REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

NIPPON LIFE INSURANCE COMPANY OF THE PHILIPPINES, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 6142

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:

FEB 04 2002

x - x

DECISION

This is a petition for review which seeks to refund the amount of P2,223,386.82, allegedly representing income taxes erroneously withheld from the interest income and gain from sale derived from Petitioner's investment in a 10-year Fixed Rate Treasury Bond for the years 1998 and 1999.

The material antecedents are as follows:

Petitioner is a domestic corporation duly organized and existing under the laws of the Republic of the Philippines, with principal office address at the 21st Floor, Tower 2, RCBC Plaza, 6819 Ayala Avenue cor. Sen. Gil Puyat Avenue, Makati City. It is engaged in the business of life insurance and was issued Certificate of Authority No. 2000-128-R on July 1, 2000 by the Insurance Commission (par. 3, Joint Stipulation of Facts).

As a company engaged in the business of life insurance, Petitioner is required under the Insurance Code of the Philippines to invest in and purchase certain government securities in the course of its operations. These investments consist of bonds or other evidences of debt of the Philippine Government, its political subdivisions or instrumentalities, or of government-owned or controlled corporations and entities. (par. 4, Joint Stipulation of Facts).

In compliance with the foregoing requirement, Petitioner invests regularly in government securities through negotiated purchases with several banks in the secondary market (par. 5, Joint Stipulation of Facts).

On December 1, 1997, Petitioner purchased from Citibank N.A. a 10-year Fixed Rate Treasury Bond (Bond, for brevity) with a face value of P20 Million. The Bureau of Treasury issued the Bond originally to Citibank N.A. on November 27, 1997 at face value and an interest coupon rate of 22.875% payable semi-annually, i.e. on May 27 and November 27 each year for 10 years. At the time of the purchase, the Bond offered a yield rate of 22.82375%, which is lower than the Bond's fixed interest rate of 22.875%. Accordingly, Petitioner had to purchase the Bond from Citibank N.A. at a premium, or at a price higher than the Bond's face value. Petitioner's total cash outlay to acquire the Bond amounted to P20,076,022.89, computed as follows:

Gross Purchase Price at a Yield Rate of 22.82375%	P 20,037,085.03
Accrued Interest Payable to Citibank N.A. from 11/27 to 11/30/97	
(4 days/360 days x 22.875% x 20 Million)	50,833.33
Subtotal	P 20,087,918.36
Less: Withholding Taxes on Purchase Price	(1,728.80)
Withholding Taxes on Accrued Interest Payable	(10,166.67)
Net Cash Outlay	P 20,076,022.89

Petitioner held on to the Bond from December 1, 1997 up to June 15, 1999. On three separate occasions during this period, or on May 27, 1998, November 27, 1998 and May 27, 1999, Petitioner collected interest income on the Bond amounting to

P1,830,000.00 for each income payment, net of P457,500.00, representing the 20% final tax withheld and remitted by the Bureau of Treasury to the BIR pursuant to Section 27 (D)(1) of the NIRC. Thus, Petitioner received a total of P5,490,000.00 as interest income on the Bond, net of P1,372,500.00 final withholding tax.

On June 16, 1999, Petitioner sold the Bond to Hongkong and Shanghai Banking Corporation (HSBC) at a premium, because on the date of the sale, the Bond offered a yield rate of 14.625%. Petitioner received P27,152,761.15 from HSBC on the sale, detailed as follows:

Gross Selling Price at a Yield Rate of 14.625%	P 27,850,230.69
Accrued Interest Receivable by Petitioner from 5/28/99 to 6/15/99	
(19 days/360 days x 22.875% x 20 Million)	241,458.33
Subtotal	P28,091,689.02
Less: Withholding Taxes on Selling Price	(890,726.20)
Withholding Taxes on Accrued Interest Receivable	(48,291,67)
Net Cash Proceeds	P 27,152,671.15

