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[G.R. No. 198756, January 13, 2015]

BANCO DE ORO, BANK OF COMMERCE, CHINA BANKING CORPORATION, METROPOLITAN BANK & TRUST COMPANY, PHILIPPINE BANK OF COMMUNICATIONS, PHILIPPINE NATIONAL BANK, PHILIPPINE VETERANS BANK AND PLANTERS DEVELOPMENT BANK, PETITIONERS,
RIZAL COMMERCIAL BANKING CORPORATION AND RCBC CAPITAL CORPORATION, PETITIONERS-INTERVENORS,
CAUCUS OF DEVELOPMENT NGO NETWORKS, PETITIONER-INTERVENOR,
VS. REPUBLIC OF THE PHILIPPINES, THE COMMISSIONER OF INTERNAL REVENUE, BUREAU OF INTERNAL REVENUE, SECRETARY OF FINANCE, DEPARTMENT OF FINANCE, THE NATIONAL TREASURER AND BUREAU OF TREASURY, RESPONDENTS.

D E C I S I O N

LEONEN, J.:

The case involves the proper tax treatment of the discount or interest income arising from the P35 billion worth of 10-year zero-coupon treasury bonds issued by the Bureau of Treasury on October 18, 2001 (denominated as the Poverty Eradication and Alleviation Certificates or the PEACe Bonds by the Caucus of Development NGO Networks).

On October 7, 2011, the Commissioner of Internal Revenue issued **BIR Ruling No. 370-2011**[1] (2011 BIR Ruling), declaring that the PEACe Bonds being deposit substitutes are subject to the 20% final withholding tax. Pursuant to this ruling, the Secretary of Finance directed the Bureau of Treasury to withhold a 20% final tax from the face value of the PEACe Bonds upon their payment at maturity on October 18, 2011.

This is a petition for certiorari, prohibition and/or mandamus[2] filed by petitioners under Rule 65 of the Rules of Court seeking to:

> a. ANNUL Respondent BIR's Ruling No. 370-2011 dated 7 October 2011 [and] other related rulings issued by BIR of similar tenor and import, for being unconstitutional and for having been issued without jurisdiction or with grave abuse of discretion amounting to lack or excess of jurisdiction. . .;
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> b. PROHIBIT Respondents, particularly the BTr, from withholding or collecting the 20% FWT from the payment of the face value of the

Government Bonds upon their maturity;

c. COMMAND Respondents, particularly the BTr, to pay the full amount of the face value of the Government Bonds upon maturity. . .; and

d. SECURE a temporary restraining order (TRO), and subsequently a writ of preliminary injunction, enjoining Respondents, particularly the BIR and the BTr, from withholding or collecting 20% FWT on the Government Bonds and the respondent BIR from enforcing the assailed 2011 BIR Ruling, as well as other related rulings issued by the BIR of similar tenor and import, pending the resolution by [the court] of the merits of [the] Petition.[3]

Factual background

By letter[4] dated March 23, 2001, the Caucus of Development NGO Networks (CODE-NGO) "with the assistance of its financial advisors, Rizal Commercial Banking Corp. ("**RCBC**"), RCBC Capital Corp. ("**RCBC Capital**"), CAPEX Finance and Investment Corp. ("**CAPEX**") and SEED Capital Ventures, Inc. (**SEED**),"[5] requested an approval from the Department of Finance for the issuance by the Bureau of Treasury of 10-year zero-coupon Treasury Certificates (T-notes).[6] The T-notes would initially be purchased by a special purpose vehicle on behalf of CODE-NGO, repackaged and sold at a premium to investors as the PEACe Bonds.[7] The net proceeds from the sale of the Bonds "will be used to endow a permanent fund (Hanapbuhay® Fund) to finance meritorious activities and projects of accredited non-government organizations (NGOs) throughout the country."[8]

Prior to and around the time of the proposal of CODE-NGO, other proposals for the issuance of zero-coupon bonds were also presented by banks and financial institutions, such as First Metro Investment Corporation (proposal dated March 1, 2001),[9] International Exchange Bank (proposal dated July 27, 2000),[10] Security Bank Corporation and SB Capital Investment Corporation (proposal dated July 25, 2001),[11] and ATR-Kim Eng Fixed Income, Inc. (proposal dated August 25, 1999).[12] "[B]oth the proposals of First Metro Investment Corp. and ATR-Kim Eng Fixed Income indicate that the interest income or discount earned on the proposed zero-coupon bonds would be subject to the prevailing withholding tax."[13]

