RATIONALIZATION OF AIRLINE TAX REGIME
POSITION PAPER
BOARD OF AIRLINE REPRESENTATIVES ("BAR")[1]

1 BACKGROUND

Foreign air carriers are currently levied with the 3% Common Carriers Tax (CCT)[2] and 2.5% (or 1.5% under bilateral tax treaties) Gross Philippine Billings Taxes (GPBT)[3] under the 1997 National Internal Revenue Code (NIRC), as amended. According to the Department of Finance (DOF), the CCT is a business tax while the GPBT is an income tax.

Per Revenue Regulation (RR) No. 15-2002, these two taxes have always been computed using only one tax base, that is, the flown revenues from ticket, cargo and excess baggage carried ex- Philippines up to the *final destination* regardless of the country of sale and/or issuance. These two taxes amounted to Php 2.5 Billion according to the Department of Finance (DOF).

Last June 22, 2011, the Bureau of Internal Revenue (BIR) issued RR No. 11-2011 as an amendment of the tax base for the CCT. The new RR changes the tax base for the CCT computations from average fares to actual direct billings and expands the coverage of gross revenues to include rentals, penalties, deposits applied as payments, advance payments, and other service charges and fees actually or constructively received during the taxable quarter. Both the DOF and the BIR argue that the change of tax base serves as "compromise" that will provide relief to the industry.

2 ISSUE

Our main issue is the <u>***lack of level playing field in international operations where foreign air carriers compete with Philippine air carriers.***</u>

The Philippine carriers are not subject to the same tax regime ***in international routes*** where they operate and compete with foreign air carriers. <u>This discriminatory practice and not our inability to pass the indirect tax burden to the passengers as alleged by the DOF and the BIR is the main reason why we have decided to elevate the matter to the Office of the President and to the Philippine Congress.</u> Foreign air

[1] Asiana Airlines, Cathay Pacific, Cebu Pacific, China Airlines, China Southern Airlines, Continental Micronesia Airlines, Emirates, Etihad Airways, Eva Air Airways, Federal Express Corp., Gulf Air, Japan Airlines, Air France – KLM Royal Dutch Airlines, Korean Air, Kuwait Airways Corp., Malaysia Airlines, Delta Airlines, Philippine Airlines, Qantas Airlines, Qatar Airways, Royal Brunei Airlines, Singapore Airlines, Swiss International Airlines, Saudi Arabian Airlines, Thai International Airways

[2] Section 118 of the NIRC, otherwise known as Republic Act No. 8424, as amended.

[3] Section 28(A)3 of the NIRC, as amended.

carriers, particularly long haul, have pulled out of the Manila market in the past 10 years as a result of these taxes. The continued imposition of these taxes amidst the liberalization of more Asian aviation markets gives prominence to the Philippines, given the quality of airport infrastructure, as a very expensive destination for airline investments.

These taxes do not create a level playing field for foreign air carriers operating in the Philippines in three ways:

(1) Philippine air carriers are subject to home country tax obligations. For income taxes, they pay either the regular corporate income tax rate of 30% on their taxable income or to the 2% Minimum Corporate Income Tax on their gross income (i.e., gross revenue less direct costs), whichever is higher. Their domestic tickets are subject to the 12% value-added tax (VAT).

In the same manner, foreign air carriers are subject to home country tax obligations. But the taxes applied on foreign air carriers create an unfair cost advantage in routes where they compete with Philippine international air carriers. **Thus, these taxes should not be treated alongside the home tax obligations of Philippine air carriers.**

In the case of income taxes, foreign air carriers pay the GPBT *regardless of whether their Philippine operations are profitable or not*. On the other hand, Philippine air carriers are exempted from paying income taxes in other countries. Even if they *may* be subject to corporate income taxes in some foreign countries where they operate as reported by the DOF, their tax dues are based on profitability of operations or deemed profit margins as internationally practiced (and not simply levied as a fixed percentage of flown revenues from ticket, cargo and excess baggage carried up to the final destination regardless of the country of sale and/or issuance from the foreign city where they operate).