On the basis of the foregoing transactions, the total amount of taxes allegedly withheld from Petitioner's income on the Bond and remitted by the Bureau of Treasury to the BIR for the years 1998 and 1999 is P2,223,386.82, computed as follows:

Withholding Taxes on Selling Price on 6/19/99	P 890,726.20
Withholding Taxes on Accrued Interest Receivable	
from 5/27/99 to 6/15/99	48,291.67
Withholding Taxes on Interest Income	
from 1/1/98 to 5/27/98 [P457,500.00 x (180-34 days)/180 days]	371,083.33
from 5/28/98 to 11/27/98	457,500.00
from 11/28/98 to 5/27/99	457,500.00
Subtotal	P2,225,101.20
Less: Withholding Tax on Purchase from Citibank N.A.	(1,714.38)
Total Amount of Taxes Withheld	P2,223,386.82

On October 25, 1999, the BIR issued BIR Ruling No. 166-99, providing that the interest income, yield or gain derived from bonds, debentures or certificates of indebtedness as deposit substitutes, which are ordinarily subject to 20% final tax under Section 27 (D)(1) of the NIRC, should exclude the interest income, yield or gain from the gross income if the bonds, debentures or the certificate of indebtedness have maturities of more than five (5) years.

On January 7, 2000, BIR Ruling No. 016-00 was issued, with the BIR reiterating its stand that if the maturity period of the bonds issued through the Bureau of Treasury will be more than five (5) years, the gains that may be derived therefrom by the bondholders shall accordingly be exempt from the 20% final withholding tax. The BIR stated further that: "Since the law speaks of the exclusion from gross income of all <u>gains</u> derived from long-term investments, it follows that embraced thereunder are income, yield or interest, which are all synonymous with gains, whether discounted or at premium. Thus, the exemption applies to interest/coupon or profit from the principal of such long-term regular or SDT bonds complying with the statutory period."

Thus, on March 17, 2000, on the basis of the foregoing rulings, Petitioner filed with Revenue District Office No. 50 of the BIR, an administrative claim for the refund of the amount of P2,223,386.82 allegedly representing taxes erroneously withheld from its income from investment in Fixed Rate Treasury Bond for the years 1998 and 1999 (pages 16-21, CTA Records)

As there was no action on the part of the Respondent, this case was filed on July 17, 2000.

Respondent filed his Answer through registered mail on September 5, 2000, claiming by way of Special and Affirmative Defenses that:

> "5. The petition states no cause of action as it does not allege the date/s when the taxes sought to be refunded were actually paid;
>
> 6. In an action for tax refund/credit, the burden of proof is on the taxpayer to establish its right to the refund and failure to sustain the burden is fatal to the action for tax refund;
>
> 7. Taxes paid and collected are presumed to have been made in accordance with law and regulations, hence, not refundable;
>
> 8. Well-settled is the rule that claims for refund is (sic) construed against the claimants since it partakes of the nature of an exemption from taxation."

In their Joint Stipulation of Facts and Issues filed on November 6, 2000, the parties submitted the following issues for resolution:

(a) Whether or not Petitioner purchased on 1 December 1997 from Citibank N.A. a 10-year Fixed Rate Treasury Bond ("Bond") with a face value of P20 Million and an interest coupon rate of 22.875% payable semi-annually, i.e., on 27 May and 27 November;

(b) Whether or not Petitioner purchased the Bond at a premium amounting to a total cash outlay of P20,076,022.89, including deductions for withholding tax on the premium of P1,714.38;

(c) Whether or not Petitioner held on to the Bond from 1 December 1997, the date of purchase, to 16 June 1999;

(d) Whether or not during the foregoing period, specifically on 27 May 1998, 27 November 1998 and 27 May 1999, Petitioner received interest income on the Bond amounting to P1,830,000.00 on each of the aforementioned dates, net of P475,500.00 representing the amount of 20% final withholding tax thereon, or a total of P5,490,000.00 as interest income on the Bond for the entire holding period, net of aggregate final withholding taxes of P1,372,500;