A **zero-coupon bond** is a bond bought at a price substantially lower than its face value (or at a deep discount), with the face value repaid at the time of maturity.[14] It does not make periodic interest payments, or have so-called "coupons," hence the term zero-coupon bond.[15] However, the discount to face value constitutes the return to the bondholder.[16]

On May 31, 2001, the Bureau of Internal Revenue, in reply to CODE-NGO's letters dated May 10, 15, and 25, 2001, issued BIR Ruling No. 020-2001[17] on the tax treatment of the proposed PEACe Bonds. BIR Ruling No. 020-2001, signed by then Commissioner of Internal Revenue René G. Bañez confirmed that the PEACe Bonds would not be classified as deposit substitutes and would not be subject to the corresponding withholding tax:

> Thus, to be classified as "deposit substitutes", the borrowing of funds must be obtained from twenty (20) or more individuals or corporate lenders at any one time. *In the light of your representation that the PEACe Bonds will be issued only to one entity, i.e., Code NGO, the same shall not be considered as "deposit substitutes" falling within the purview of the above definition. Hence, the withholding tax on deposit substitutes will not apply.*[18] (Emphasis supplied)

The tax treatment of the proposed PEACe Bonds in BIR Ruling No. 020-2001 was subsequently reiterated in BIR Ruling No. 035-2001[19] dated August 16, 2001 and BIR Ruling No. DA-175-01[20] dated September 29, 2001 (collectively, the 2001 Rulings). In sum, these rulings pronounced that to be able to determine whether the financial assets, i.e., debt instruments and securities are deposit substitutes, the "20 or more individual or corporate lenders" rule must apply. Moreover, the determination of the phrase "at any one time" for purposes of determining the "20 or more lenders" is to be determined at the time of the original issuance. Such being the case, the PEACe Bonds were not to be treated as deposit substitutes.

Meanwhile, in the memorandum[21] dated July 4, 2001, Former Treasurer Eduardo Sergio G. Edeza (Former Treasurer Edeza) questioned the propriety of issuing the bonds directly to a special purpose vehicle considering that the latter was not a Government Securities Eligible Dealer (GSED).[22] Former Treasurer Edeza recommended that the issuance of the Bonds "be done through the ADAPS"[23] and that CODE-NGO "should get a GSED to bid in [sic] its behalf."[24]

Subsequently, in the notice to all GSEDs entitled Public Offering of Treasury Bonds[25] (Public Offering) dated October 9, 2001, the Bureau of Treasury announced that "P30.0B worth of 10-year Zero[-] Coupon Bonds [would] be auctioned on October 16, 2001[.]"[26] The notice stated that the Bonds "shall be issued to not more than 19 buyers/lenders hence, the necessity of a manual auction for this maiden issue."[27] It also required the GSEDs to submit their bids not later than 12 noon on auction date and to disclose in their bid submissions the names of the institutions bidding through them to ensure strict compliance with the 19 lender limit.[28] Lastly, it stated that "the issue being limited to 19 lenders and while taxable shall not be subject to the 20% final withholding [tax]."[29]

On October 12, 2001, the Bureau of Treasury released a memo[30] on the "Formula for the Zero-Coupon Bond." The memo stated in part that the formula (in determining the purchase price and settlement amount) "is only applicable to the zeroes that are not subject to the 20% final withholding due to the 19 buyer/lender limit."[31]

A day before the auction date or on October 15, 2001, the Bureau of Treasury issued the "Auction Guidelines for the 10-year Zero-Coupon Treasury Bond to be Issued on October 16, 2001" (Auction Guidelines).[32] The Auction Guidelines reiterated that the Bonds to be auctioned are "[n]ot subject to 20% withholding tax as the issue will be limited to a maximum of 19 lenders in the primary market (pursuant to BIR Revenue Regulation No. 020 2001)."[33] The Auction Guidelines, for the first time, also stated that the Bonds are "[e]ligible as liquidity reserves (pursuant to MB Resolution No. 1545 dated 27 September 2001)[.]"[34]

On October 16, 2001, the Bureau of Treasury held an auction for the 10-year zero-coupon bonds.[35] Also on the same date, the Bureau of Treasury issued another memorandum[36] quoting excerpts of the ruling issued by the Bureau of Internal Revenue concerning the Bonds' exemption from 20% final withholding tax and the opinion of the Monetary Board on reserve eligibility.[37]

During the auction, there were 45 bids from 15 GSEDs.[38] The bidding range was very wide, from as low as 12.248% to as high as 18.000%.[39] Nonetheless, the Bureau of Treasury accepted the auction results.[40] The cut-off was at 12.75%.[41]

After the auction, RCBC which participated on behalf of CODE-NGO was declared as the winning bidder having tendered the lowest bids.[42] Accordingly, on October 18, 2001, the Bureau of Treasury issued P35 billion worth of Bonds at yield-to-maturity of 12.75% to RCBC for approximately P10.17 billion,[43] resulting in a discount of approximately P24.83 billion.

