Proposed Reforms under Package 4 of the Comprehensive Tax Reform Program *

I. INTRODUCTION

The fourth package of the Comprehensive Tax Reform Program (CTRP) covers the taxation of passive income, financial intermediaries, and financial transactions. It complements the recently passed Tax Reform for Acceleration and Inclusion (TRAIN) Act (Republic Act No. 10963) by making the financial sector taxation simpler, fairer, more efficient and regionally more competitive.

Package 4 will greatly simplify the complicated tax structure of the financial sector by reducing the number of tax base and tax rate combinations from 80 to 41. It will harmonize the tax rates on interests, dividends and capital gains, and the business taxes imposed on financial intermediaries to minimize opportunities for tax arbitrage. It will likewise rationalize the documentary stamp tax (DST) on financial transactions to lessen friction cost and enhance taxpayer compliance.

With the proposed reforms, the country can compete better in attracting capital and investments which are urgently needed to finance large-scale infrastructure including the Build, Build, Build (BBB) program, create more and better jobs and boost the growth of the economy.

II. OBJECTIVES OF PACKAGE 4

Specifically, Package 4 aims to achieve the following objectives:

1. Provide neutrality in tax treatment across financial institutions, financial instruments and transactions;
2. Simplify what has become a complex system;
3. Improve equity across investors and savers;
4. Minimize arbitrage opportunities; and
5. Promote capital market development within the context of financial globalization and increased international mobility and financial inclusion.

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III. KEY ISSUES ON FINANCIAL SECTOR TAXATION

Presently, the country's passive income and financial intermediary taxation is faced with the following issues:

1. Complicated tax structure

Based on current tax system, there are 80 tax base and tax rate combinations applicable to financial income, financial intermediation services, and financial transactions. The tax on income depends on many factors and conditions which are difficult to ascertain. The factors that affect the taxation of income include the type of product, type of lending, issuer, currency, maturity, taxpayer, residency, business status, and various special laws. These result in the variations in the tax base and tax rate even among comparable financial instruments and transactions.

2. Susceptible to tax arbitrage

The variations in tax rates and unequal tax treatment among equivalent or comparable financial instruments give rise to arbitrage. Different tax treatment among sectors, or between financial institutions and non-financial institutions offering the same service and/or product, or between interests and dividends open window for arbitrage or leveraging. The disparities in the tax treatment distort investment decisions considering that tax impositions overshadow all other factors. Competitive advantage arises in favor of the financial sector granted preferential tax treatment.

3. Uneven playing field

The current tax system provides certain concessions or different tax treatments of certain transactions for some types of financial institutions (FIs) compared to similar transactions of other FIs. For instance, there are tax exemptions allowed on long-term investments, bank deposits, individual trust funds, and investment management accounts in favor of resident individuals. Such exemptions do not cover long-term savings offered by other FIs, such as life insurance, pre-need/pension plans, investment houses, among others.

Also, classifications between different FIs cause unequal treatment considering that some are subject to gross receipts tax (GRT), while some are subject to premium tax, while others to value-added tax (VAT). For instance, banks, quasi-banks, and other FIs are subject to GRT, while life insurance companies are subject to premium tax, and lending investors, property insurers, pre-need companies, health maintenance organizations (HMOs), and money remitters are subject to the VAT.

4. Inequitable distribution of tax burden

Investments in equity and some forms of long-term investments are either exempt or subject to lower taxes. Hence, only the rich who can invest in long-term savings become exempt or pay lower taxes while individuals who can only put money on savings deposits pay higher taxes.

5. Uncompetitive tax system

A comparison of taxes on passive income in ASEAN member-countries shows that the Philippines remains to have the highest tax in the region. Consequently, the country's capital market remains shallow and uncompetitive, and continues to lag behind ASEAN neighbors.

6. High administrative and compliance cost

The complicated structure of the current taxation of the financial sector makes administration and compliance difficult and costly. For instance, firms have to pay different taxes that are derived from the same tax base.

7. Not supportive of capital market development

There are a number of taxes on financial transactions that hinder capital market development. The initial public offering (IPO) tax, for instance, is essentially a tax on capital, and does not take into consideration income generation. Such an imposition serves as a deterrent to public listing. This results in the Philippine Stock Exchange (PSE) lagging behind other ASEAN member-countries in terms of market capitalization. Also, ad valorem documentary stamp tax (DST) which is based on value imposes friction cost and puts heavy toll on compliance. Likewise, the high tax on interest income impedes savings and thrift consciousness.

IV. PROPOSED REFORMS UNDER PACKAGE 4

As of this writing, the following are the proposed reforms under Package 4:

A. On Taxes on Passive Income

1. Imposition of a uniform 15 percent final tax on interest income earned from debt instruments, bank deposits, deposit substitutes and similar arrangements by individuals and corporations regardless of the type of taxpayer, issuer, currency, term or maturity.

2. Removal of the exemption and/or preferential tax rate on interest income received by offshore banking units (OBUs) and foreign currency deposit units (FCDUs) and subject the same to a uniform 15 percent final tax.

3. Harmonization of the tax on cash and/or property dividends received from a domestic corporation with the tax on interest income at 15 percent final tax.

4. Removal of the exemption of activities which are registered with the Philippine Economic Zone Authority (PEZA) from the 15 percent branch profit remittance tax.

5. Increasing the improperly accumulated earnings tax from 10 percent to 15 percent to equate it with the dividends tax of 15 percent.