Being based on a gross amount, foreign air carriers operating at a loss in the Philippines are still subject to Philippine tax at the effective rate of 2.5%, or 1.5% (for those with tax treaties). In other words, the GPBT has nothing in common with income tax as internationally practiced since it is a fixed percentage which foreign air carriers have to pay irrespective of the financial results of their Philippine operations. Thus, the GPB tax regime, even at 1.5 percent, is not “considerably preferential” as argued by the DOF.

(2) Foreign air carriers are subject to the 3% CCT while their Philippine counterparts enjoy VAT zero-rating for *international operations*. Again, the CCT should not be treated alongside the VAT imposed on the domestic operations of Philippine carriers.

The DOF reported that PAL has no domestic flights in China so the business tax imposed is for outbound international flights, and in this case, the tax is similar to Philippines' CCT. On top of this, Shanghai charges River and Road Maintenance tax computed as a percentage of flown revenues generated in Shanghai. Beijing charges local tax computed as a percentage of flown revenues generated in Beijing.

Foreign air carriers are not subject to "percentage taxes" that are believed to be levied on Philippine carriers in destinations such as China and said to be the same as the CCT. In Beijing, for example, Philippine carriers are said to be charged with the 4 percent state business tax. However, foreign air carriers with operations in Beijing are not subject to such tax. Hence, there is flexibility for the Philippine government to negotiate for such exemption for Philippine carriers, if indeed such tax is imposed. This state (local) tax of Beijing cannot be compared with the Philippine CCT which is a national tax.

(3) The change of tax base for the CCT under the new RR No. 11-2011[4] still does not level the playing field, contrary to statements by the DOF and the BIR.

a) When these taxes are passed on to the passengers, they will increase fares and make foreign air carriers very uncompetitive relative to their Philippine counterparts in the international routes where they compete. Tickets purchased by passengers buying international tickets from Philippine air carriers are VAT zero-rated whereas those purchased from foreign air carriers will be charged with 3% CCT. This new practice will only heighten the discrimination in tax treatment.

[4] Under the old RR No. 15-2002, both the CCT and GPBT are levied on only one tax base. This tax regime therefore treats "business taxes" on equal level as "income taxes" for foreign air carriers. Section 28 (A)(3) of the NIRC, as amended by Republic Act (RA) 9337 defines GPB to "*refer to the amount of gross revenue derived from carriage of persons, excess baggage, cargo and mail originating from the Philippines in a continuous and uninterrupted flight, irrespective of the place of sale or issue and the place of payment of the ticket or passage document: Provided, That tickets revalidated, exchanged and/or indorsed to another international airline form part of the Gross Philippine Billings if the passenger boards a plane in a port or point in the Philippines: Provided, further, That for a flight which originates from the Philippines, but transshipment of passenger takes place at any port outside the Philippines on another airline, only the aliquot portion of the cost of the ticket corresponding to the leg flown from the Philippines to the point of transshipment shall form part of Gross Philippine Billings.*" The NIRC did not provide any definition for the CCT but the BIR, through its own interpretation, defined the CCT's tax base to be the same as that of the GPBT in its RR No. 15-2002. The DOF claims that the new RR No. 11-2011 makes the argument on double taxation moot since the tax base for the CCT has been changed. But this RR No. 11-2011 still fails to address the issue of lack of level playing field.

b) The administrative measure will only make the tax computations more complicated and burdensome given the range of itineraries, the various places of issuance and payment of tickets, the complexity of airline pricing and the differences in purchase prices by country, distribution channel and individual distributor within any given channel. How will distributors' margins overseas be accounted for in the computations?

c) The percentage tax is computed based on the one way allocated airfare of the portion of the ticket originating in the Philippines. Each industry player would have its own distinct proprietary methodology to determine segment or combinations of segment values; the issue is complex.

d) Deposits or advance payment should not be subjected to CCT as these are either return to customer/agents or applied to tickets as partial/full payment for airfare and other charges/taxes if any. In the case of the latter even taxes due to Phil/other countries will be subjected to CCT including the cost of ticket where the partial/full payment was applied resulting on double taxation.