(e) Whether or not the Bureau of Treasury withheld the amount of P1,372,500.00 as 20% final withholding taxes from Petitioner's Bond investment during the entire holding period, and remitted such amount to the BIR;

(f) Whether or not Petitioner received net cash proceeds of P27,152,671.15 from the sale of the Bond to HSBC on 16 June 1999, which includes deductions for withholding taxes on the selling price and accrued interest receivable amounting to P890,726.20 and P48,291.67, respectively;

(g) Whether or not Petitioner has an overpaid withholding tax on the Bond in the amount of P2,223,386.82, and is therefore entitled to the refund of said amount;

(h) Whether or not the administrative claim for refund of the above amount and the Petition for Review were filed within the 2-year prescriptive period for recovery of taxes erroneously or illegally collected, prescribed under Section 229 of the NIRC; and

(i) Whether or not the term "gains", as used in Section 32(B)(7)(g) of the National Internal Revenue Code of the Philippines ("NIRC"), encompasses all forms of "income" derived from bonds, debentures and other certificates of indebtedness with a maturity of more than 5 years, including the interest income and yield derived from such long-term certificates of indebtedness, considering the connotation of the term "gains" in relation to the financial treatment of bonds, debentures and other certificates of indebtedness.

After a careful perusal of the records and evaluation of the pertinent laws and rulings, We partially grant the petition.

We rule first on the issue of the timeliness of the administrative and judicial claims for refund, for if Petitioner's claim has already prescribed, there is no need to dwell on the rest of the issues presented.

Petitioner's claim covers final taxes withheld starting May 27, 1998 or during the second quarter of 1998. Counting from July 25, 1998, the considered date of payment of final taxes withheld for the second quarter of 1998, Petitioner had until July 24, 2000 within which to file its administrative and judicial claims for refund. Clearly, both Petitioner's claim for refund filed with the BIR on March 17, 2000 and this petition for review filed on July 17, 2000 fall within the two-year prescriptive period.

We now proceed to the legal issue which mainly revolves on the proper interpretation of the term "gains" as used in Section 32(B)(7)(g) of the Tax Reform Act of 1997. Under the said section, gains realized from the sale or exchange or retirement of bonds, debentures or other certificate of indebtedness with a maturity of more than five (5) years shall not be included in gross income and shall be exempt from taxation.

The instant petition involves a claim for refund of final taxes withheld on Petitioner's interest income and gain from sale of its long-term fixed rate treasury bond. As to the final taxes withheld by HSBC on the gain from sale realized by Petitioner totaling P890,726.20, the same is exempt from tax by clear provision of law.

However, the problem lies with the interest income earned by Petitioner from the time it purchased the Bond up to the time of the sale of the Bond to HSBC. Petitioner interpreted the word "gains" in Section 32(B)(7)(g) as broad enough to include "profit", "income" and other similar forms of wealth or value which flow into the taxpayer through a period of time, other than as a mere return of capital.

To support its view that interest from the Bond is exempt from tax, Petitioner cites Respondent's own rulings, namely, BIR Ruling No. 166-99 dated October 25, 1999, BIR Ruling No. 016-2000 dated January 7, 2000 and BIR Ruling No. 020-01 dated May 31, 2001.

In BIR Ruling No. 166-99, issued on October 25, 1999 and addressed to Aegon Life Insurance (Philippines), Inc., which is engaged in the same line of business as that of the Petitioner, Respondent ruled that interest income or yields or gain from the sale of bonds, debentures and certificates of indebtedness with maturities of more than five (5) years are excluded from gross income in accordance with Section 32(B)(7)(g) of the 1997 Tax Code and therefore exempt from the 20% final withholding tax on deposit substitutes. BIR Ruling No. 166-99 states in pertinent part:

