REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE
National Office Building
Quezon City

Republic Act No. 10142
DOF Opinion No. 012-2020 BIR Ruling No. OT-312-2022
OT-001-2023
JAN 06 2023

PHILIPPINE AIRLINES, INC.
8F PNB Financial Center
Pres. Diosdado Macapagal Avenue
CCP Complex, Pasay City

Attention: MR. ALVIN KENDRICH O. LIMQUECO
OIC – Chief Financial Officer

Gentlemen:

This refers to your request on behalf of Philippine Airlines, Inc. ("**PAL**") for confirmation of your opinion that the mandatory exchange of PAL equity into PAL Holdings, Inc. ("**PHI**") equity which resulted from a financial restructuring under a court supervised bankruptcy proceeding does not give rise to any taxation event, specifically capital gains tax ("**CGT**") and donor's tax.

Background:

PAL is a domestic corporation primarily engaged in air transport of passengers and cargo within the Philippines and between the Philippines and several international destinations. It is owned by PHI as of December 31, 2021. On the other hand, PHI is owned by Trustmark Holdings Corporation, which in turn is owned by Buona Sorte Holdings, Inc. and owned by Horizon Global Investments, Ltd.

On September 3, 2021, due to the devastating impact of the COVID-19 pandemic on the global aviation industry, PAL embarked on a comprehensive business and financial restructuring by filing a voluntary petition for relief under Chapter 11 of the U.S. Bankruptcy Code with the United States Bankruptcy Court for the Southern District of New York ("**US Court**") docketed as Case No. 21-115669 ("**Chapter 11 Case**"). The Petition is for PAL to be authorized to continue to operate its business and manage its operations as a debtor-in-possession pursuant to Sections 1107 and 1108 of the US Bankruptcy Code and pursue confirmation of the pre-arranged plan of reorganization to effect the contemplated resizing and reshaping of its operations, permanent restructuring of its obligations and broad recapitalization.

On September 24, 2021, PAL also filed a petition under Republic Act (RA) No. 10142, otherwise known as the "Financial Rehabilitation and Insolvency Act (FRIA) of 2010" before the Regional Trial Court, National Capital Judicial Region, Branch 111, Pasay City ("**RTC-Pasay**"), seeking recognition of the Chapter 11 Case.

On October 13, 2021, PAL filed the Plan of Reorganization of Philippine Airlines, Inc. (the "**Plan**") and a Disclosure Statement[1] before the US Court. The Plan[2] includes, among others:

[1] Dated November 9, 2021.
[2] Per Note 2 of the AFS.

a. claims of impaired unsecured creditors under the category of "General Unsecured Claims (Class 3)"[3] will be cancelled and each holder of an Allowed General Unsecured Claim on account thereof will receive its Pro Rata[4] share of the Unsecured New Equity Allocation.[5] Also, in the exercise of the conversion option, such creditors have agreed to waive and, thereby, receive no recovery on account of their General Unsecured Claims against PAL.

b. PAL is obligated to provide for a mechanism whereby the impaired unsecured creditors will be able to exchange their PAL equity into its parents interests or, for the avoidance of doubt, PHI equity,[6] within one (1) year from the effective date of the Plan. The conversion percentage ratio of equity shall be based on the valuation of an independent third-party valuation by the valuation expert accredited by the Philippine Stock Exchange ("**PSE**") and the Securities and Exchange Commission ("**SEC**"). For this purpose, PAL engaged the services of FTI Consulting, Inc. and based on the valuation report and fairness opinion provided, the conversion ratio is 1 PAL share with par value of PhP1.00 per share to 15.57 PHI share with par value of PhP1.00 per share is within the acceptable range.

The above arrangements (collectively, the "**Mandated Arrangements**") resulted to a reduction of losses incurred by the impaired unsecured creditors but not a total elimination of their losses.

On October 22, 2021, RTC-Pasay granted PAL's petition and rendered judgment (i) recognizing the Chapter 11 Case; and (ii) giving force and effect to the Chapter 11 Case and all court orders issued or may be issued by the US Court relating thereto.

On December 17, 2021, the US Court confirmed its approval of the Plan which calls for the conversion of all unsecured creditor loans/claims amounting to USD 1,261,751,747.58 into new equity in PAL. On December 31, 2021, PAL filed with the US Court a Notice of Effective Date and Entry Order (a) confirming PAL's Plan; and (b) Granting Related Relief before the US Court.

In view thereof, you now request for confirmation of your opinion that the implementation of the Mandated Arrangements which resulted from a financial restructuring under a court supervised bankruptcy proceeding does not give rise to any taxation event.