3 IMPLICATIONS OF STATUS QUO

This current tax policy on foreign air carriers, that currently provide about 50 percent of total incoming seat capacity per week, is not aligned with the vision, strategies and targets of both the executive and legislative branches of government to generate employment and reduce poverty in the country through tourism and trade development The government seeks to maximize the Philippine's export potentials in industries such as health tourism, retirement, logistics, creative industries, business process outsourcing (BPO), high yield backroom operations and regional headquarters. These industries require direct access and easy entry and exit, which unfortunately, the Philippines cannot offer to the global markets.

These industries will not benefit from loss of capacity to neighbouring countries. Location can be a vital component in trade and foreign investment choices, having an additional enroute transfer in the Middle East or a neighbouring country will not enhance Philippine competitiveness. Attracting additional services, particularly by full service carriers with global networks, whether to NAIA or Clark will not be facilitated through the CCT and GPBT.

Poor international air connectivity The application of the GPBT and the CCT truly makes it difficult for foreign air carriers doing business in the Philippines to become commercially viable in order to maintain and even expand operations.

In the past decade, the Philippines witnessed the exit of foreign air carriers (i.e. Air France, Alitalia, British Airways, Egypt Air, Swissair/Swiss International Airlines, United and Vietnam Airlines). The list of airlines above is primarily long haul in nature and leaves Manila with service from only one European carrier. One can easily speculate that the list will grow given the advent of effective competition from Tokyo and China for European and U.S. carrier capacity; both China and Tokyo are liberalizing their air services agreements and investing heavily in infrastructure to provide the necessary airport slots.

Air transportation is a capital intensive industry with very thin margins of 1-2% and non profitable lines are under heavy pressure to be shifted to profitable routes, given the 4.5% to 5.5% taxes on gross amounts. Foreign air carriers cannot and do not charge income and business taxes on the tickets of passengers. They do not reclaim them from the passengers who fly from different places and pay different fares for the different classes. Clearly, the burden is on the foreign air carriers. If passed on to the passengers on a per ticket basis, these taxes will only increase fares and make foreign carriers very uncompetitive relative to the Philippine carriers. In turn, foreign carriers will be forced to move capacity to neighboring countries providing financial incentives for them to enter their markets. Their additional capacity will lead to greater competition and better fares, thus stimulating traffic growth and ultimately generating jobs and income at the expense of the Philippines.

Indeed, the exit of foreign air carriers from the Philippines due to these CCT and GPB (and other disincentives[5]), has been in stark contrast to the growth in services experienced by neighboring Asian countries that either incent or do not tax foreign carriers. The Philippines' passenger traffic has hardly grown in the past decade while the rest of Southeast Asia continues to experience double-digit growth. Foreign air carriers with operations in the Philippines have been adding capacity to almost every Asian destination, except to the Philippines. They are responding to the growth in international travel, including millions of Europeans travelling to the Far East, except to the Philippines. Today, KLM is the only European carrier left providing direct service between the Philippines and Europe. It will stop these direct flights by first quarter of 2012 as a result of these taxes.

The heretofore restricted markets of China and Japan are liberalizing access and have invested in infrastructure to attract foreign carriers. Carriers with extensive global networks have already left the Philippines, shifting capacity to benefit of neighboring countries' tourism and trade. Direct flights between Philippines and Europe have declined significantly from 22 in 2001 to 7 in 2010 and to zero by 2012.

[5] Apart from the GPB and CCT, foreign air carriers are also disincentived by (1) payments for overtime fees, meals and transportation allowances of Customs, Immigration and Quarantine personnel are charged to international airlines, (2) 15 percent branch remittance taxes on their excess cash (which do not represent branch profits), (3) non-compliance by the government on reciprocal provisions for excise fuel tax exemption if member airlines flying to secondary gateways outside of Manila (e.g. Palawan, Iloilo) source fuel from companies that do not bonded warehouses (as experienced by member airlines in Cebu).