> "B. As a general rule, the interest income on currency bank deposit and <u>yield or other monetary benefit from these "deposit substitutes"</u> and similar arrangement derived by banks and non-bank financial intermediaries are being taxed at the final rate of 20% under Section 27(D)(1) of the 1997 Tax Code.
>
> However, Section 32(B)(7)(g) of the 1997 Tax Code, provides an exception, thus,
>
> "**Section 32.** ***Gross Income.*** —

> xxx xxx xxx
>
> "(B) *Exclusions from Gross Income.* - The following items shall not be included in gross income and shall be exempt from taxation under this Title:
>
> xxx xxx xxx
>
> "(7) *Miscellaneous Items.* —
>
> xxx xxx xxx
>
> "(g) Gains from the Sale of Bonds, Debentures or other Certificate of Indebtedness. Gains realized from the sale or exchange or retirement of bonds, debentures or other certificate of indebtedness with a maturity of more than five (5) years."
>
> The idea therefore, is to still treat bonds, debentures or other certificates of indebtedness as "deposit substitutes" the interest income, yield or gain derived therefrom subject to the 20% final tax under Section 27(D)(1) of the 1997 Tax Code, but exclude said interest income, yield or gain from the gross income if the bonds, debentures or the certificate of indebtedness have maturities of more than five (5) years. Conversely, only the income derived on these debt instruments with maturity of more than five (5) years shall be excluded from the gross income.
>
> Furthermore, the term sale is not limited to the subsequent transfer of the instrument but to its <u>origination</u> and <u>issuance</u>, as well. Thus, from the time of its issuance, we should consider the "income" which is actually the amount coming to a person within a specified time, whether as payment for the services, <u>interest, or profit from investment</u>. Its usual synonyms being "gain", "profit", "revenue". (Trefry v. Putnam, 116 N.E. 904, 907 227 Mass. 522, L.R.A. 1917F, 806." (Words & Phrases, Gain, page 11, Permanent Edition 18) (BIR Ruling No. 166-99)

Notwithstanding the abovementioned rulings, We cannot agree with Petitioner's contention that interest on its long term investments should be considered gain exempt from income tax pursuant to Section 32(B)(7)(g) of the Tax Code.

Rulings issued by the Commissioner of Internal Revenue command respect and weight. However, such rulings are not conclusive upon the courts and will be ignored if found to be erroneous. Hence, in the case of **Philippine Bank of Communications vs. Commissioner of Internal Revenue, G.R. No. 112024, January 28, 1999,** our Supreme Court, in disregarding a Revenue Memorandum Circular issued by the Commissioner of Internal Revenue, held:

> It bears repeating that Revenue memorandum-circulars are considered administrative rulings (in the sense of more specific and less general interpretations of tax laws) which are issued from time to time by the Commissioner of Internal Revenue. It is widely accepted that the interpretation placed upon a statute by the executive officers, whose duty is to enforce it, is entitled to great respect by the courts. Nevertheless, such interpretation is not conclusive and will be ignored if judicially found to be erroneous. Thus, courts will not countenance administrative issuances that override, instead of remaining consistent with, the law they seek to apply and implement.
>
> In the case of *People vs. Lim*, it was held that rules and regulations issued by administrative officials to implement a law cannot go beyond the terms and provisions of the latter.
>
> > x x x Of course, in case of discrepancy, the basic Act prevails, for the reason that the regulation or rule issued to implement a law **cannot go beyond** the terms and provisions of the latter. x x x In this connection, the attention of the technical men in the offices of Department Heads who draft rules and regulations is called to the importance and necessity of closely following the terms and provisions of the law which they are intended to implement, this to avoid any possible misunderstanding or confusion as in the present case.
>
> Further, fundamental is the rule that the State cannot be put in estoppel by the mistakes or errors of its officials or agents. x x x
>
> x x x
>
> Article 8 of the Civil Code recognizes judicial decisions, applying or interpreting statutes as part of the legal system of the country. But administrative decisions do not enjoy that level of recognition. A memorandum-circular of a bureau head could not operate to vest a taxpayer with a shield against judicial action. For there are no vested rights to speak of respecting a wrong construction of the law by the

