FINANCIAL TRANSPARENCY COALITION

Illicit Financial Flows:
Issues and Challenges from the Philippine Experience

Asian Peoples' Movement on Debt and Development (APMDD)

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Executive Summary

The Philippines today counts among several Asian countries with the highest levels of illicit financial flows globally. Traced largely to various types of trade misinvoicing, these flows represent billions of lost and foregone tax revenues critical to developing countries such as the Philippines.

The Philippines' IFFs, however, is not recent phenomena. The "ill-gotten wealth" amassed by Ferdinand Marcos and the "capital flight" into secret tax haven accounts became cutting edge issues that eventually led to the regime's ouster in 1986. Studies found links between increased levels of foreign borrowings and bigger volumes of capital flight, indicating that these flows were not reactions to destabilizing factors or efforts to seek higher returns. In addition to graft and corruption, trade misinvoicing was found to factor significantly in these outflows (Boyce and Lyuba) (Beja Jr.).

Domestic revenue erosion through abusive tax behavior persists in even greater magnitude today. In GFI's reports on illicit flows[1], the Philippines continues to be implicated in heavy IFFs, which have been traced largely to the enduring practice of trade misinvoicing. Estimates have consistently ranked the Philippines among the top 20 countries with the highest IFFs worldwide. For the period 2002-2011, the Philippines ranked 14TH among the top 20 countries with the highest cumulative illicit flows and was one of six Asian countries in the list (also China, Malaysia, India, Thailand and Indonesia) (Kar and LeBlanc).

An earlier GFI study focused on the Philippines concluded that over a 52-year span (1960-2011), cumulative illicit flows from trade mispricing, unrecorded money transfers, balance of payments leakages, money laundering, etc., amounted to $410.5 billion. Overall, trade misinvoicing through under-invoicing of both exports and imports (no longer the overinvoicing of imports as before) thus overwhelmingly spurred IFFs during the period. Of the $277.6 billion illicit flows into the Philippines, underinvoicing of imports and the resulting customs leakage accounted for the greater bulk of this figure at $267.8 billion (or 96%). To a lesser but no less significant degree, illicit flows going out of the country reached $132.9 billion, out of which $95.2 billion or about 72% was traced to export under-invoicing (Kar and LeBlanc ix).

Abusive transfer pricing or transfer mispricing takes place within the larger arena of trade misinvoicing, and it is highly likely that transfer mispricing is a major component of the heaviest cause of the Philippines' IFFs tracked by GFI. As part of multilateral efforts recognizing the rampant practice, the Philippine government adopted the country's first transfer pricing guidelines in 2013. It remains to be seen how these guidelines will play out but it must be remembered that they only cover intra-group transactions of TNCs whose beneficial owners are unknown, and not the more wide-ranging practice of trade mispricing.

The phenomenon of IFFs is not only aided by the ease of digitally moving money to financial secrecy jurisdictions but more critically, by a policy environment intent on attracting foreign investments and

[1] GFI's studies on "illicit financial flows", using a different methodology from Beja's, highlight a problem and responsibility that cannot be solely pinned on developing countries from where the money comes from, as the term capital flight suggests. It emphasizes that "'the phenomenon is a two-way street'" involving "industrialized countries [which] have for decades solicited, facilitated, transferred, and managed both licit and illicit financial flows out of poorer countries" (Herkenrath citing Raymond Baker).

offering terms to attract the same, notwithstanding the many openings provided for tax abusive behavior. Whether licit or illicit, they pave the way for negative financial flows, and commonly benefit from a lack of transparency and accountability. They also share in the intent of vastly reducing taxable income and allowing greater profit than would have been otherwise possible; as well as in the impacts of facilitating public revenue loss, usurping sovereign taxing rights and undermining taxation's basic function of serving the common good.

For one, a comprehensive and un-rationalized investment incentives system found by government itself to promote transfer pricing abuse and thus, tax avoidance. An initial Tax Expenditures Report showed that income tax holidays accounted for P64.4 billion of the PhP157 billion lost to fiscal incentives in 2012, an increase of P18.8 billion from the PhP45.6 billion ITH-related losses in 2011. This redounds to more than 10% of government revenues and close to 9% of government expenditures in 2012. Government has also been negotiating more tax treaties, which pit developing countries against each other in a race to the bottom for the lowest tax revenues and widen opportunities for corporate profit-shifting to low or no-tax jurisdictions within and outside the Philippines.

It is this broad range of revenue-draining, IFF issues that this paper attempts to address and upon which policy actions will be sought. The injustice of failing to provide adequately and affordably for the most basic essential social services while public money is allowed to drain away cannot be more plainly stated. Public expenditure for health has never reached the 5% of GDP international standard committed to by the Philippine government; health costs are heavily out-of-pocket, and health services are being privatized. The education budget as well has consistently fallen short of living up to another international commitment, the Delors Commission benchmark of 6% of GNP. There are substantial, persistent gaps as well in job creation, decent housing, public transportation systems, and the urgent concern for climate resilience.

This heavy drain on public resources raises critical issues of social justice and human rights. It denies and violates the sovereign right of peoples to raise and use revenues for the immediate improvement of their lives and for their long-term development and well-being. It justifies the privatization of social services and the deepening of debt which have proven to exacerbate already difficult lives led by the disadvantaged and the impoverished.

The problem of IFFs cannot be effectively addressed in a piecemeal manner but should begin from a diligent examination of the structural causes and key actors that allow it to continue. Applying a fiscal and tax justice perspective to an immediate review and a strategic transformation of tax systems, laws and policies are crucial steps to take in this direction.

As initial steps, we recommend undertaking a comprehensive, participatory review – jointly and/or independently -- by policy-makers and civil society of tax laws and policies; free trade agreements, bilateral investment treaties and double taxation avoidance agreements to ensure that tax serves its highest purpose of serving the public interest; enacting the Freedom of Information Bill to ensure that everyone, particularly corporations and wealthy individuals pay their fair share of the tax burden; conducting a rigorous, public audit of tax compliance of corporations, giving close attention to TNCs in the extractives industry; and along with these measures, instituting transparent and participatory budget processes and transforming public spending policy to serve as an instrument for the enjoyment of human rights and sustainable, people-centered development.

Introduction

In 2014, several major media outlets headlined the main findings of a Global Financial Integrity (GFI) report showing billions of dollars of public revenues lost by developing countries to illicit financial flows (IFFs) during the period 2003-2012. The Philippines ranked 15th out of 145 countries, with total inbound and outbound IFFs amounting to $93.49 billion between 2003-2012, or averaging $9.35 billion yearly (Kar and Spanjers).

The issue of IFFs and their revenue-eroding implications bear critical importance to developing countries such as the Philippines. Budgets for social services such as education and health still remain below international standards and fall far from complying with government's legally binding obligations as a States Party to core human rights treaties. Public service facilities such as water and power have also been among the first of state assets to be privatized on grounds that government can no longer afford to subsidize their delivery. These have led to greater difficulties especially for impoverished communities and sectors without the means to pay for even the most basic services. The inadequacy of resources is also used to rationalize government's continued dependence on borrowings to fund programs, and its insistence on attracting private sector investments even on disadvantageous terms to finance infrastructure development.

GFI defines IFFs as "illegal movements of money from one country to another that are illegally earned, transferred, and/or utilized." These include money laundering activities, mispricing or misinvoicing trade transactions to evade customs and tax liabilities, and transfers of dirty money to financial secrecy jurisdictions (GFI). Not all public revenue-draining issues can be neatly pegged as IFFs; if anything, many are openly extended as terms investors would find attractive. Whether licit or illicit, they commonly open avenues for negative financial flows, and benefit from a lack of transparency and accountability. They share in the intent of vastly reducing taxable income and allowing greater profit than would have been otherwise possible; as well as in the impacts of facilitating public revenue loss, usurping sovereign taxing rights and undermining taxation's basic function of serving the common good.

The legal system itself in many developing countries such as the Philippines provides the very context enabling of IFFs. We thus adopt a broader appreciation of IFFs that is not limited to illicit and illegal attempts to conceal the full nature of financial flows and evade duties and accountabilities. We also need to closely examine practices that, while licit and legal, undermine the sovereign right of peoples to collect taxes from profit-generating activities in their jurisdiction and erode the most reliable and predictable means for them to fund their overall well-being and development. In this paper, we attempt to address a wider range of flows that include the following characteristics:

- flows are largely unrecorded (not captured by the [Balance of Payments] BoP and other official statistics)
- associated with active attempts to hide origin, destination and true ownership
- associated with public loss and private gain because no (or little) tax is paid on them or because they may be comprised of bribes paid
- constitute domestic wealth permanently put beyond the reach of domestic authorities in the source country
- not part of a 'fair value' transaction and would not stand up to public scrutiny if all information about them was disclosed (Kapoor, Illicit Flows and Capital Fight)

This Policy Brief intends to look at some of the sources of these flows, the actors involved and the factors enabling these IFFs, especially the roles played by the state and institutions. Secondly, it aims to put forward policy recommendations as well as advocacy points towards effectively addressing a major cause of public revenue erosion in the country and the inability of government to provide for the well-being of its people.

It is hoped that this study will contribute to engaging government for changes in tax, trade and investment policies. By this, we mean substantive reforms needed to recover, mobilize and safeguard public financial resources critical to the fulfillment of people's immediate needs and the long-term enjoyment of their human rights.

IFFs as 'Capital Flight' – a continuing vehicle for IFFs

Illicit financial flows (IFFs) are not new to Filipinos. In the 70s and 80s, they learned first-hand about IFFs as "capital flight", which came largely from over $10 billion of "ill-gotten wealth"[2] amassed by and stashed away in tax havens by the Marcos dictatorship and its cronies.