In reply, please be informed as follows:

<u>Income tax/CGT</u>

Section 19 of RA No. 10142 states that taxes and fees due to the national government imposed upon the issuance of the commencement order and until the approval of the rehabilitation plan or dismissal of the petition, whichever is earlier, shall be considered waived, to *wit*:

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[3] Means any claim against PAL as of the petition date that is neither secured by a lien on collateral nor entitled to priority under the Bankruptcy Code or any order of the Bankruptcy Court (other than an Intercompany Claim, an Employee Claim, a Customer Claim and a General Unsecured Trade Claim). (Section 1.6 of the Plan)

[4] The proportion that an Allowed Claim or Interest in a particular Class bears to the aggregate amount of Allowed Claims or Interests in that Class, or the proportion that Allowed Claims or Interests in a particular Class bear to the aggregate amount of Allowed Claims and Disputed Claims or Allowed Interests and Disputed Interests in a particular Class and other Classes entitled to share in the same recovery as such Class under the Plan. (Section 1.8 of the Plan)

[5] The New Common Stock to be issued on the Effective Date to holders of Allowed General Unsecured Claims, which shall be in an amount equal to 20.5% of the New Common Stock. For this purpose, "New Common Stock" refers to the shares of common stock, par value of $0.001 per share, of PAL authorized pursuant to its certificate of incorporation, as included in the Plan Supplement. (Section 1.67 and 1.110 of the Plan); Article V (C)(3) of the Disclosure Statement.

[6] Sections 1.71 and 5.14 of the Plan; Article V (C) (14) of the Disclosure Statement on Post-Emergence Exchange Offer.

*"**Section 19.** Waiver of Taxes and Fees due to the National Government and to Local Government Units (LGUs). - Upon issuance of the Commencement Order by the court, and until the approval of the **Rehabilitation Plan** or dismissal of the petition, whichever is earlier, the imposition of all taxes and fees, including penalties, interests and charges thereof, due to the national government or to LGUs **shall be considered waived**, in furtherance of the objectives of rehabilitation." (Emphasis and underscoring supplied)*

Section 4 (gg) of RA No. 10142 defines rehabilitation as follows:

"Section 4. Definition of Terms. — As used in this Act, the term:

xxx xxx xxx

*(gg) **Rehabilitation** shall refer to the restoration of the debtor to a condition of successful operation and solvency, if it is shown that its continuance of operation is economically feasible and its creditors can recover by way of the present value of payments projected in the plan, more if the debtor continues as a going concern than if it is immediately liquidated."* (Emphasis and underscoring supplied)

In the case of ***Bureau of Internal Revenue, Assistant Commissioner Alfredo V. Misajon, Group Supervisor Rolando M. Balbido and Examiner Reynante DP. Martinez vs. Lepanto Ceramics, Inc.,***[7] the Supreme Court held that:

"[C]ase law has defined corporate rehabilitation as an attempt to conserve and administer the assets of an insolvent corporation in the hope of its eventual return from financial stress to solvency. It contemplates the continuance of corporate life and activities in an effort to restore and reinstate the corporation to its former position of successful operation and liquidity.

*Verily, the inherent purpose of rehabilitation is to find ways and means to minimize the expenses of the distressed corporation during the rehabilitation period by providing the best possible framework for the corporation to gradually regain or achieve a sustainable operating form. [It] enable[s] the company to gain a new lease in life and thereby allow creditors to be paid [t]heir claims from its earnings. Thus, **rehabilitation shall be undertaken when it is shown that the continued operation of the corporation is economically more feasible and its creditors can recover, by way of the present value of payments projected in the plan**, more, if the corporation continues as a going concern than if it is immediately liquidated.*

*In order to achieve such objectives, Section 16 of RA 10142 provides, inter alia, that upon the issuance of a Commencement Order — which includes a Stay or Suspension Order — all actions or proceedings, in court or otherwise, for the enforcement of "claims" against the distressed company shall be suspended. Under the same law, claim "shall refer to all claims or demands of whatever nature or character against the debtor or its property, whether for money or otherwise, liquidated or unliquidated, fixed or contingent, matured or unmatured, disputed or undisputed, including, but not limited to; **(1) all claims of the government, whether national or local, including taxes, tariffs and customs duties**; and (2) claims against directors and officers of the debtor arising from acts done in the discharge of their functions falling within the scope of their authority: Provided, That, this inclusion does not prohibit the creditors or third parties from filing cases against the directors and officers acting in their personal capacities." (Emphasis and underscoring supplied)*