> administrative officials and such wrong interpretation could not place the Government in estoppel to correct or overrule the same. Moreover, the non-retroactivity of rulings by the Commissioner of Internal Revenue is not applicable in this case because the nullity of RMC No. 7-85 was declared by the respondent courts and not by the Commissioner of Internal Revenue. Lastly, it must be noted that, <u>as repeatedly held by this Court, a claim for refund is in the nature of a claim for exemption and should be construed in *strictissimi juris* against the taxpayer.</u>

In this case, We conclude that the aforementioned BIR rulings are erroneous. Such rulings were based on the mistaken belief that the term "gains" as used in Section 32(B)(7)(g) of the Tax Code include interest.

It is a well-settled rule of statutory construction that tax exemptions are strictly construed against the taxpayer. Consequently, where Section 32(B)(7)(g) of the Tax Code, which grants tax exemption, is susceptible of a restrictive interpretation, such interpretation must be adopted.

We take the view that "gains" as the term is used therein in Section 32(B)(7)(g) of the Tax Code cannot include interest since it clearly refers to *gains from the sale* of bonds, debentures and other certificates of indebtedness.

Initially, it must be pointed out that whereas the term "gains" includes "interest" as a general rule, this rule cannot be applied to Section 32(B)(7)(g) of the Tax Code which particularly refers to "*Gains from the Sale of Bonds, Debentures or other Certificate of Indebtedness*" in its title and "Gains realized from the sale or exchange or retirement of bonds, debentures and other certificate of indebtedness with a maturity of more than five (5) years" in its body. Stated otherwise, Section 32(B)(7)(g) of the Tax Code specifically refers to *gains from the sale* of bonds, debentures and other certificates of indebtedness as contradistinguished from the term "gains" in its general sense, which is synonymous to income.

In this regard, Section 32(A) of the Tax Code defines "gross income" as follows:

> SEC. 32. *Gross Income.* –
>
> (A) *General Definition.* – Except when otherwise provided in this Title, gross income means all income derived from whatever source, including (but not limited to) the following items:
>
> (1) Compensation for services in whatever form paid, including, but not limited to fees, salaries, wages, commissions and similar items:
>
> (2) Gross income derived from the conduct of trade or business or the exercise of profession;
>
> (3) <u>Gains derived from dealings in property</u>;
>
> (4) <u>Interests</u>;
>
> (5) Rents;
>
> (6) Royalties;
>
> (7) Dividends;
>
> (8) Annuities;
>
> (9) Prizes and winnings;
>
> (10) Pensions; and
>
> (11) Partner's distributive share from the net income of the general professional partnership.

From the aforequoted Section 32(A) of the Tax Code, it is clear that there is a distinction between "gains derived from dealings in property" and "interests", which are separately classified as items of gross income. "Gains realized from the sale or exchange or retirement of bonds, debentures and other certificate of indebtedness" would fall under the category of "gains derived from dealings in property". On the other hand, "interests" would include interest from bonds, debentures and other certificate of indebtedness. Gain realized from the sale or exchange or retirement of bonds, debentures and other certificate of indebtedness and interest from bonds, debentures and other certificate of indebtedness fall under separate and distinct income categories.

Moreover, it should be noted that both Sections 24(B)(1) and 25(A)(2), respectively, of the Tax Code expressly exempt interest derived from certain long-term deposit or investment (covered by Bangko Sentral ng Pilipinas (BSP) certificates and with maturity of five years or more) by citizens, resident aliens and nonresident aliens engaged in trade or business within the Philippines from income tax. However, there is no such exemption from income tax on such interest for corporations, domestic or foreign, under Sections 27 and 28 of the Tax Code.