Capital flight was generally understood as "the transfer of assets abroad in order to reduce loss of principal, loss of return, or loss of control over one's financial wealth due to government-sanctioned activities…." (Epstein). Its nature was thus clear as "an inherently political phenomenon involving the role of the government and the prerogatives of those – usually the wealthy – with access to foreign exchange"(Ibid). As well, it was seen not simply as a way of seeking higher returns in the face of unstable conditions, but as an act of self-aggrandizement and deceit, by way of avoiding "the formal and informal, controls on capital, which include societal norms and expectations on the use of foreign exchange, the legal, extralegal, or nongovernmental exactions on the use or allocation of resources, including taxation,…." (Capital Flight and the Philippines Economy 71).

Almost three decades after Marcos' ouster, the full scale of the riches and properties amassed by his family and friends remains unclear. In 2012, the issue of capital flight surfaced anew with disclosures of shell companies in the British Virgin Islands held by the late dictator's kin, who are also serving public office (Landingin and Ilagan). Other members of the Senate and the House of Representatives were linked to BVI accounts. Although legal, such accounts were not reported in their Statement of Assets, Liabilities and Net Worth, which government officials are required to submit each year (Mangahas).

Deregulation, financial liberalization and illicit flows

Over time, capital flight traced to high level graft and corruption though still continuing from unabated reports up to the present, has receded from the public eye. Other less publicized channels of resource flows have gained importance, notably the flows from trade practices such as transfer mispricing. Significantly, this grew even further when the Philippines began to liberalize its financial sector, contrary

[2] The Philippine Supreme Court defined "ill-gotten-wealth" as wealth or property "acquired through or as a result of improper or illegal use of or the conversion of funds belonging to the Government or any of its branches, instrumentalities, enterprises, banks or financial institutions, or by taking undue advantage of official position, authority, relationship, connection or influence, resulting in unjust enrichment of the ostensible owner and grave damage and prejudice to the State" (Bataan Shipyard & Engineering Co., Inc. v. Presidential Commission on Good Government, 1987).

to the expectations of proponents, that "with deregulation and financial liberalization, there should be no more capital flight because there will be no more incentives to avoid social controls" (Beja Jr. 56).

Boyce in 1988, citing the "False Invoicing of Exports and Imports", wrote that the

> "[m]anipulation of trade invoices provides another important mechanism of capital flight…False invoicing is widely believed to have been a major avenue for Philippine capital flight. Cowitt (1985, p. 675) reports that "underinvoicing of exports and overinvoicing of imports represented a major part of the trade [in the foreign currency black market], while bank note smuggling accounted for less than 10 percent." (Boyce and Lyuba 196)

Table 1 shows a "consistent pattern of underinvoicing" of exports over 25 years. Except for 1963 and 1973, IMF data used by Boyce revealed that the value of imports from the Philippines recorded by trading partners surpassed the value of exports (adjusted for shipping costs) recorded in the Philippines from 1962 – 1986. Generally averaging 13%, the discrepancy rises to 24% or $1.2 billion/year in the 80s, around the time of the Philippines' transition to financial liberalization. During the same period, imports were consistently under-, not over-invoiced, which indicated according to Boyce, that "capital flight through import overinvoicing was exceeded in magnitude by smuggling through underinvoicing or non-reporting of imports". (Boyce and Lyuba 207).

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In terms of imports, data consistently show as well underinvoicing or non-reporting of imports. However, in the 80s, a changing picture started to emerge with the export discrepancy overtaking the import discrepancy. In other words, during these years "…the capital flight effect generally overwhelmed the smuggling effect" (observed previously from the 60s onwards), with the net effect of an additional US$945 million upon total estimated nominal capital flight from 1962-86. (Ibid.)

Boyce further stressed that although the net effect on total estimated nominal capital flight (export discrepancy less import discrepancy) seems small at $945 million,

> "…this fairly modest total does not imply that trade invoice manipulation has been a relatively unimportant mechanism of capital flight. On the contrary, export underinvoicing alone amounted to $11 billion in the entire period. The misinvoicing adjustment captures the net effect of a) capital flight via false trade invoicing; and b) the use of unrecorded capital outflows to finance the undeclared portion of Philippine imports…" (Ibid)

Table 1. Trade Invoicing Discrepancies, 1962-1985 (US$ million)

Year	**Export Discrepancy** Trading partners' imports from the Philippines minus recorded Philippine exports x (CIF/FOB[3] factor)	**Import Discrepancy** Trading partners' exports to the Philippines x (CIF/FOB factor) minus recorded Philippine imports	**Capital Flight Misinvoicing Adjustment** Export discrepancy – import discrepancy
1962	81	51	30
1963	-3	209	-212
1964	37	161	-124
1965	29	183	-155
1966	72	184	-111
1967	144	223	-79
1968	178	305	-127
1969	305	312	-7
1970	129	319	-190
1971	112	286	-174
1972	101	248	-147
1973	-46	298	-344
1974	63	-32	96
1975	458	203	255
1976	133	253	-121
1977	250	266	-16
1978	438	659	-221
1979	593	640	-47
1980	949	623	326
1981	1071	593	477
1982	1181	541	-640
1983	870	1194	-324
1984	1395	803	592
1985	1516	886	630
1986	1223	923	300
Total[d]	11,277	10,332	945

Notes:

a. Export discrepancy = Trading partners' imports from the Philippines – (recorded Philippine exports x (CIF/FOB[4] factor)
b. Import discrepancy = Trading partners' exports to the Philippines x CIF/FOB factor) – recorded Philippine imports
c. Misinvoicing adjustment = Export discrepancy – import discrepancy
d. Figures were rounded.

Source: (Boyce and Lyuba 207)

Adopting more expansive measures, Boyce and Lyuba added to the misinvoicing adjustment (see table above), their calculation of "changes in gross foreign debt minus net direct investment outflow, the current account deficit, and increases in official reserves"[5]. They estimated that the total capital flight from the Philippines during the 25-year period, reached $10.4 billion in nominal terms. However, in real terms, the total value of capital flight stood at $22.3 billion or almost 79% of the country's $28.3 billion external outstanding debt as of end-1986. (Ibid.)

[3] Cost Insurance and Freight/Free on Board
[4] Cost Insurance and Freight/Free on Board
[5] Referred to as inclusive residual measure.

Beja posited a "revolving door process" between capital flight and external borrowings, with both flows "directly linked [to] and [reinforcing] each other". Using net unrecorded capital outflow or the residual of officially recorded sources and uses of funds, he estimated total capital flight amounting to $16 billion in the 70s; $36 billion in the 80s; $43 billion in the 90s; and $36 billion between 2000 and 2002 – for a total of $131 billion or "2.8 times the total external debt in 2002"[6] (Capital Flight and the Philippines Economy).

Significantly, it was further established that these trends were enabled by a policy context of greater neoliberal economic and financial openness, i.e., "there are more opportunities for capital flight and external borrowing". (Ibid)

> Further analysis on the revolving door revealed that capital flight actually increased, especially in the 1990s during the financial liberalization period. Arguably, as the neoliberal regime deepened, expanded, and thus became entrenched in the country, there was also intensified capital flight and external borrowing. Given the empirical evidence, we thus argue that the neoliberal regime (including the socioeconomic and political dynamics that come with it) underpinned capital flight and external borrowing, ultimately hollowing out the Philippine economy. (Ibid) (68)

The indirect link between foreign borrowings as a driver of illicit flows perhaps needs to be revisited considering changes in the Philippine debt profile. However, the revolving door concept may still be applied to understand the mutually reinforcing dynamics of transfer pricing abuse which has been shown in more recent data to heavily cause illicit flows.

IFFs and Trade Misinvoicing

In GFI's reports on illicit flows[7], the Philippines has continued to be implicated in heavy IFFs, which have been traced largely to the enduring practice of trade misinvoicing or mispricing. Also described by GFI as "trade-based money laundering", trade misinvoicing refers to "a method for moving money illicitly across borders which involves deliberately misreporting the value of a commercial transaction on an invoice submitted to customs" (Global Financial Integrity). Trade misinvoicing thus involves overinvoicing and underinvoicing exports and imports. By underinvoicing exports, enterprises are able to reduce not only customs duties but also taxes on income, while underinvoiced imports allow them to move huge sums of money untaxed in addition to evading customs tariffs. These schemes would not work without the involvement of other actors which include, among others, clandestinely owned holding firms in financial secrecy jurisdictions, offshore bank accounts and corrupt public officials.
Estimates have consistently ranked the Philippines among the top 20 countries with the highest IFFs worldwide. For the period 2002-2011 during which Asia was found to account for more than 39% of

[6] 1995 constant prices.

[7] GFI's studies on "illicit financial flows", using a different methodology from Beja's, highlight a problem and responsibility that cannot be solely pinned on developing countries from where the money comes from, as the term capital flight suggests. It emphasizes that "'the phenomenon is a two-way street'" involving "industrialized countries [which] have for decades solicited, facilitated, transferred, and managed both licit and illicit financial flows out of poorer countries" (Herkenrath citing Raymond Baker).

cumulative outflows, the Philippines ranked 14TH among the top 20 countries with the highest cumulative illicit flows and was one of six Asian countries in the list (also China, Malaysia, India, Thailand and Indonesia) (Kar and LeBlanc). Although the amounts are massive, it is important to note GFI's clarification that the estimates are conservative because they do not include IFFs from criminal activities nor trade in services as only trade in goods is covered by data sources.

