The Philippines continues to be implicated in heavy illicit financial flows (IFFs), both inbound and outbound, which have been traced largely to the enduring practice of trade mispricing or the under/over-reporting of trade transactions.

Global Financial Integrity (GFI) studies consistently rank the Philippines among the top 20 countries with the highest IFFs worldwide. Although country contexts vary, the Philippines’ IFFs indicates the large amount of lost financial resources that could have financed its many development needs. In the last 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 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.)

An earlier GFI study focused on the Philippines covering the years 1960-2011 concluded that over this 52-year span, the country lost around $410.5 billion in illicit flows -- $132.9 billion outbound and $277.6 billion inbound. Of the illicit outflows from export under-invoicing and import over-invoicing, $95.2 billion or about 72% was due to the mispricing of trade (Kar and LeBlanc 10). It also observed from estimates that firms operating in the country were “consistently, and increasingly under-reporting the value of both their imports and export, suggesting efforts to evade taxes” (308).

A particular aspect of the Philippines’ IFFs through trade mispricing lies in illicit inflows through the under-invoicing of imports or technical smuggling and the over-invoicing of exports. These flows amounted to $187 million or more than double the value of illicit outflows for the period 2003-2012. This suggests that while under-pricing imports would result in higher income tax liabilities from the lowering of business costs, there is more profit to be gained overall from skirting customs duties and VAT income. Moreover, as Kar and LeBlanc point out, “[w]hen such underpricing of imports occurs, there is not always a comparable means of completing
payment for the underpriced imports, usually by overpricing some other imports, underpricing exports, or via alternative money laundering schemes (Illicit Financial Flows to and from the Philippines: A Study in Dynamic Simulation, 1960-2011 12-13).

Applying the effective tariff rates to under-invoiced imports and exports, 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)

Finally adopting its own Transfer Pricing Guidelines in 2013, the Philippine government has formally recognized how the transfer pricing can be exploited by corporations as a channel for illicit financial flows. Transfer pricing is a mechanism by which enterprise such as a multinational company sets the prices of goods and services transacted among its affiliates. Fair business practice demands that this be conducted at arm’s length, as if the affiliates are not related at all. In reality, corporations use this mechanism to report their incomes in low and no-tax jurisdictions proliferate, thus reducing taxes and maximizing profits.

The TP guidelines are supposed to bring the OECD’s arm’s length principle to bear on already existing powers of the national revenue authority (under the Tax Code) to allocate income or deductions of enterprises if it is established that such actions are needed, to determine taxable income. The tax authority can thus make transfer pricing adjustments based on her review “to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions” (Ibid).

However, the regulations are likely to meet many challenges. For one, 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 Bureau of Internal Revenue (BIR) can validate the data that taxpayers will provide to prove arms’ length in their dealings or comparability of independent transactions (Pricewaterhouse Coopers). The Revenue Commissioner’s authority is also limited and does not include the authority “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” (Kho-Sy 62). Past rulings on transfer pricing disputes indicate some of the hurdles 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 (CTA) in 1999 seeking cancellation and withdrawal of BIR’s assessment notices for taxable year 1994, for Congested public hospitals are a common sight in the Philippines. Health budgets have consistently been below widely accepted standards and medical expenses remain largely out-of-pocket.

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1 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.
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)

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)

IFFs directly implicate multinational corporations but also the Philippine government which facilitates the conditions for this to occur. A more expansive meaning of IFFs should include licit but illegitimate and iniquitous financial flows as well which are enabled, among others by tax covenants, free trade agreements, investment treaties and generous incentives packages.

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. While trade mispricing and specifically transfer mispricing place the proximate responsibility for IFFs on corporations and government policy, this heavy drain on our resources cannot be stemmed in a piecemeal manner but should begin from a diligent examination of the historical and structural causes, as well as the 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. #