Governing the taxation of interest, including interest from deposits and yield from deposit substitutes and trust funds and similar arrangements, realized by citizens and resident aliens, Section 24 of the Tax Code provides in pertinent part:

> SEC. 24. *Income Tax Rates.* –
>
> (A) *Rates of Income Tax on Individual Citizen and Individual Resident Alien of the Philippines.* -
>
> (1) An income tax is hereby imposed:
>
> (a) On the taxable income defined in Section 31 of this Code, other than income subject to tax under Subsections (B), (C) and (D) of this Section, derived for each taxable year from all sources within and without the Philippines by every individual citizen of the Philippines residing therein;
>
> (b) On the taxable income defined in Section 31 of this Code, other than income subject to tax under Subsections (B), (C) and (D) of this

Section, derived for each taxable year from all sources within the Philippines by an individual citizen of the Philippines who is residing out of the Philippines, including overseas contract workers referred to in Subsection (C) of Section 23 hereof; and

(c) On the taxable income defined in Section 31 of this Code, other than income subject to tax under Subsections (B), (C) and (D) of this Section, derived for each taxable year from all sources within the Philippines by an individual alien who is a resident of the Philippines

The tax shall be computed in accordance with and at the rates established in the following schedule:

x x x

(B) *Rate of Tax on Certain Passive Income.* –

(1) *Interests, Royalties, Prizes, and Other Winnings.* – A final tax at the rate of twenty percent (20%) 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 fund and similar arrangements; x x x: *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%) of such interest income: *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 by this Subsection: *Provided, finally,* That should the holder of the certificate preterminate the deposit or investment before the fifth (5^{th}) 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 years - 5%

Three (3) years to less than four years - 12%

Less than three (3) years - 20%

x x x

Section 25(A) of the Tax Code taxes nonresident alien individuals engaged in trade or business within the Philippines on interest realized from Philippine sources in the same manner as citizens and resident alien individuals taxed under the aforequoted Section 24 of t Sections 24(B)(1) and 25(A)(2), respectively, of the Tax Code. However, Section 25(B) of the Tax Code taxes nonresident alien individuals not engaged in trade or business within the Philippines on their interest realized from Philippine sources as follows:

> SEC. 25. *Tax on Nonresident Alien Individual.* –
>
> x x x
>
> (B) *Nonresident Alien Individual Not Engaged in Trade or Business Within the Philippines.* – There shall be levied, collected and paid for each taxable year upon the entire income received from all sources within the Philippines by every nonresident alien individual not engaged in trade or business within the Philippines as interest x x x, or other fixed or determinable annual or periodic or casual gains, profits, and income, and capital gains, a tax equal to twenty-five (25%) of such income. x x x

On the other hand, Section 27 of the Tax Code governs the taxation of interest income realized by domestic corporations. Section 27 provides in pertinent part:

> SEC. 27. *Rates of Income Tax on Domestic Corporations.* –
>
> (A) *In General.* – Except as otherwise provided in this Code, an income tax of thirty-five percent (35%) is hereby imposed upon the taxable income derived during each taxable year from all sources within and without the Philippines by every corporation, as defined in Section 22(B) of this Code and taxable under this Title as a corporation, organized in, or existing under the laws of the Philippines: *Provided,* That effective January 1, 1998, the rate of income tax shall be thirty-four percent (34%); effective January 1, 1999, the rate shall be thirty-three percent (33%); and effective January 1, 2000 and thereafter, the rate shall be thirty-two percent (32%).
>
> x x x

> (D) *Rates of Tax on Certain Passive Incomes.* -
>
> (1) *Interest from Deposits and Yield or any Monetary Benefit from Deposit Substitutes and from Trust Funds and Similar Arrangements, and Royalties.* – A final tax at the rate of twenty percent (20%) 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: *Provided, however,* That interest income derived 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%) of such interest income.
>
> x x x (*Underscoring supplied.*)

Under Section 28(A) of the Tax Code, resident foreign corporations are subject to the same tax imposed on interest income realized from Philippine sources as domestic corporations. On the other hand, under Section 28(B) of the Tax Code, nonresident foreign corporation are generally subject to 32% tax based on gross income, including interest, effective January 1, 2000. However, on interest income derived from foreign loans contracted on or after August 1, 1986, a final withholding tax rate of 20% is imposed.