Also on October 16, 2001, RCBC Capital entered into an underwriting agreement[44] with CODE-NGO, whereby RCBC Capital was appointed as the Issue Manager and Lead Underwriter for the offering of the PEACe Bonds.[45] RCBC Capital agreed to underwrite[46] on a firm basis the offering, distribution and sale of the P35 billion Bonds at the price of P11,995,513,716.51.[47] In Section 7(r) of the underwriting agreement, CODE-NGO represented that "[a]ll income derived from the Bonds, inclusive of premium on redemption and gains on the trading of the same, are exempt from all forms of taxation as confirmed by Bureau of Internal Revenue (BIR) letter rulings dated 31 May 2001 and 16 August 2001, respectively."[48]

RCBC Capital sold the Government Bonds in the secondary market for an issue price of P11,995,513,716.51. Petitioners purchased the PEACe Bonds on different dates.[49]

BIR rulings

On October 7, 2011, "the BIR issued the assailed 2011 BIR Ruling imposing a 20% FWT on the Government Bonds and directing the BIR to withhold said final tax at the maturity thereof, [allegedly without] consultation with Petitioners as bondholders, and without conducting any hearing."[50]

"It appears that the assailed 2011 BIR Ruling was issued in response to a query of the Secretary of Finance on the proper tax treatment of the discount or interest income derived from the Government Bonds."[51] The Bureau of Internal Revenue, citing three (3) of its rulings rendered in 2004 and 2005, namely: BIR Ruling No. 007-04[52] dated July 16, 2004; BIR Ruling No. DA-491-04[53] dated September 13, 2004; and BIR Ruling No. 008-05[54] dated July 28, 2005, declared the following:

> The Php 24.3 billion discount on the issuance of the PEACe Bonds should be subject to 20% Final Tax on interest income from deposit substitutes. It is now settled that all treasury bonds (including PEACe Bonds), regardless of the number of purchasers/lenders at the time of origination/issuance are considered deposit substitutes. In the case of zero-coupon bonds, the discount (i.e. difference between face value and purchase price/discounted value of the bond) is treated as interest income of the purchaser/holder. Thus, the Php 24.3 interest income should have been properly subject to the 20% Final Tax as provided in Section 27(D)(1) of the Tax Code of 1997. . . .
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> However, at the time of the issuance of the PEACe Bonds in 2001, the BTr was not able to collect the final tax on the discount/interest income realized by RCBC as a result of the 2001 Rulings. Subsequently, the issuance of BIR Ruling No. 007-04 dated July 16, 2004 effectively modifies and supersedes the 2001 Rulings by stating that the [1997] Tax Code is clear that the "term public means borrowing from twenty (20) or more individual or corporate lenders at any one time." The word "any" plainly indicates that the period contemplated is the entire term of the bond, and not merely the point of origination or issuance. . . . Thus, by taking the PEACe bonds out of the ambit of deposits [sic] substitutes and exempting it from the 20% Final Tax, an exemption in favour of the PEACe Bonds was created when no such exemption is found in the law. [55]

On October 11, 2011, a "Memo for Trading Participants No. 58-2011 was issued by the Philippine Dealing System Holdings Corporation and Subsidiaries ("PDS Group"). The Memo provides that in view of the pronouncement of the DOF and the BIR on the applicability of the 20% FWT on the Government Bonds, no transfer of the same shall be allowed to be recorded in the Registry of Scripless Securities ("ROSS") from 12 October 2011 until the redemption payment date on 18 October 2011. Thus, the bondholders of record appearing on the ROSS as of 18 October 2011, which include the Petitioners, shall be treated by the BTr as the beneficial owners of such securities for the relevant [tax] payments to be imposed thereon." [56]

On October 17, 2011, replying to an urgent query from the Bureau of Treasury, the Bureau of Internal Revenue issued **BIR Ruling No. DA 378-2011**[57] clarifying that the final withholding tax due on the discount or interest earned on the PEACe Bonds should "be imposed and withheld not only on RCBC/CODE NGO but also [on] 'all subsequent holders of the Bonds.'"[58]

On October 17, 2011, petitioners filed a petition for certiorari, prohibition, and/or mandamus (with urgent application for a temporary restraining order and/or writ of preliminary injunction)[59] before this court.