONTRIBUTION COLLECTED, WHETHER SUCH PREMIUMS OR CONTRIBUTIONS ARE PAID IN MONEY, NOTES, CREDITS OR ANY SUBSTITUTE FOR MONEY; BUT PREMIUMS OR CONTRIBUTIONS REFUNDED OR RETURNED WITHIN SIX (6) MONTHS AFTER PAYMENT TO THE PURCHASER OF A PRE-NEED PLAN SHALL NOT BE INCLUDED IN THE TAXABLE RECEIPTS.

Revenue Regulation 06-05 108.3(j)

[DELETE: Pre-need companies are corporations registered with the Securities and Exchange Commission and authorized/licensed to sell or offer for sale pre-need plans, whether single plan or multi-plan. They are engaged in business as seller of services providing services to plan holders by managing the funds provided by them and making payments at the time of need or maturity of the contract.]

As service providers, the compensation for their services is the premiums or payments received from plan holders.]

8. **Suspend or Abolish IPO taxes**

SEC. 127. Tax on Sale, Barter or Exchange of Shares of Stock Listed and Traded Through The Local Stock Exchange [DELETE: or Through Initial Public Offering].

DELETE: (B) Tax on Shares of Stock Sold or Exchanged Through Initial Public Offering. - There shall be levied, assessed and collected on every sale, barter, exchange or other disposition through initial public offering of shares of stock in closely held corporations, as defined herein, a tax at the rates provided hereunder based on the gross selling price or gross value in money of the shares of stock sold, bartered, exchanged or otherwise disposed in accordance with the proportion of shares of stock sold, bartered, exchanged or otherwise disposed to the total outstanding shares of stock after the listing in the local stock exchange....

(C) Return on Capital Gains Realized from Sale of Shares of Stocks. -

(1) Return on Capital Gains Realized from Sale of Shares of Stock Listed [DELETE: and Traded in the Local Stock Exchange]. - It shall be the duty of every stock broker who effected the sale subject to the tax imposed herein to collect the tax and remit the same to the Bureau of Internal Revenue within five (5) banking days from the date of collection thereof and to submit on Mondays of each week to the secretary of the stock exchange, of which he is a member, a true and complete return which shall contain a declaration of all the transactions effected through him during the preceding week and of taxes collected by him and turned over to the Bureau Of Internal Revenue.

DELETE: (2) Return on Public Offerings of Share Stock. - In case of primary offering, the corporate issuer shall file the return and pay the corresponding tax within thirty (30) days from the date of listing of the shares of stock in the local stock exchange. In the case of secondary offering, the provision of Subsection (C)(1) of this Section shall apply as to the time and manner of the payment of the tax.

9. *Permanently exempt from DST the sale, barter, or exchange of stocks listed in the stock exchange*

Sec. 199. *Documents and Papers Not Subject to Stamp Tax.* - The provisions of Section 13 to the contrary notwithstanding, the following instruments, documents, and papers shall be exempt from the documentary stamp tax:

....

(e) Sale, barter or exchange of shares of stock listed and traded through the local stock exchange [~~DELETE: for a period of five (5) years from the effectivity of this Act].~~]

10. *The Fire Code: Delete Sec. (b) (4)*

P.D. 1185, *The Fire Code*

(b) To partially provide for the funding of the Fire Service the following taxes and fees which shall accrue to the General Fund of the National Government, are hereby imposed:

....

~~[DELETE: (4) Two per centum (2%) of all premiums, excluding re-insurance premiums for the sale of fire, earthquake and explosion hazard insurance collected by companies, persons or agents licensed to sell such insurances in the Philippines;]~~

....

11. *PERA Bill Amendments:*

Sec. 5. Maximum Annual PERA Contributions - A Contributor may make an annual maximum contribution of [~~DELETE: Fifty Thousand Pesos (P50,000.00)~~] **ONE HUNDRED THOUSAND PESOS (P100,000.00)** to his/her PERA per year; Provided that if the Contributor is married, each of the spouses shall be entitled to make a maximum contribution of [~~DELETE: Fifty Thousand Pesos (P50,000.00)~~] **ONE HUNDRED THOUSAND PESOS (P100,000.00)** per year to his/her respective PERA. The Secretary of Finance may adjust the maximum contribution from time to time, taking into consideration the present value of the said maximum contribution using the Consumer Price Index as published by the National Statistics Office, fiscal position of the government and other pertinent factors.

[DELETE: Section 8. Tax Treatment of Contributions - The Contributor shall be given an income tax credit equivalent to five percent (5%) of the total PERA contribution; Provided however, that at no instance can there be any refund of the said tax credit arising from the PERA contributions.]