Obviously, from the aforementioned Sections 24, 25, 27 and 28 of the Tax Code, in relation to Sections 31 and 32 of the Tax Code, there is no sweeping exemption from income tax of interest from bonds, debentures or other certificates of indebtedness with a maturity of more than five (5) years.

There is a clear distinction between interest from bonds and gain from the sale of bonds. It is only the "Gains realized from the sale or exchange or retirement of bonds, debentures or other certificate of indebtedness with a maturity of more than five (5) years" that is excluded from gross income and thus exempt from income tax under

Section 32(B)(7)(g) of the Tax Code. Such gains from sale or exchange or retirement of bonds, debentures or other certificate of indebtedness fall within the general category of "Gains derived from dealings in property", as distinguished from interest from bonds, debentures or other certificate of indebtedness, which fall within the general category of "Interests" under Section 32(A) of the Tax Code.

As previously noted, only citizens, resident aliens and nonresident aliens engaged in trade or business are exempt from income tax on interest from long-term (with a maturity of five years or more) 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) pursuant to Sections 24(B)(1) and 25(A) of the Tax Code. On the other hand, domestic and resident foreign corporations are subject to a 20% final tax on such interest pursuant to Sections 27(D)(1) and 28(A) of the Tax Code.

We believe that if Congress intended to exempt *interest* from bonds, debentures and other certificates of indebtedness under Section 32(B)(7)(g) of the Tax Code, it would have done so in clear and specific terms. The fact that it used the term "Gains from sale" in the aforementioned section, knowing full well of the reference to interest under Sections 24, 25, 27 and 28 of the Tax Code shows that it did not intend to exempt such interest under the aforementioned Section 32(B)(7)(g) of the Tax Code.

Parenthetically, in the United States, where it is the interest on certain state and local bonds that is exempt whereas gain from the sale thereof is taxable, there is a clear distinction between interest and gain from sale. Hence, Section 8.07 of Mertens, *The Law Of Federal Income Taxation,* provides in pertinent part:

§8.07. Interest.

The interest exclusion on state and local bonds is limited to interest income relating to tax-exempt bonds. It does not include gain on the sale or exchange of obligations.

Discount

The word "interest" in the Code includes "discount." When state or municipal securities are *issued* at a discount, amounts representing the discount received by the holder either upon the redemption or sale of the securities are tax-exempt as being equivalent to interest. As between successive holders of a tax-exempt municipal bond, the original issue discount which is tax-exempt is apportioned on the basis of the time each of the holders held the bond. The remainder of the proceeds is treated as the amount realized on the redemption or sale for purpose of determining gain or loss.

Market Discount

When a dealer resells bonds at a discount which he purchased at par or above, that discount is commonly referred to as "market" discount in contrast to "issue" discount. If the bonds are capital assets in the hands of the purchaser from the dealer, then the market discount when subsequently realized would give rise to a capital gain. Certain insurance companies, however, would be required to accrue this market discount each taxable year as investment income and would also adjust the basis for the bonds so that no gain would be realized upon redemption if the bonds were held to maturity.

The distinction must be noted between accrued interest and discount received upon the redemption of state or local obligations prior to maturity and any premium paid on such redemption. It has been ruled that while the accrued interest and discount constitute interest and are, thus, tax-exempt, any premium received upon redemption is taxable income. Mertens, *The Law Of Federal Income Taxation,* Section 8.07, Vol. 1, Chap. 8, pp. 22-24. (*Underscoring supplied.*)

From the above discussion, only the gain from sale (as distinguished from interest) of the Bond subject of this case is exempt from income tax.