[7] GR No. 224764, April 24, 2017

In this case, it is undisputed that PAL filed a petition under RA No. 10142 on September 24, 2021 before RTC-Pasay seeking recognition of the Chapter 11 Case, which was granted on October 22, 2021 (i) recognizing the Chapter 11 Case; and (ii) giving force and effect to the Chapter 11 Case and all court orders issued or may be issued by the US Court relating thereto. Thus, all taxes and fees due to the national government imposed upon the issuance of the commencement order and until the approval of the rehabilitation plan shall be considered waived.[8]

Moreover, exemption from income tax of income actually or presumptively received/gained from acts and/or transactions in compliance with a court order is not novel in the Philippines. In ***BIR Ruling No. OT-312-2022,***[9] it was ruled that any gain resulting from a mandated restructuring plan is not taxable for income tax purposes, citing the following:

1. BIR Ruling No. [DA-028-05][10]

   *"Considering that in the case of your client, Bayantel, **it was through court action that the debt rehabilitation plan was approved and is now being implemented.** In other words, the restructuring was not a result of the mutual agreement of the debtors and creditors, but of judicial action. Accordingly, the gain resulting from condonation of the Bayantel's debt to its various creditors shall not be subject to income tax nor to gift tax since there is no donative intent on the part of its various creditors but is solely for business consideration."* (Emphasis and underscoring supplied)

2. BIR Ruling No. DA-260-07[11]

   *"... ... any gain resulting from the condonation of RCPI's debt is not taxable for income tax purposes; and that **any conversion of debt into equity as a result of the debt restructuring plan is likewise not subject to income tax, it being in the nature of capital transaction.**"* (Emphasis and underscoring supplied)

In the instant case, it is undisputed that under the court-approved Plan, the claims of impaired unsecured creditors are to be converted into new PAL equity. Such claims under the category of "General Unsecured Claims (Class 3)" are cancelled and each creditor received its pro rata share of the PAL shares based on the said Plan.

Also, in the same Plan, we note that PAL is obligated to provide a mechanism whereby the impaired unsecured creditors will be able to exchange their PAL shares into PHI shares within one (1) year from the effective date of the Plan. In the said mandatory exchange process, the conversion percentage ratio of equity per the Fairness Opinion and Valuation Report of FTI Consulting, Inc., is 1 PAL share with par value of Php 1.00 per share to 15.57 PHI share with par value of Php 1.00 per share.

Thus, in view of the foregoing, this Office hereby rules that: (1) the conversion of claims of impaired unsecured creditors to PAL equity; and (2) swapping of PAL shares to PHI shares; even if they are to be effected within one (1) year from the effective date of the Plan, which is after the approval of the Plan by the court, is not subject to income tax and/or CGT, considering that (a) these acts are in the nature of capital transactions; (b) being done not as a result of the mutual agreement/s of PAL and its creditors, but of judicial action, (c) being made in furtherance of the objectives of the rehabilitation plan; and (d) being implemented in compliance with the Plan approved by the US Court and recognized by RTC-Pasay pursuant to RA No. 10142.

[8] DOF Opinion No. 012-2020 dated October 21, 2020; BIR Ruling No. OT-312-2022 dated June 24, 2022
[9] Dated June 24, 2022
[10] Dated January 24, 2005
[11] Dated April 25, 2007

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Donor's Tax

Section 98 of the National Internal Revenue Code of 1997, as amended, provides that donor's tax shall be imposed upon the transfer by any person, resident or non-resident, of a property by gift or donation. Article 725 of the New Civil Code of the Philippines ("**Civil Code**") defines donation as "an act of liberality whereby a person disposes gratuitously of a thing or right in favor of another, who accepts it." Hence, to be a valid donation, it is essential that: (1) there is reduction of the patrimony of the donor; (2) there is increase in the patrimony of the donee; (3) the intent on the part of the donor to do an act of liberality (*animus donandi*); and (4) the donee accepts the gift.

In this case, there was no act of liberality or donative intent present since the conversion of the impaired unsecured creditors' debts into PAL shares and its subsequent mandatory exchange to PHI shares were made pursuant to the court-approved Plan. Therefore, the Mandated Arrangements are likewise not subject to donor's tax.

This ruling is issued on the basis of the foregoing facts as represented. However, if upon investigation it shall be disclosed that the facts are different, then this ruling shall be considered null and void.

Very truly yours,

ROMEO D. LUMAGUI, JR.
Commissioner of Internal Revenue
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