Table 2. Top 20 Countries' Cumulative Illicit Outflows (2002-2011), In US$ Billions

Rank	Country	Average IFF (where data is available)
1	China, Mainland	107,557
2	Russian Federation	88,096
3	Mexico	46,186
4	Malaysia	37,038
5	India	34,393
6	Saudi Arabia	26,643
7	Brazil	19,269
8	Indonesia	18,183
9	Iraq	15,756
10	Nigeria	14,227
11	Thailand	14,088
12	United Arab Emirates	11,464
13	South Africa	10,073
14	Philippines	8,887
15	Costa Rica	8,065
16	Belarus	7,508
17	Qatar	6,282
18	Poland	4,939
19	Serbia, Republic of	4,937
20	Chile	4,520

Source: (Kar and LeBlanc, Illicit Financial Flows from Developing Countries: 2002-2011)

In the latest GFI release covering the period 2003-2012, the Philippines remained in the top 20 countries with the highest IFFs globally, registering an increase from $88.87 billion (2002-2011) to $93.49 billion (2003-2012). (It bears noting that the highest flows in the 10-year period were registered under Gloria Macapagal Arroyo's presidency, during which the level of borrowings rose steeply to surpass those of previous administrations combined. Whether there is a correlation is a matter for further study.)

Table 3. National Government Outstanding Debt 1995-2005
(In Million Pesos)

Year	Domestic Debt	Foreign Debt	Total
1995	718,395	440,227	1,158,622
1996	742,057	413,180	1,155,237
1997	749,608	600,966	1,350,574
1998	850,931	645,290	1,496,221
1999	978,404	796,952	1,775,356
2000	1,068,200	1,098,510	2,166,710
2001	1,247,683	1,137,234	2,384,917
2002	1,471,202	1,344,266	2,815,468
2003	1,703,781	1,651,327	3,355,108
2004	2,001,220	1,810,734	3,811,954
2005	2,164,293	1,723,938	3,888,231

(Bureau of the Treasury)

Table 4. Illicit Financial Flows, Philippines (2003-2012)
(In millions of US dollars, nominal)

Year	Amount
2003	8,255
2004	9,214
2005	13,488
2006	10,001
2007	7,982
2008	6,899
2009	8,650
2010	8,871
2011	10,965
2012	9,157
Cumulative	93,494
Average	9,348

(Kar and Spanjers, Illicit Financial Flows from Developing Countries: 2003-2012)

An earlier GFI study focused on the Philippines concluded that over a 52-year span (1960-2011), cumulative illicit flows from trade mispricing, unrecorded money transfers, balance of payments leakages, money laundering, etc., amounted to $410.5 billion. Overall, trade misinvoicing through under-invoicing of both exports and imports (no longer the overinvoicing of imports as before) thus overwhelmingly spurred IFFs during the period. Of the $277.6 billion illicit flows into the Philippines, underinvoicing of imports and the resulting customs leakage accounted for the greater bulk of this figure at $267.8 billion (or 96%). This means that importers under-declared the value of their imports and must have paid less in customs tariffs and other import duties than what was actually due. According to the study, up to 25% of the value of imported goods to the Philippines, or 1 out of every 4 dollars, was found to have been undeclared. To a lesser but no less significant degree, illicit flows going out of the country reached $132.9 billion, out of which $95.2 billion or about 72% was traced to export

under-invoicing (Kar and LeBlanc ix). Firms operating in the country were "consistently, and increasingly under-reporting the value of both their imports and exports, suggesting efforts to evade taxes", the report also observed (308).

Previous studies cited above on the significant role of trade misinvoicing in enabling the Philippines' capital flight tell us that it is not new phenomena. Clearly, the practice endures as attested by the GFI's latest report showing the Philippines among the top 10 countries with the highest IFFs from under-pricing exports.

The majority of countries in the group enforce regulations on the surrender and repatriation of export proceeds, which could possibly indicate that trade misinvoicing is encouraged by the very controls that are supposed to curtail it (Kar and Spanjers). As some studies suggest, if controls over trade transactions are lifted or relaxed, illicit flows would not be incentivized and would therefore decline. However, this does not seem to apply to countries like the Philippines, Indonesia and Chile since large volumes of IFFs have persisted over the years of trade and finance liberalization and deregulation.

Table 5. Ten Largest Export Under-Invoicers with Respective Export Proceeds Requirements, 2003-2012 (in billions of U.S. dollars, or in cumulative years in force)

Rank*	Countries	Export Underinvoicing, 2003-2012, (billions of U.S. dollars)	Surrender Requirement (Years in Force)**	Repatriation Requirement (Years in Force)**
1	China, P.R.: Mainland	828.4	4	10
2	Russian Federation	824.9	3	10
3	Brazil	145.7	10	5
4	Indonesia	129.9	0	2
5	India	125	10	10
6	South Africa	95	10	10
7	Philippines	72.2	0	0
8	Thailand	65	6	10
9	Honduras	31.5	10	10
10	Chile	27	0	0

*Does not include Liberia or Offshore Financial Centers as defined by the IMF
**Surrender and repatriation requirements refer to proceeds of exports of goods only
Sources: GFI (Export Under-Invoicing), IMF (Surrender Requirement), IMF (Repatriation Requirement)
(Kar and Spanjers, Illicit Financial Flows from Developing Countries: 2003-2012)

An equally worrying aspect of the Philippines' IFFs through trade mispricing lies in the under-invoicing of imports or technical smuggling (trade misinvoicing inflows) and the under-invoicing of exports (trade misinvoicing outflows). The table below shows illicit inflows from under-pricing of imports amounting to $187 million or more than double the value of illicit outflows from the under-pricing of exports for the period 2003-2012. This suggests that while underpriced imports may lead to lower tax deductions on business costs, and underpriced exports would reduce export tax credits and access to export incentives, there is more profit to be gained overall from being able to skirt customs duties and other tax, and having the flexibility to move money out of the country or bringing it back in as foreign investments.

Table 6. Components of the Philippines' Trade Misinvoicing, 2003-2012 (in millions of U.S. dollars, nominal, or in percent)*

Import Misinvoicing	
Over-invoicing (a)	5,652
Under-invoicing (b)	153,536
Export Misinvoicing	
Over-invoicing (c)	33,861
Under-invoicing (d)	72,173
Total Trade Misinvoicing Inflows (b+c)	187,397
Total Trade Misinvoicing Outflows (a+d)	77,825
Gross Trade Misinvoicing (a+b+c+d)	265,223

Source: (Kar and Spanjers)

Applying the effective tariff rates to under-invoiced imports and exports[8], GFI calculated that more than $12 billion in potential tax revenues have been lost since 1990, or an average of $1.46 billion per year since 2000. "To put this into perspective, the $3.85 billion in lost tax revenues in 2011 was over twice the size of the fiscal deficit and also constitutes 95 percent of the Philippines total government expenditures on social benefits during the same year." (Ibid)

The Philippines' Transfer Pricing regulations, significant challenges

TNC networks have grown so extensively across national and regional boundaries that up to 60% of international trade estimated to take place within these very networks and not between independent companies (Tax Justice Network). When these related entities trade with each other, they abide by previously set *transfer prices* or "the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises" (OECD). The problem is not with the transfer pricing mechanism itself, which is legal, but the manipulation of transfer prices within TNC organizations for the purpose of reducing or eliminating tax obligations in different types of tax jurisdictions where these related entities operate.

Abusive transfer pricing or transfer mispricing takes place within the larger arena of trade misinvoicing, and it is highly likely that transfer mispricing has been a major component of the heaviest cause of the Philippines' IFFs tracked by GFI. As part of multilateral efforts to curb transfer mispricing, the Philippine Department of Finance and the BIR finally adopted the country's first transfer pricing guidelines in 2013 to govern both cross-border and domestic transactions between and among related enterprises. They premised on the assumption that a transfer price complying with the arm's length principle would remove privileged transactions among group members and consequently, as explained in the Philippines' transfer pricing guidelines, allow market forces to operate and reflect the "true" economic value of the contributions made by each entity in their transactions (Department of Finance).

[8] Effective rate of taxes on international trade defined as total taxes on international trade over imports and effective rate on incomes, profits, and capital gains defined as taxes on incomes, profits, and capital gains over GDP.

The guidelines were originally drafted in 2006, and subsequently followed by several BIR issuances and circulars. Based on statutory rules in the national tax code[9], these regulations authorize the Commissioner of Internal Revenue (CIR) to review controlled transactions among associated enterprises and to apportion gross income or deductions among them to reflect the income attributable to such transactions and to prevent tax avoidance (Revenue Regulations No. 2-2013).

The regulations raise a number of other questions. For instance, it is not concretely defined what is meant by selecting the tax pricing methodology that would yield the "most appropriate" arm's length results; there are at least five methodologies in the guidelines that can produce varying results as to tax obligations and profits. It is also unclear how the BIR can validate the data that taxpayers will provide to prove comparability of independent transactions. On the burden of proof, it is generally understood that this is initially borne by the taxpayers who therefore should be prepared to argue that their transfer prices comply with the arm's length principle; once the enterprise demonstrates that its TPs are at arm's length, the burden passes on the BIR to show otherwise (Pricewaterhouse Coopers).

The TP guidelines have also been described by Kho-Sy as akin to anti-avoidance laws in other countries, though constrained by several limitations. The Revenue Commissioner, for example, is not authorized "to reconstruct a transaction nor to group different taxpayers into a single unit, whose taxes shall be computed based on the grouping and to be subsequently allocated among the various taxpayers belonging to that group". Moreover, related parties in a transaction can be made to look unrelated, (in which case the guidelines would not be applicable since they only deal with transfer prices among associated enterprises). Third, Kho-Sy stresses the fact that the CIR cannot ascribe tax obligations and can only exercise its powers to distribute, apportion or allocate income and deductions on reported information (Kho-Sy 62).

