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Fighting for PEACe

Last week, a showdown ensued between the Department of Justice (DOJ) and the Supreme Court. This started as DOJ prevented former President and now Congresswoman Gloria Macapagal-Arroyo from traveling abroad to seek medical attention. DOJ implemented the travel ban even as the Supreme Court issued a temporary restraining order (TRO) on the exclusion of Arroyo from the immigration watchlist.

Lost behind the headline-grabbing TRO was another TRO issued by the Supreme Court. The TRO against the collection of withholding taxes on the earnings from the PEACe bonds has been relegated to the background because of the historic arrest that has gripped the nation's attention. Also last week, just as the conflict between the Supreme Court and DOJ was intensifying, the Supreme Court asked the Bureau of Internal Revenue (BIR) to show cause and explain why it should not be held in contempt for failing to comply with the TRO on the PEACe bonds.

In this article, we discuss the history and features of the PEACe bonds in order to shed some light on this complicated tax issue. Also, we assess the impact of the disputed taxes on our local banking system.

What are the PEACe bonds?

The PEACe bonds are Poverty Eradication and Alleviation Certificates issued by the Bureau of Treasury (BTr). They are 10-year zero-coupon bonds which were issued in 2001 and they matured more than a month ago. The bonds were devised by Caucus of Development NGO Networks (CODE-NGO), who also lobbied for perks, such as exemption from withholding taxes and eligibility for reserves of financial institutions. BTr conducted a bond auction and RCBC won the auction by bidding on behalf of CODE-NGO. The bonds were later sold by CODE-NGO to RCBC Capital, which then sold it to other financial institutions, primarily banks.

What is a zero-coupon bond?

A zero-coupon bond is a debt security that does not pay interest but trades at a deep discount from its face value. Since the bond does not pay a coupon, the interest accrues and the bond trades nearer its face value as its maturity date approaches.

In the case of the PEACe bonds, the government borrowed ~P10.2B from the bond issuance in 2001. To compensate for the lack of coupon payments over the life of the bond, the government is supposed to pay the bond holders P35.0B upon maturity of the bond. The difference between the amount borrowed and the amount to be paid on maturity date corresponds to the interest for 10 years.

What is the yield to maturity of the PEACe bonds?

The PEACe bonds had a yield to maturity of 12.75%. This was lower than the prevailing 16.50% yield on 10-year bonds issued in 2001. After deducting 20% in taxes, net yields on 10-year bonds in 2001 amounted to 13.20%. This means that the government, thru BTr, benefited from issuing the PEACe bonds since they were issued with a yield that was lower than the prevailing after-tax market rates.

Why is there a dispute on the withholding tax for PEACe bonds?

At the time of the issuance, BTr relied on previous BIR rulings, asserting that the earnings from PEACe bonds were tax-free, provided that they were not considered deposit substitutes, since they were issued to 19 lenders or less. BIR then argued that the tax exemption does not apply to the bonds since they were originally issued to one entity, which was RCBC. Later in 2001, BIR issued a ruling that agreed with BTr's stand and declared that the bonds were tax-exempt.

However, in 2004, BIR came up with a ruling that reversed and superseded its previous rulings. The 2004 BIR ruling clarified that government debt instruments and securities are to be considered deposit substitutes, regardless of the number of lenders at the time of issuance. With this ruling, BIR declared that the earnings from PEACe bonds were taxable.

As the maturity date of the bonds approached, the Department of Finance (DOF) affirmed the 2004 BIR Ruling and clarified that the interest income from PEACe bonds are indeed taxable.

Various business groups have sponsored full-page newspaper ads to voice their stand on this tax dispute. What are their concerns?

Various groups such as the Bankers Association of the Philippines, the Makati Business Club, the Management Association of the Philippines and the Fund Managers Association of the Philippines have united in making a stand against the collection of the withholding taxes on the earnings from the PEACe bonds. These groups argue that the retroactive imposition of the withholding tax after the issuance of the bonds is an unfair and unpredictable implementation of rules. Further, the said groups maintain that the government's actions may compromise the sanctity of contracts and investor protection. Lastly, the groups contend that the retroactive imposition of taxes may consequently give a wrong impression about the fairness and predictability of our capital markets.

Why did BIR proceed with the collection of the disputed taxes?

Since the 2004 BIR ruling was not reversed, the current DOF and BIR officials maintain that they have to implement the ruling and collect the appropriate withholding taxes on the PEACe bonds; otherwise, they would be considered remiss in their duties.

It should also be noted that the PEACe bond holders did not actively oppose or clarify the 2004 BIR Ruling when it came out. This is why the said ruling had been relatively unchallenged up until the maturity date of the PEACe bonds was near.

Further, the regulators assert that they did not violate the Supreme Court's TRO, as BIR only received the TRO on October 19, 2011, a day after the taxes were withheld when the bonds were paid by BTr.

Who should pay for the taxes?

Since interest income for bonds are accrued periodically, everyone who held the bonds for a certain period and earned interest income from holding the bonds should pay for a proportional share of the withholding taxes. However, the P5.0B in taxes was withheld when BTr paid the bond holders on maturity date. This means that the bond holders as of maturity date paid for 10 years' worth of withholding taxes even if some of them did not earn 10 years' worth of interest income. Consequently, this means that bond holders who earned and sold before the maturity date were probably not taxed proportionately.

Who are the holders of the PEACe bonds?

It is not yet clear who exactly held the PEACe bonds when they matured last October 18, 2011. While most of the big local banks have still declined to give specifics about their exposures to the PEACe bonds, it is likely that they hold a substantial portion of the P35.0B debt. Big listed banks such as BDO, Metrobank, PNB and China Bank protested the collection of taxes on PEACe bonds and filed a case with the Supreme Court. There were reports that RCBC filed a separate appeal with the Court of Tax Appeals. The banks were successful in securing a Supreme Court TRO on the collection of the withholding taxes.

What is the impact of the disputed taxes on Philippine banks?

The 2010 Net Income of local universal and commercial banks was P83.4B. The estimate for the 2011 Net Income of local universal and commercial banks by Wealth Securities is P92.8B. The disputed taxes therefore correspond to 6.0% of the 2010 Net Income and 5.4% of the estimated 2011 Net Income of local universal and commercial banks. The impact on a sector-wide level seems manageable and we do not expect the stock prices of most listed local banks to decline as a result of this issue. However, there might be problems if certain banks, investment houses or other financial institutions hold a disproportionate share of the bonds.

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