What now remains to be resolved is whether or not Petitioner was able to prove the factual aspect of its claim for refund.

As clearly shown from Citibank, N.A.'s Confirmation of Sale without Recourse dated December 1, 1997 (Exhibit A) and Confirmation Letter dated February 22, 2000 (Exhibit C), Petitioner actually purchased on December 1, 1997 from Citibank N.A. a 10-year Fixed Rate Treasury Bond with series No. PIBD1007K042, face value of P20,000,000.00, issue date of November 27, 1997, yield rate of 22.82375%, coupon rate of 22.875% payable semi-annually, i.e., on May 27 and November 27 of each year during the bond's 10-year term. It was also indicated in the said documents that the purchase price paid by Petitioner in acquiring the bond amounted to P2,076,022.89 net of the 20% final withholding taxes of P1,728.80 and P10,166.67 on the purchase price and accrued interest, respectively.

The Certification from the Bureau of Treasury dated February 28, 2000 (Exhibit E) and certain pages of Petitioner's bank passbook with RCBC (Exhibits J to L) establish that Petitioner actually received from the Bureau of Treasury on three separate dates, i.e., on May 28, 1998, November 27, 1988 and May 27, 1999, the interest income payments due on its bond investment in the total amount of P5,490,000.00 net of 20% final withholding taxes of P1,372,500.00.

Petitioner's subsequent sale of the bond to Hongkong and Shanghai Banking Corporation on June 16, 1999 is duly supported by the Confirmation of Outright Sale of Government Securities dated June 16, 1999 addressed to the Bureau of Treasury's Registry of Scriptless Securities (Exhibit G) and Confirmation letter from Hongkong and Shanghai Banking Corporation (Exhibit I). As reflected in the said documents, Petitioner's proceeds from sale of the bond amounted to P27,152,671.16 (Exhibits G-2 & I-6), net of 20% final withholding taxes of P890,726.20 on gross price and P48,291.67 (Exhibit I-4) on accrued interest, or a total of P939,017.87 (Exhibit I-5) due on the accrued interest and gross price, respectively.

In sum, Petitioner was able to prove that from December 1, 1997 to June 16, 1999, Petitioner invested in a 10-year Fixed Rate Treasury Bond and derived interest income and gain from the sale thereof from which 20% final taxes were withheld in the total amount of P2,223,372.40 computed as follows:

20% Final Taxes Withheld on:	
Selling Price – 06/16/99	P 890,726.20
Accrued Interest Receivable from 05/27/98 to 06/15/99	48,291.67
Interest Income	
from 01/01/98 to 05/27/98 [P457,500 x (180-34 days)/ 180 days]	371,083.33
from 05/28/98 to 11/27/98	457,500.00
from 11/28/98 to 05/27/99	457,500.00
Total 20% Final Taxes Withheld	P2,225,101.20
Less: 20% final withholding taxes upon purchases from Citibank, N.A.	1,728.80
Net Amount of Final Taxes Withheld from Petitioner's bond investment	P2,223,372.40

It is clear from the foregoing that Petitioner paid a 20% final withholding tax in the amount of P890,726.20 on the gain derived from the sale of the Bond in 1999 out of the total tax withheld for the years 1998 and 1999 on both interest from the Bond and the gain from sale thereof. It is this amount that is exempt from income tax under Section 32(B)(7)(g) of the Tax Code.

WHEREFORE, premises considered, the Court finds the instant Petition partly meritorious. Accordingly, Respondent is hereby **ORDERED** to **REFUND** to Petitioner the amount of P890,726.20, representing income tax erroneously withheld from Petitioner's gain from sale of long-term fixed rate treasury bond for the year 1999.

SO ORDERED.

JUANITO C. CASTAÑEDA, JR.
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

AMANCIO Q. SAGA
Associate Judge

CERTIFICATION

I hereby certify that the above decision was reached after due consultation with the members of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

ERNESTO D. ACOSTA
Presiding Judge