Past rulings on transfer pricing disputes indicate some of the challenges that the BIR faces when it questions an MNC's information on intra-group transactions. In the case of Avon Products Mfg. Inc. vs. the Commissioner of Internal Revenue, the petitioner filed for review before the Second Division of the Court of Tax Appeals in 1999 seeking cancellation and withdrawal of BIR's assessment notices for taxable year 1994, for deficiencies in income taxes, expanded withholding tax and VAT amounting to over PhP9.5 million (Avon Products Mfg. Inc. vs. Commissioner of Internal Revenue).

One of the issues CIR raised against the petitioner was its failure to fully declare export sales. The CIR averred that it sold its manufactured products to foreign affiliates at prices lower than the prices of its local sales resulting in undeclared export sales due to transfer pricing in the amount of PhP14.2 million. But Avon countered that its lower export prices are fair market prices considering that "…, we have to compete with…AVON Manufacturing plants in US, Europe and Japan", while it has a captured local market by virtue of an exclusive supply agreement with its Philippine customer, Avon Cosmetics Inc. (Ibid)

[9] Section 50, National Internal Revenue Code. Allocation of income and deductions. - In the case of two or more organizations, trades, or businesses (whether or not incorporated and whether or not organized in the Philippines) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organization, trade, or business, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organization, trade or business."

The CTA Second Division deemed the export sales prices to be at arms' length, ruling that it "finds petitioner's evidence sufficient to establish its position that the prices of its export sales may be lower than its local sales, taking into account the respondent's [CIR] lack of evidence to support his assertion." Taxable income for 1994 was consequently reduced from PhP74.9 million to PhP53.7 million, thereby reducing basic income tax deficiency as well from PhP7.25 million to a little over PhP121,500. (Ibid)

While a review for transfer pricing adjustments can surface tax errors and lead to a firm's restatement of earnings and thus, tax liabilities, the lack of concrete standards worldwide to judge arm's length compliance leaves many areas open disputes and to various ways of settlement. One of these is through Advance Pricing Agreements (APAs), a mechanism that is extended by the guidelines to taxpayers engaged in cross-border transactions as a means to reduce, for one, "the risk of transfer pricing examination". The APA is "an agreement entered into between the taxpayer and the Bureau [of Internal Revenue] to determine in advance an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto) to ascertain the transfer prices of controlled transactions over a fixed period of time." (Ibid)

The BIR is yet to formally issue separate guidelines on APAs but according to one transfer pricing advisory firm, a multinational has already expressed interest in signing an APA, promoting the BIR to "[accelerate] the development and future release date of the APA guidelines". It added that the national tax authority "has indicated that it views APAs as an attractive option to secure the tax base and reduce uncertainty over tax collections" (Quantera Global).

In October 2014, the BIR held a discussion with private and public sector panellists on the draft APA rules and regulations. Essentially, the BIR and the taxpayer agree in advance on a transfer pricing method over a three-year period with respect to the transactions of associated enterprises. These include sales, purchases, transfer and use of tangible and intangible property, financing and provision of services (F. D. Miguel).

It was not reported whether the experience of the countries such as the US with APAs were discussed. APAs have been criticized for binding countries into agreeing with aggressive tax planning strategies whose consequences may not immediately be apparent until many years later. Lowered tax liabilities of big business enterprises such as Oracle, Google and Amazon were traced to these "secret deals" with the US Internal Revenue Service. APAs are shielded from public scrutiny by taxpayer confidentiality laws. More applications for APAs have been filed by some of these firms (Browning).

Another concern vis-à-vis the adopted Transfer Pricing rules is that it has dropped the provisions on *thin capitalization*, the practice among MNCs of heavily funding branches or subsidiaries with interest-incurring loans from related parties, rather than with equity or share capital. The 2006 draft of the guidelines specified a debt-to-equity threshold ratio of 3:1, meaning that debts for financing businesses in the Philippines should not be more than three times the equity invested in order for interest to be deductible as business expenses. Interest payments on debts beyond this threshold would be considered as dividends and hence, non-deductible. Since the Philippines does not have statutory rules to counter thin capitalization, the "thin cap rule" in the original draft would have contributed "to further tighten all possible avenues that may be used by multinationals to shift income outside the Philippines without being taxed" (Du-Baladad).

Without thin capitalization rules, enterprises operating largely on debt rather than equity will remain, as debt financing is more profitable under Philippine investment and tax laws. Pre-tax profits can still be shifted as interest, and tax liabilities can be reduced by claiming interest as business costs. (Ibid) Further, for as long as interest rates do not appear unusually high, they will not be affected by the TP regulations.

The tax treatment of interest income earned on the loans or advances that MNCs typically extend to their subsidiaries also figures in how the tax authorities evaluate prices and transactions between affiliated and non-affiliated enterprises, and decide on adjustments based on the arm's length principle. There are no explicit provisions in the Philippines' TP guidelines unlike Malaysia's, for example, which stipulates the authority of the Inland Revenue Board to make such adjustments to reflect arm's length interest rates by imputing interest (Inland Revenue Board of Malaysia). The Supreme Court spoke on the matter in 2011 when it ruled against the petition of the CIR to charge Filinvest Development Corporation (FDC) for imputed interest on advances to its affiliates, based on the tax authority's lack of jurisdiction. The cash advances amounted to PhP2.56 billion in 1996 and PhP3.36 billion in 1997. The tax authority had assessed Filinvest for tax deficiencies on the income it would have earned from the arm's length interest rate on said advances (Commissioner of Internal Revenue vs. Filinvest Development Corporation). This put to rest earlier conflicting decisions of the Court of Tax Appeals and the Court of Appeals, the former having found for the CIR that

> theoretical interests can be imputed on the advances FDC extended to its affiliates in 1996 and 1997 considering that, for said purpose, FDC resorted to interest-bearing fund borrowings from commercial banks. Since considerable interest expenses were deducted by FDC when said funds were borrowed, the CIR theorizes that interest income should likewise be declared when the same funds were sourced for the advances FDC extended to its affiliates. (Ibid)

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The CIR stressed its authority "to allocate, distribute or apportion income or deductions between or among controlled organizations, trades or businesses even in the absence of fraud, since said power is intended 'to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses.'" However, the Supreme Court in its ruling stated that despite the broad powers of the CIR, they "[do] not include the power to impute '"theoretical interests"' to the controlled taxpayer's transactions". In other words, for income to be taxable "there must be proof of the actual or, at the very least, probable receipt or realization by the controlled taxpayer of the item of gross income sought to be distributed, apportioned or allocated by the CIR." (Ibid)

The SC affirmed the CA's decision which led, among others, to the cancellation of deficiency income taxes of PhP150 million and PhP5.7 million for 1996 and 1997, respectively. These were the amounts assessed on the taxable gain supposedly realized by Filinvest from transactions with its subsidiaries, including the arm's length interest rate and documentary stamp taxes that would have been imposed on its advances to affiliates. (Ibid)

The Civil Code provision that "no interest shall be due unless it has been expressly stipulated in writing" was also cited by the Supreme Court in its promulgation. Advances or loans, however, and other forms of "unremunerated transfers" have been observed to be often without written agreements. Bullen writes that "[t]he OECD Guidelines,…, clearly presuppose that controlled transactions can exist even in the absence of a written agreement…In factual substance, a transaction has taken place; the total absence of remuneration 'merely' implying that the transaction is extremely underpriced. Therefore, the

imputation of an arm's length remuneration to the transferor does not imply that a hypothetical transaction is introduced" (Bullen).

Some commentaries disagreeing with the SC's position on notional interest, noted that "[i]In one particular case, the US Second Circuit Court held that imputation of interest is consistent with the scope and purpose of the general transfer pricing law -- loans without interest are obviously not arm's length, since no unrelated party would lend such large sums without interest". The power of the CIR "is precisely to reflect the related parties' true taxable income" which, in effect, was curtailed by the SC decision against imputing interest on the tax-free advances of Filinvest (Carado II).

Whether these guidelines will eventually have an impact on reducing if not stopping IFFs through trade mispricing, still remains to be seen. It must be remembered that they only cover intra-group transactions of TNCs whose beneficial owners are unknown, and not the more wide-ranging practice of trade mispricing. The applicability of the arm's length principle in today's context of very large, complex TNC organizations; comparing intra-group prices/profit margins with individual enterprises engaged in similar transactions; and coming up with arm's length compliant transfer pricing methodologies for particular cases has been increasingly questioned.

Arguably, IFFs through trade misinvoicing and specifically corporate tax dodging through TP abuse have grown massively grown since the OECD's promotion of the arm's length methodology in the 60s. "In truth,…, the arm's length principle is very hard to implement, even with the best intentions…," the Tax Justice Network notes. "There is great scope for misunderstanding and for deliberate mispricing – providing much leeway for abuse, especially with regard to intellectual property such as patents, trademarks, and other proprietary information" (2014).