6. Imposition of a 15 percent final tax on net capital gains realized from the sale, exchange, barter or disposition of non-listed and non-traded debt instruments and other securities to harmonize it with the tax on net capital gains realized from the sale, exchange, barter or disposition of shares of stock not traded through the local stock exchange or licensed organized marketplace.

7. Gradual reduction of the 0.6 percent final tax based on the gross selling price or gross value in money on every sale, barter, exchange or disposition of listed and traded shares of stock through the local stock exchange or in an organized marketplace by 0.1 percentage point every year until it reaches 0.1 percent in 2024. This provision is transferred from Title V (Other Percentage Taxes) to Title II (Income Tax) of the National Internal Revenue Code (NIRC) of 1997, as amended.

8. Imposition of 0.1 percent final tax on gross selling price or gross value in money on every sale, barter, exchange or disposition of debt instruments and other securities listed and traded in local exchange or in an organized marketplace.

9. Removal of the IPO tax to support capital market development.

B. On Taxes on Financial Intermediaries

1. Harmonization of the taxation of banks and non-bank financial intermediaries (NBFIs) by imposing a single 5 percent gross receipts tax (GRT) on income, regardless of the nature of such income and the term of maturity of instrument. However, dividends and equity shares and net income of subsidiaries shall remain exempt.

2. Exemption of collective investment schemes (CIS) such as mutual fund, unit-linked investment trust fund and unit-linked variable insurance from the GRT, VAT, or other percentage taxes, provided that the CIS have at least 1,000 owners, investors or participants.

3. Clarification that incidental income from financial intermediation services derived by entities not licensed to do financial intermediation shall be subject to the tax imposed on its principal activity, provided that such income, to be considered incidental, shall not exceed 50 percent of its total annual income. If more than 50 percent, with at least six (6) transactions entered into during the year, the total income from financial intermediation shall be subject to the 5 percent GRT.

4. Shifting of the taxation of entities doing business similar to life and health insurance, such as pre-need companies, pension fund companies and health maintenance organizations, from the 12 percent VAT to 2 percent premium tax on gross premiums, plan payments or installment payments collected.

5. Subjecting non-life insurance including fire, property, motor vehicle, marine, and other types of non-life insurance (except cooperative insurance companies) to 5 percent premium tax.

6. Subjecting reinsurance premiums to the premium tax; provided that premiums collected where the tax on direct premium has already been paid by the direct insurer shall be exempt from the tax: Provided, a certification in a form to be prescribed in a regulation issued by the direct insurer that the tax thereon has already been paid, shall be attached to the quarterly premium tax return to be filed.

C. On DST on Financial Transactions

1. Reduction of DST rates on the following financial transactions:

    a. Original issue of shares of stock, or units of participation in a CIS, from 1.0 percent to 0.75 percent of par value: Provided that in the case of original issue of shares of stock without par value, the DST shall be based upon actual consideration: Provided, further, that the tax in the case of stock dividends, shall be based on the actual value represented by each share. (Section 174, NIRC of 1997, as amended)

    b. Policies of insurance upon property, from 12.5 percent of premium to be reduced by one percentage point every year until it reaches 7.5 percent in 2024. (Section 184)

    c. Fidelity bonds and other insurance policies, from 12.5 percent of premium to be reduced by one percentage point every year until it reaches 7.5 percent in 2024. (Section 185)

2. Removal of the DST on the following financial transactions:

    a. Sales, agreements to sell, memoranda of sales, deliveries, or transfer of shares or certificates of stock (Section 175)

b. Certificates of profits or interest in property or accumulations (Section 177)

c. Bank checks, drafts, certificates of deposit not bearing interest, and other instruments (Section 178)

d. All bills of exchange (between points within the Philippines) or drafts (Section 180) to promote financial inclusion.

e. Proxies (Section 192)

f. Powers of attorney (Section 193)

g. Assignments or transfer of any mortgage, lease or policy of insurance (Section 198)

3. Imposition of 0.30 percent on foreign bills of exchange and letters of credit: Provided that in the case of a letter of credit on which the DST imposed under Section 182 is paid upon opening, the same shall not be subject again under Section 195 upon availment of the trust receipt line where the property subject of the letter of credit is made a security for payment.

4. Increase in the DST rate on certificates from PhP30.00 to PhP50.00 per certificate but is limited to notarized certificates only. (Section 188)

5. Simplification of the DST on mortgages, pledges and deeds of trust from the current rate of PhP40.00 for the amount secured not exceeding PhP5,000, and an additional PhP20.00 on each PhP5,000 in excess of PhP5,000 into a single ad valorem rate of 0.3 percent of the amount secured. (Section 195)

6. Reduction of the maturity from not more than seven (7) to not more than five (5) days of interbank call loans to cover deficiency in reserves against deposit liabilities including those between or among banks and quasi-banks, which are exempt from the DST. [Section 199 (n)]

7. Additional provision in the Tax Code stating that the redemption, sale or exchange of shares of stock or units of participation in a CIS or other CIS securities listed and traded in a local exchange or an organized marketplace as part of the documents and papers shall not be subject to the DST. The original issuance of such, however, is not covered by the exemption. [Section 199(o)]

D. Repeal of Certain Special Laws

Package 4 also includes provisions repealing thirty-two (32) special laws that provide exemptions on taxes on passive income, financial intermediaries and financial transactions.

V. CONCLUSION

The inclusion of the taxation of passive income, financial services and financial transactions in the CTRP provides a window of opportunity to achieve the much-needed reforms in the financial sector. The taxation of the financial system should indeed be viewed as a major component of these reforms, an ingredient that could fuel and direct the movement of capital rightly to where they are most needed, so that higher, sustainable, and more inclusive growth can be achieved.