Double Taxation Avoidance Agreements as enabler

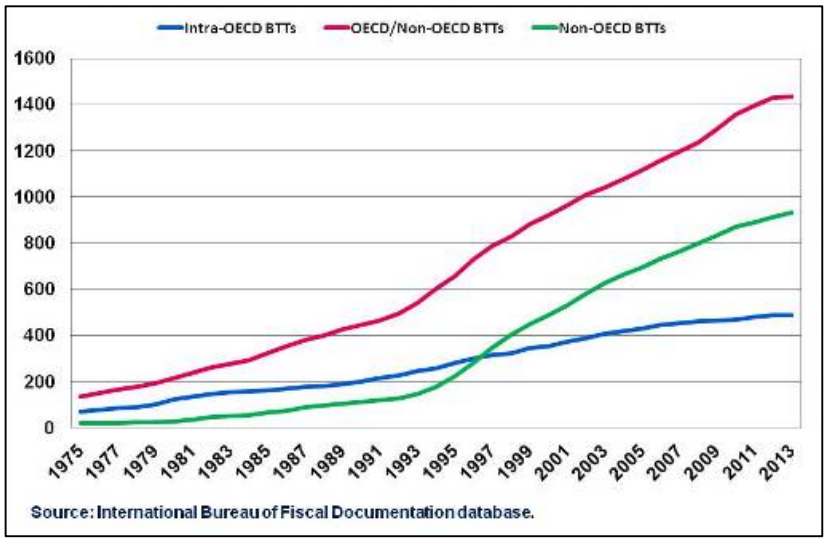
One of the measures promoted to prevent transfer mispricing and hence, the huge drain on public resources that go with it, is to enter into bilateral tax treaties or Double Taxation Avoidance Agreements (DTAAs/DTAs). This has been contested in various reports, among them a paper commissioned by the development agency of the Swiss government, which pointed out the inadequacy of the arm's length standard in most DTAs to stem transfer pricing abuse and concluded that "[a]gainst the backdrop of aggressive international tax competition, various types of DTA networks are abetting [base erosion and profit shifting]" (Bonami and Meyer-Nandi).

DTAs have in fact widened the scope for aggressive tax planning and tax avoidance, and in many ways, legitimizing IFFs from trade-misinvoicing. Tax treaties typically contain Most-Favored Nation (MFN) clauses which means that the lower tax rates offered to a treaty partner must be made available to other DTA partners with whom MFN treatment has been agreed upon. Since all of the Philippines' tax treaties contain MFN provisions, the lowest tax rates offered *under similar circumstances* can be availed of by all tax treaty partners. By manipulating transfer prices, a corporation can assign pre-tax net profits of its subsidiaries in the Philippines, for example, to other affiliates registered in tax havens or low tax countries that are tax treaty partners of the Philippines, thus reducing its worldwide tax exposure.

The earliest tax treaties on income and capital were signed in 1976 by the Philippine government with Belgium, France, the UK and the US, but they vary in the period of negotiations before coming into

force. More DTAs followed almost every year hence until 2009, but some of them have been renegotiated and amended as recent as 2013 such as the DTAs with Germany and France. As of this writing, the Philippines has entered into more than 40 DTAs including known financial secrecy jurisdictions such as Switzerland, Singapore, including six protocols amending tax treaties with Belgium, France, Japan, Norway, Thailand and Germany.

Graph 1: Number of Bilateral Tax Treaties, 1975-2013



Source: (Keen)

In the absence of unitary rules on taxation, DTA networks are likely to expand further. The ASEAN already committed to only two tax-related reforms in the ASEAN Economic Community Blueprint, one of which is to expand DTA networks in the region. This clearly stems from the notion that the potential attraction for FDIs outweighs the loss from the race-to-the-bottom for lower tax exposure that DTAs invite.

The RP-China DTA which entered into force in January 2002. A provision on Royalties provides for "10 per cent of the gross amount of royalties arising from the use of, or the right to use, any patent, trade mark, design or model, plan, secret formula or process, or from the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience" (Article 12 (2)b). In comparison, the RP-US DTA contains general guidelines that the tax imposed by the Philippines should be "the least of (i) 25 percent of the gross amount of the royalties, (ii) 15 percent of the gross amount of the royalties, where the royalties are paid by a corporation registered with the Philippine Board of Investments and engaged in preferred areas of activities, and (iii) the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State" (Article 13 (2)(b) (Bureau of Internal Revenue).

In November 2004, the BIR issued a circular explaining the implications of the RP-China tax treaty on the RP-US tax treaty. Specifically, it clarified that with China's entitlement to not more than 10% of the gross amount of royalties related to the activities mentioned, the same rate will be applied to transactions involving the RP-US DTA on the basis of its MFN clause.

The US has also claimed lower tax rates enjoyed by other Philippine DTA partners on the strength of the US-RP tax treaty's provision on MFN and non-discrimination. In the case of royalties, although US companies are to be taxed at 25% for the gross amount, and at 15% where the gross amount is included in the Board of Investments' preferred activities, the treaty provides as well for the "lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State". Pursuant to this MFN provision, a US firm was able to invoke and gain a BIR ruling (BIR Ruling No. 126-11, 15 April 2011) on its entitlement to the 10% tax on royalties under the RP-Czech Tax Treaty (Grant Thornton).

A DTA involved in setting precedent and changing the interpretation of national tax laws is the Philippines – Germany tax treaty. On October 21, 2003, Deutsche Bank AG Manila (DB Manila) withheld and remitted to the BIR, Php67,688,553, or the 15% Branch Profit Remittance Tax (BPRT) on its income for 2002 and previous taxable years' that was to be remitted to Deutsche Bank Germany (DB Germany). (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue).

However, two years after on October 4, 2005, DB Manila filed an administrative claim for a tax refund with the BIR. It also sought confirmation of being entitled to the preferential rate of 10% under the Philippines-Germany DTA. Receiving no action on this claim, it then filed on October 18, 2005 before the Second Division of the Court of Appeals a Petition for Review, with the intent of being refunded of more than Php22.5 million, or the difference between the regular rate and the tax treaty rate. (Ibid)

In August 2008, the Second Division of the Court of Tax Appeals dismissed the petition for lack of merit, thus denying DB Manila's petition for a tax refund. Among the reasons cited was the failure of DB Manila to formally invoke the treaty provisions by applying with the International Tax Affairs Division (ITAD) of the BIR; a previously decided case had also set legal precedent that a foreign corporation wishing to avail of preferential rates under tax treaties should invoke this claim[10] (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue).

Finally, in 2013, DB Manila elevated the case to the Supreme Court (First Division), and won a reversal of the CTA ruling from the high court. Completely disagreeing with the CTA, the SC supported DB Manila's claim and allowed the issuance of a tax credit certificate to refund the overpayment (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue). Further, in addition to affirming the doctrine of *pact sunt servanda*, it also averred that the "BIR must not impose additional requirements that would negate the availment of the reliefs provided for under international agreements" (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue 7).

The BIR was ordered by the SC to issue a TCC amounting to PhP22,562,851.17 to refund the difference between PhP67,688,553.51 (15% BPRT) DB Manila had paid and the PhP45,125,702.34 (I0% BPRT) it is entitled to under the tax treaty. In addition to the favorable decision gained by Germany from the SC ruling, the renegotiation of the Philippines-Germany DTA in September 2013 ushered in more tax benefits in terms of lesser source-based taxation and lower preferential rates.

[10] Mirant (Philippines) Operations Corporation (jonnerly: Southern Energy Asia-Pacific Operations [Phils.], Inc.) v. Commissioner of Internal Revenue

Table 7. The Philippines-Germany DTA – before and after renegotiations

Article	Tax rate under the previous DTA	New tax rate under the renegotiated DTA
Article 10 on Dividends	10%	5%
Article 11 on Interest	15%	10% (unless exempted)
Interest in connection with sale on credit of a commercial or scientific equipment and of an enterprise-to-enterprise sale on credit, if the recipient is also the beneficial owner thereof	Taxed in the source state at 10%	Taxable only in the residence state
Article 12 on Royalties	Taxed at either 15 percent or 10 percent, depending on the type of royalty.	10 percent, regardless of type

(A. Miguel)

Table 8. Outcomes of Other Tax Treaty Amendments

Philippines Tax Treaty with --	Outcomes
Japan	• Royalty payments made by a Philippine Economic Zone Authority (PEZA)- registered enterprise to a non-resident Japanese corporation are subject to the 25% preferential tax rate on the gross amount of the royalties under the RP-Japan Tax Treaty. However, starting January 1, 2009, these royalty payments shall be subject to the 10% preferential tax rate pursuant to the amendatory Protocol to the RP-Japan Tax Treaty. (http://www.proinfinity.com/acpapp/images/stories/tax_bulletin_march20111.pdf • The general rate applicable on dividends was reduced from 25% to 15%. • The ownership threshold for big shareholders to avail of the 10% tax rate was also reduced from 25% to 10% of voting shares or total shares issued. (Article 10) • The general rate applicable on interest was reduced from 15% to 10%. Previously, the 10% rate applied only on interest paid in respect of government securities, or bonds or debentures and those paid by BOI-registered firms. The distinction has been removed. (Article 11) http://www.punongbayan-araullo.com/pnawebsite/pnahome.nsf/section_docs/QH899H_12-12-08
New Zealand	• Rates on dividends was reduced from a split rate of 15% and 25% to a flat rate of 15%; on interest from 15% to 10%; and on royalties from a split rate of 15% and 25% to a flat rate of 15%. http://taxpolicy.ird.govt.nz/news/2008-10-16-nz-philippines-dta-updated
Thailand	• The maximum dividend withholding tax rate was reduced from 20% to 15%, while those directly holding at least 25% equity of the paying company would be entitled to a 10% rate (formerly 15% rate with direct equity ownership of 15% with additional conditions for Thai companies). • Branch profits remittance tax is also expressly included and capped at a maximum rate of 10%. • All interest payments from the Philippines will suffer withholding tax at the general rate of 15%. The lower (10%) rate on interest related to publicly issued bonds, debentures or similar obligations was eliminated. • Royalties will now be taxed at a uniform withholding tax rate of 15% regardless of the nature of the royalty payments or status of the licensee. http://www.pwc.com/ph/en/taxwise-or-otherwise/2013/more-treats-from-the-treaty-front.jhtml

Following the Supreme Court decision, several MNCs thereafter sought action from the BIR-ITAD or filed cases with the Court of Tax Appeals based on the same arguments that granted relief to DB Manila. The table below shows only a few of these tax refund claims where the DB Manila decision is reiterated.

Table 9. Examples of Tax Refund Claims Following the Supreme Court's Decision on the DB Manila case

Corporation Involved	DTA invoked	Decision	Refund (in PhP)
Deutsche Bank AG Manila Branch	Philippines-Germany	January 2014: SC rules with finality that TTRA is not a pre-requisite to enjoying the 10% final withholding tax rate. Since DB Manila followed the regular 15% FWT, it is entitled to a refund of the difference between the two rates (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue).	22,562,851.17
Lindberg Subic SA	Philippines-Denmark	Feb. 11, 2014: Lindberg Subic is entitled to the preferential tax rate of 10% under the treaty. Thus, it should not be held liable for deficiency FWT for taxable year 2007 on interest payments (Lindberg Subic, Inc. vs Commissioner of Internal Revenue).	1,438,549.22
Carrier Air Conditioning, Philippines, Inc. vs.	RP-US	March 17, 2015: Petitioner is entitled to refund or issuance of a TCC representing final tax withheld and remitted on the excess cash dividends paid by petitioner to Carrier BV on November 24, 2009 and December 22, 2009 (Carrier Air Conditioning Philippines, Inc.).	11,395,574.20
Masin-AES Pte Ltd – Philippine Branch	Philippines - Singapore	10 April 2014: The petitioner correctly applied the tax treaty rate of 15% (not the regular 20% rate) in computing the final withholding tax on the interest payments on foreign loans. Petitioner thus cannot be held liable for the assessed deficiency taxes and penalties (MASIN-AES Ltd. Pte. Philippine Branch)..	135,357,321.90
Kepco Ilijan Corporation	Philippines – Republic of Korea	10 July 2014: The income payments made to the non-resident foreign corporation Kepco, pursuant to a Management and Technical Services Agreement between them is exempt from final withholding tax. Petitioner (the domestic corporation) is thus not liable to pay any deficiency final withholding tax on the income payments made to KEPCO (Kepco Ilijan Corporation vs Commissioner of Internal Revenue).	65,378,965.93
Penn Philippines Inc.	Philippines-Spain	Feb. 12, 2014: CTA En Banc upheld the decision of the Court in Division cancelling the final withholding tax deficiency assessment corresponding to the management and consultancy fee paid to its parent company in Spain which has not attained permanent establishment status in the Philippines. Penn Philippines Inc. is thus exempt from 2002 FWT on management and consultancy fees paid to Dogi International Fabrics S.A.	15,068,187.73

Fiscal Incentives – eroding efforts to curb trade misinvoicing

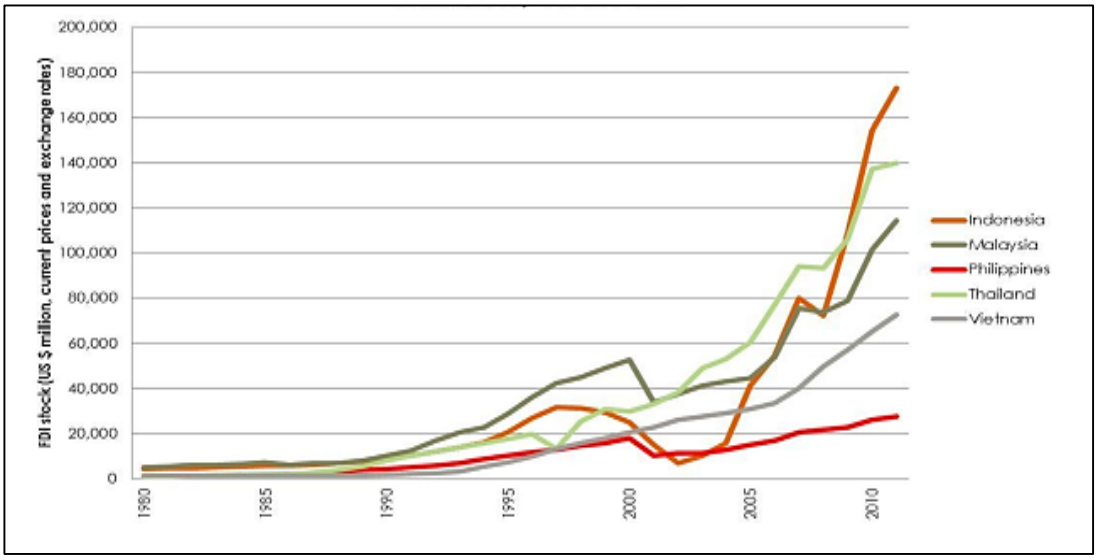
Government has been undertaking efforts to stem IFFs and tax dodging, such as issuing TP guidelines and participating actively in the UN Committee of Experts on International Cooperation on Tax Matters where, among others, protecting the tax base of developing countries is discussed and advocated. Yet, at the same time, it maintains as a matter of law and policy, a fiscal incentives system that it admits costs significant amounts of draining public revenues. Described recently as "tax evasion…with an official stamp", tax incentives like those offered by the Philippines, ironically also promotes the very issues around tax abusive behavior that government has internationally committed to combat.
Over 211 special laws provide tax incentives in the form of 4 to 8 years income tax holidays (ITHs), exemptions on duties, taxes, wharfage dues, export tax credits and additional deductions from taxable income (e.g., labor expenses). In addition, there are 14 Investment Promotion Agencies, each operating their own tax regime, with no publicly available data on the cost of incentives and do not have an incentives monitoring and evaluation system in place (Jacinto-Henares).

Of the types of incentives, ITHs are still the most preferred mode in the Philippines and other Asian countries because of simpler administration. However, they are also known to provide many opportunities for tax dodging. As currently designed, ITHs carry no sunset clauses and can thus be extended for indefinite periods. Companies take advantage of this extension through the "creative redesignation of existing instruments as new instruments" (also referred to as "double-dipping") and continue to operate tax-free (Senate Economic Planning Office). ITHs are tapped for tax avoidance not only across high-tax and low-tax countries but also domestically through transfer mispricing between affiliates of an MNC group. A company can partner one subsidiary that is not tax-exempt with one enjoying this incentive, and then artificially reduce prices of goods sold to the tax-exempt subsidiary which then sells these goods at the original (higher) cost. The difference adds to the company's profits.

The incentive of lower corporate income tax rates provides still another way to engage in tax avoidance, through transfer pricing, i.e. setting the price on goods and services for subsidiaries to calculate the profits that will be taxed in the country their respective countries of operation. By under-pricing the goods and services passing from affiliates in high-tax to those in low tax countries, corporations are able to shift profits to the lower tax jurisdiction.

Despite decades of offering increasingly liberal fiscal incentives, there is little to show in support of this claim, not to mention the damaging impacts on many foreign investment-funded projects. FDI stock has not risen at par with other countries in the region, prompting a renewed push for a law on the rationalization of fiscal incentives. These tax perks have also been found to be "redundant", meaning that for certain site-specific undertakings, the investment would have been made anyway without government giving up a significant portion of its potential income. (Ibid) Even with those sectors that reported positive growth, increased investments could not be strongly linked to more generous fiscal incentives.

Graph 2. FDI Stock, 1980-2011



Source: (Manasan and Parel)

An initial Tax Expenditures Report showed that almost 1.5% of GDP in 2011 or PhP144 billion was lost due to incentives, translating to 9.26% of government expenditures and 10.61% of government revenues. Of this figure, PhP45.6 billion or 31% was traced to ITHs and the special rate of 5% on gross income earned (GIE) beyond the ITH period. The DoF, however, clarified that only 29% of firms registered with Investment Promotion Agencies had been covered by the report (Cerda).

Actual revenues foregone from tax expenditures in 2012, as reported by the Department of Budget and Management, indicates an increase to nearly PhP160 billion, of which ITHs and the special rate of 5% on gross income earned[11] accounted for more than PhP87.3 billion. It should be noted that more than half of the 5,338 IPA-registered firms were not covered in this report (Department of Budget and Management)

[11] Granted to enterprises registered with the Philippine Economic Zone Authority for as long as the life of their investments.

Table 10. Investment Tax Expenditures, By Investment Promotion Agency, 2012-2015
(In thousand pesos)

Investment Promotion Agency	Income Tax Holiday and Special Rate[a/]			Total tax expenditures
	Number of Firms that Filed ITR through e-FPS[b/]	Tax Expenditure	Customs Duties	
Board of Investments	585	24,226,385	41,398	24,267,783
Philippine Economic Zone Authority	1,390	61,069,729	61,108,686	129,178,415
Authority of the Freeport Area of Bataan	22	103,682	199,475	302,157
Cagayan Economic Zone Authority	18	45,130	12,519	57,649
Clark Freeport Zone	91	991,792	1,132,043	2,123,835
Poro Point Freeport Zone	3	67,837	486	68,323
Subic Bay Freeport Zone	364	772,812	3,114,444	3,887,256
Total	2,473	87,277,367	72,608,051	159,885,418

Sources cited by DBM: Bureau of Internal Revenue, Bureau of Customs, Department of Finance staff calculations
a/ As declared in the annual corporate income tax return (BIR form 1702) for FY 2012 and the Electronic to Mobile Customs system. Amounts include the income tax holiday (ITH), the special rate of 5% on gross income earned (GIE) and customs duties.
b/ Total number of registered firms as of 2012 is 5,338 as submitted by the investment promotions agencies to the Department of Finance. However, the total number of firms used for Poro Point Freeport Zone and Board of Investment is as of 2008 pending submission of an updated data.

Source: (Department of Budget and Management)

Box 1. Philippine Economic Zone Authority (PEZA)

Operating Economic Zones

- 21 Agro-Industrial Economic Zone
- 216 IT Parks and Centers
- 68 Manufacturing Economic Zone
- 2 Medical Tourism Zone
- 19 Tourism Economic Zone

Economic Zones Being Developed

- 5 Agro-Industrial Economic Zone
- 87 IT Parks and Centers
- 28 Manufacturing Economic Zone
- 6 Tourism Economic Zone

PEZA's Fiscal Incentives

PEZA alone extends the following fiscal incentives to its registered enterprises:

- Income Tax Holiday (ITH) – 100% exemption from corporate income tax
  - 4 years ITH for Non-pioneer Project
  - 6 years ITH for Pioneer Project
- Upon expiry of the Income Tax Holiday - 5% Special Tax on Gross Income and exemption from all national and local taxes
- Tax and duty free importation of raw materials, capital equipment, machineries and spare parts.
- Exemption from wharfage dues and export tax, impost or fees
- VAT zero-rating of local purchases subject to compliance with BIR and PEZA requirements
- Exemption from payment of any and all local government imposts, fees, licenses or taxes. While under Income

Tax Holiday, no exemption from real estate tax, but machineries installed and operated in the economic zone for manufacturing, processing or for industrial purposes shall be exempt from real estate taxes for the first three (3) years of operation of such machineries. Production equipment not attached to real estate shall be exempt from real property taxes

- Exemption from expanded withholding tax

(Philippine Economic Zone Authority) * as of May 31, 2015

In December 2015, President Benigno Aquino III signed into law Republic Act 10708 or the "Tax Incentives Management and Transparency" Act. The law is supposed to "promote fiscal accountability and transparency in the grant and management of tax incentives by developing means to measure the government's fiscal exposure on these grants and to enable the government to monitor, review and analyze the economic impact thereof and thereby optimize the social benefit of such incentives (Corrales)".

Beyond this mandate, the question of recovering revenues foregone from tax incentives remains a shady area. One indication are the reassurances to the private sector that the measure "will not appropriate tax incentives availed…" and that it "[should] not be construed to diminish or limit, in whatever manner, the amount of incentives that IPAs may grant, pursuant to their charters and existing laws (Rappler, 8 June 2015)." The coalition of Philippine Business Groups and Joint Foreign Chambers (PBG-JFC) had earlier pushed for several amendments which included highlighting the state's policy to attract foreign investments, deleting BIR's requirement for electronic filing of ITR, lower penalties for improperly filing incentives claims and defining BIR's role in relation to IPAs and the Board of Investments in light of Supreme Court decisions on the exclusive jurisdiction of these bodies over investment incentives (Rappler, 31 May 2015). The Implementing Rules and Regulations will be drafted within 60 days from the law's adoption.

One of the most generously provided industries in terms of tax incentives is the mining industry. Marcopper Mining Corp. (MMC), the mine that caused what many still recognize as the worst environmental disaster to date, enjoyed several fiscal incentives during the height of its operation during the Marcos administration. It was closed down by the government but it left behind a biologically dead river and more than a billion pesos in real property taxes owed to the local government of Marinduque, a province in Southern Luzon. (See Box 4)

Box 2. Marcopper's Tax Obligations—
inflicting continuing harm on the people of Marinduque

In 1996, the tailings dam of the Marcopper Mining Corporation (Marcopper) in Marinduque collapsed, causing the most destructive socio-economic and environmental disasters in Philippine history. Some 1.6 million cubic meters of toxic wastes poured into the Makulapnit - Boac river system, buried the village of Hinapulan and displaced thousands of families. Many more lost the food, water and livelihoods resources that the river supplied.

Marcopper was 39.9%-owned by one of Canada's largest gold producers Placer Dome, Inc. from 1964 to 1997. The mining company was acquired in 2006 by another Canadian mining company and the largest gold mining company in the world, Barrick Gold Corporation.

It is now almost two decades since the Philippine government shut down Marcopper but it continues to inflict harm on the people of Marinduque. On top of its unmet commitments for compensation, it also left behind millions of unpaid real property taxes.

Based on the 2013 Report on Marinduque province of the Commission on Audit (COA), the Real Property Tax delinquency of Marcopper totaling PhP19,253,315.36 has not yet been collected despite the Supreme Court's favorable decision on the case in 2009. COA recommended that the Provincial Treasurer "serve the Statement of Account to MMC [Marcopper] through its subsidiary MR Holdings, Ltd., demanding full payment…."

The SC decision, however, concerns only the unpaid taxes for the site occupied by the siltation dam and decant system, and a fraction of its total tax delinquencies for properties in other parts of the province. More than a billion pesos was reportedly owed in RPT as of the 2nd quarter of 2006 according to records of the Marinduque Provincial Treasurer (Marinduque Council for Environmental Concerns).

Marcopper's Tax Delinquencies

Municipality	Period	Real Property Taxes	
		PhP	US$
Sta. Cruz	1980 - 2006, 2nd Quarter	1,013,101,529.51	18,908,203.24
Torrijos	1983 – 1996, 2nd Quarter	11,164,686.80	208,374.15
Mogpog	1999 – 2006, 2nd Quarter	1,194,977.89	22,302.69
Boac	1985 – 2006, 2nd Quarter	23,163,602.60	432,318.08
	TOTAL	**PhP1,048,624,496.80**	**$19,571,198.16**

*($1=PhP53.58, Bangko Sentral ng Pilipinas)

Two years before the disaster, Marcopper was given an Assessment Notice for real property taxes (RPT) due on its properties that included the Siltation Dam and Decant System in Brgy. La Mesa, Sta. Cruz, Marinduque.

Marcopper questioned the assessment by filing an appeal for review with the Local Board of Assessment Appeals (LBAA). Seeking seek RPT exemption on its siltation dam and decant tower system at the mine site in Sta. Cruz, Marinduque, the mining firm invoked Sec. 234 (e) of the Local Government Code (Republic Act 7160) which includes in its list of possible exemptions, "Machinery and equipment used for pollution control and environmental protection". In other words, Marcopper argued that the Siltation Dam and Decant System are specialized facilities and that the property they occupy should be exempt from RPT.

The LBAA dismissed the appeal in a decision dated November 10, 1995. It rejected Marcopper's argument, saying that the specialized facilities erected by Marcopper on said property were in fact "improvements on the principal real property" and therefore, subject to tax. In a second attempt, Marcopper sought relief from the Central Board of Assessment Appeals (CBAA), and was again rejected. In its decision dated December 21, 1998, the CBAA agreed with the LBAA decision. It said that the property in question was "neither machinery nor equipment but a permanent improvement", and is *not* tax exempt under the LGC. The Code also includes a definition of machinery and equipment that does not apply to the siltation dam and decant system. A third attempt by Marcopper was to file a Motion for Partial Reconsideration but this was also denied by the CBAA in a decision dated July 27, 2000.

Finally, Marcopper brought its petition before the Court of Appeals (CA) and won a favorable decision on May 30, 2005. The CA, overturning the CBAA rulings, upheld MMC's assertion and directed the Municipal Treasurer of Sta. Cruz, Marinduque to "refund the tax payments made by petitioner under protest, or in lieu thereof, to credit said payments in favor of petitioner for any taxes it will be required to pay in the future". According to the CA, the pertinent provision on machinery in the LGC is "broad enough to include a machinery, instrument, apparatus or device consisting of parts which, functioning together, allows a person to perform a task more efficiently, such as the subject property…." Further, it reasoned that said "machinery" or "pollution control device" is part and parcel of Marcopper's operations to protect the environment and clean the waste waters before they are released in the Mogpog and Boac Rivers. On the finding of the LBAA and CBAA that the facility had been damaged in a typhoon and were non-operational since 1993, the CA maintained that this "does not remove it from the purview of the…RA 7160.

The CA denied the Motion for Reconsideration filed by the Marinduque LGU, prompting the elevation of the case before the Supreme Court with the CA and Marcopper named as respondents. The Supreme Court (3rd Division) eventually rejected the claim for real property tax exemption on the siltation dam and decant facility. It also reversed and set aside the 2005 decision of the Court of Appeals granting the tax exemption and ordering the Municipal Government to refund Marcopper.

The SC, in sum, ruled that "the CA committed grave abuse of discretion in ignoring irrefutable evidence that the subject property is not a machinery used for pollution control, but a structure adhering to the soil and intended for pollution control, but has not been actually applied for that purpose during the period under assessment" It also declared the Tax Assessment Notice valid under the Local Government Code.

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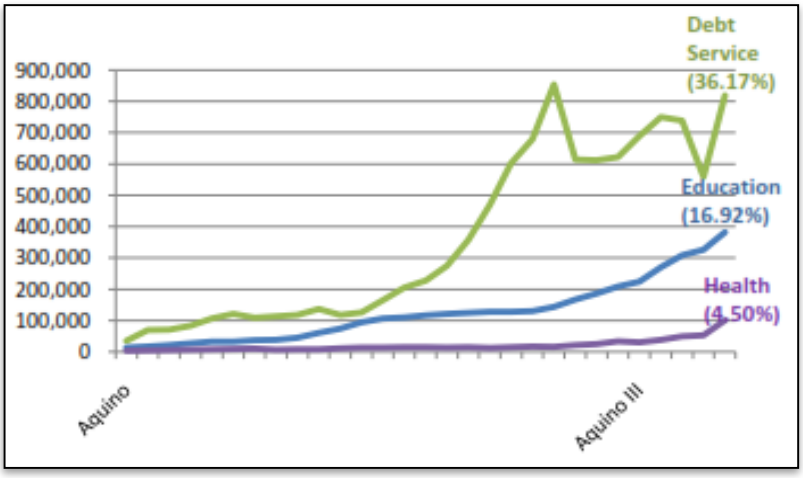
Unmet basic needs, unfulfilled human rights

The sizable amounts of domestic resources lost to IFFs starkly contrasts with long unmet needs for essential social services that are critical to enjoying a secure, healthy and decent life. An oft-cited reason for low public services budgets and poor delivery is the lack of funds, which also lays the basis for government to go into privatization, depend on aid and resort to increased borrowings.

The budget for education, for example, has continuously declined, from a high of 30.78% of the national budget in the 50s to less 14.97% as of 2013. Education spending from the post-Marcos years up to the present is yet to reach the 6% of GNP UNESCO Delors standard (Freedom from Debt Coalition). Health costs are still largely out-of-pocket (57% of expenditures in 2007), and expenditures have persisted until the present below the World Health Organization (WHO) recommendation of 5% share of GDP. More than 50% of public hospitals as of 2009 were characterized as "comparable only to infirmaries" and there were only 1.04 beds per 1,000 population against WHO's standard of 20. The maternal mortality rate slightly rose to 163 per 100,000-population, thus missing the MDG target of 52 by a wide margin (Department of Health).

Graph 2. Debt Service and Spending for Education and Health from Corazon Aquino to Benigno Aquino III (share in the National Budget)



(Freedom from Debt Coalition)

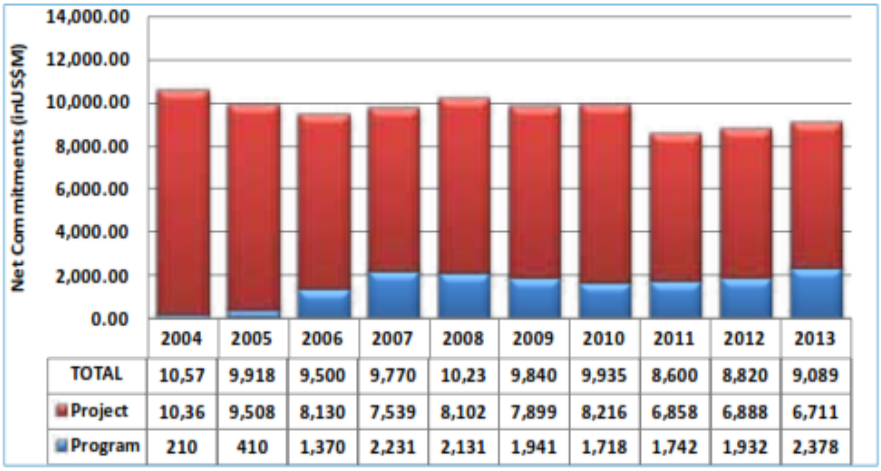
Table 11. Government Spending for 2015

	In Billion PhP	% of PhP2.6 Trillion Budget
Debt Service	**763.249**	**26.29%**
Interest Payments	372.863	14.30%
Principal Amortization	390.386	14.98%
Education, Culture and Manpower Development	450.207	17.28%
Health	103.147	3.96%
Natural Resources and the Environment	23.642	1.03%
Agriculture and Agrarian Reform	109.273	4.19%
Social Security, Welfare and Employment	261.370	10.02%
Housing and Community Development	4.396	0.17%

Source: 2015 Budget of Expenditures and Sources of Financing cited in (Freedom from Debt Coalition)

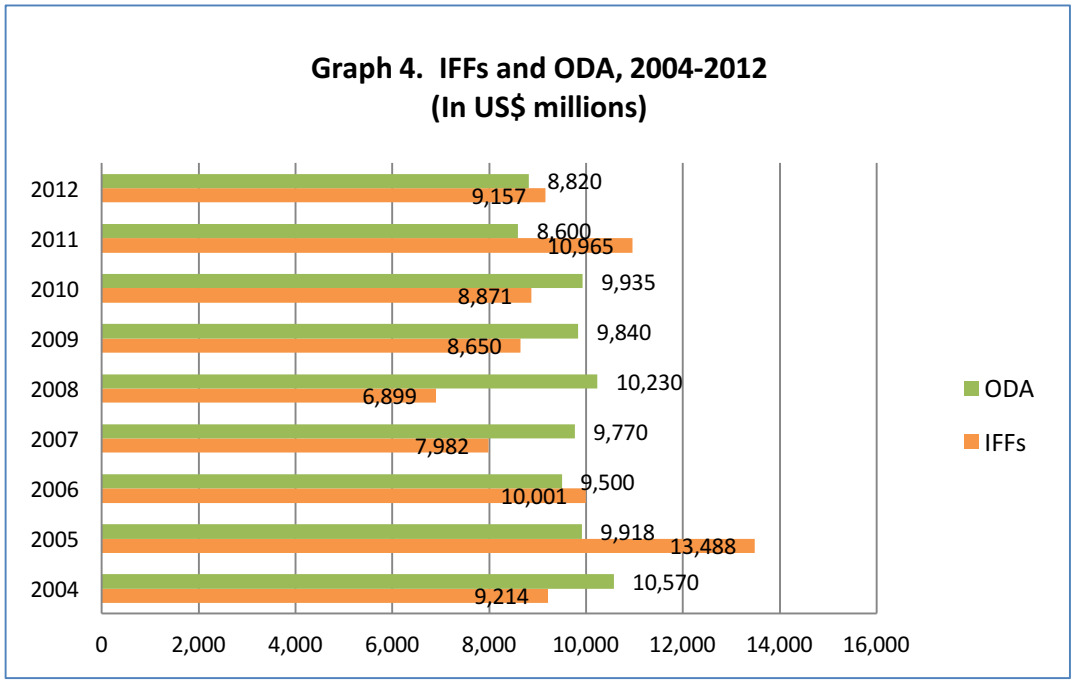
Borrowings more than doubled from PhP2.4 billion in 2001 to PhP5.74 billion in 2014 (Bureau of the Treasury). This means that debt service payments – an expenditure that by law is automatically appropriated before any other item -- also grew bigger (see Table 10). Official Development Assistance is also tapped to fund projects and programs as vital as flood control, potable water supply and sanitation, watershed conservation, electrification and women's reproductive health, among others. Although the grant element is substantial (almost 60%), ODA resources are loans nonetheless that will be paid from the public purse. Graph 4 shows several years where the levels of IFFs significantly outpace ODA.

Graph 3. Magnitude of ODA Portfolio, 2004-2013



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
TOTAL	10,57	9,918	9,500	9,770	10,23	9,840	9,935	8,600	8,820	9,089
Project	10,36	9,508	8,130	7,539	8,102	7,899	8,216	6,858	6,888	6,711
Program	210	410	1,370	2,231	2,131	1,941	1,718	1,742	1,932	2,378

(National Economic Development Authority)



Sources: (National Economic Development Authority 5) and (Kar and Spanjers, Illicit Financial Flows from Developing Countries: 2003-2012)

Conclusion and immediate recommendations

The issue of illicit financial flows has gained much public importance in recent years with the publication of newer, comprehensive data, at the same time that crucial questions are being raised on where to source funds for a post-2015 sustainable development agenda. However, capital flight, and more expansively, illicit financial flows, is not a new phenomenon for developing countries such as the Philippines where the draining of both actual and potential resources has historically been a major feature of contexts dominated by the interests of socio-economic and political elites in government and big business pursuing a neoliberal agenda.

Since the post-Marcos years, the Philippines' IFFs have risen to count among the highest in the world today. There are strong connections to be made with the country's increasing deregulation and liberalization of finance and trade from the 1990s onwards, and some of the attendant measures taken by government to attract foreign investments and achieve "greater global competitiveness", has been the enabling context for driver of continuing, rising IFFs.

Arguably, capital flight as an outlet of illegal proceeds from graft and corruption persists in the Philippines. However, trade misinvoicing and transfer pricing abuse as a major mechanism in eroding domestic resources through tax dodging and profit shifting appears to have currently overrun other IFF drivers. The trend directly implicates multinational corporations whose trading activity is known as largely taking place within their own wide-ranging networks of subsidiaries. Necessarily, the government's role in according preferential treatment to MNCs through the country's bilateral tax treaties and generous incentives packages, among others, and its culpability in enabling IFFs, is implicated as well.

In the face of continuing deprivation of the most basic needs such as health, education, water and sanitation for millions of Filipinos, the siphoning of public resources by private, profit-motivated interests raises critical issues of social justice and human rights. It denies and violates the sovereign right of peoples to raise and use revenues for the immediate improvement of their lives and for their long-term development and well-being. It justifies the privatization of social services and the deepening of debt which have proven to exacerbate already difficult lives led by the disadvantaged and the impoverished.

As major causes of the country's IFFs, trade misinvoicing and transfer mispricing demand close attention and immediate action. But this heavy drain on our resources cannot be stemmed in a piecemeal manner but should begin from a diligent examination of the structural causes and key actors that allow it to continue. Applying a fiscal and tax justice perspective in reviewing and transforming policy is a crucial step in this direction.

As basic first steps, we recommend the following actions:

- Undertake a comprehensive, participatory review – jointly and independently -- by policy-makers and civil society of --
  - tax laws and policies, including tax expenditures and transfer pricing guidelines
  - free trade agreements, bilateral investment treaties and double taxation avoidance agreements

to ensure that public revenues are justly raised, diligently safeguarded and used in line with the Philippine government's national and international commitments to human rights, social justice and gender equality. This will lay the basis for repealing or amending laws and policies, and renegotiating or cancelling treaties found onerous to the immediate and long term interests of the Filipino people.

- Pass the Freedom of Information Bill, with a view particularly towards enforcing transparency standards on corporations and wealthy individuals and determining their fair share of the tax burden.

- Conduct a rigorous, public audit of tax compliance of corporations, giving close attention to TNCs in the extractives industry.

- Along with these measures relating to public revenues, institute and conduct transparent and participatory budget processes and a spending policy aimed at realizing social and environmental justice, the enjoyment of human rights and people-centered development.

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