U.S. carriers operate only 16 flights per week, compared to 24 in 2001. The Philippines is served by only 360 incoming flights per week by foreign carriers. Following considerable growth elsewhere, here are the figures for some select ASEAN countries: Cambodia (342), Vietnam (433), Indonesia (652), Malaysia (734), Thailand (1194) and Singapore (1,385). The Philippines' links with global markets in tourism and trade is poor relative to neighboring countries and will suffer substantial further deterioration.

The current level of available flights is not enough to service tourism, trade and the OFWs, thus hampering their growth. Although there is a strong demand for capacity, airlines are not interested to invest because of the financial consequence of the taxes.

Poor international tourism performance - The Aquino administration seeks to double the visitor arrivals from 3 million to 6.6 million by 2016. Such targets will bring the Philippines closer to the performance of the rest of its ASEAN competitors. However, tourism and its marketing efforts are shaped by international air connectivity, especially since 98 percent of international visitors to the Philippines arrive by air. These unfavorable taxes negatively impact on the ability of foreign air carriers to offer competitive rates and adequate connectivity to service target markets, thus diverting tourism flows to destinations other than the Philippines or bypassing the country in favor of those with friendlier business environment.

The ability of the travel and tourism industry direct suppliers (e.g. airports, tour operators, hotels, local transport operators, convention and exhibition organizers) and indirect suppliers (e.g. vegetable farmers, fruit growers, retailers and restaurants, telecommunications providers) to expand market shares is constrained by the poor air access.

Loss of job opportunities Foreign air carriers in the Philippines generate significant employment to the Philippine economy due to the vast expanse of economic activities stimulated by on-line flights.

In the airport alone, foreign air carriers pay overflying rights, handling fees, departure taxes and generate jobs for handling staff, immigration, customs and other departments. The carriers' operations require a number of private services to be rendered by Philippine-based providers - catering, ground handling, security, real estate, advertising, computer, transport and other related services. These operations also stimulate demand for retail services by the passengers. As an example, an Airbus 320 turnaround daily flight in Manila can generate about US$123 Million per year of business for private suppliers and the government from airport and aeronautical charges. Direct and indirect, these activities are worth US$321 million and contribute to generating 430 jobs each year. A weekly Boeing 747 passenger service, to for example Sydney is worth over PhP 845 Million (M) annually and 640 jobs across the economy. Assuming Manila's economic benefit is just 60 percent of

Sydney's benefit then one weekly flight would be worth Php 507 M of economic benefit annually for the Philippines.

International tourists contribute at least US$2.3 Billion in export receipts (2009 data). Potential tourists avoid the Philippines due to the lack of non-stop connections from/to the USA and Europe. Every missing tourist translates into one (1) lost job[6] and lost revenues to an amount of approximately US$765 (direct) and US$1,600 (direct and indirect),[7] which also has a negative impact on fiscal revenues from tourist consumption.

The lack of non-stop services also negatively impacts airfreight, penalizing existing and potential exporters of electronics, fashion items, seafood and vegetables. These taxes increase the air freight cost and business development costs for exporters, particularly the small and medium-sized enterprises from the countryside, seeking access in new markets like Europe and the Americas.

3.4 Unsustainable operations by Philippine carriers Philippine carriers will likely be taxed similarly abroad, the impact of which would greatly impact their ability to offer the current levels of air services. To date, per advise from Philippine Airlines, four countries (i.e. Thailand, Saudi Arabia, Kuwait and Germany) have already retaliated by imposing taxes on Philippine carriers. This list will likely expand if this issue is not resolved soon. Foreign carriers will lobby their respective governments to consider reciprocal action should legislation not provide tax relief. A precedent exists in the US for such action was taken against the Argentine carriers.

4 BAR'S APPEAL – LEVEL THE PLAYING FIELD

The resolution of this issue is the major reform package that the Aquino administration should implement in order to support its other national objectives for tourism and trade.

4.1 Optional VAT registration

The foreign air carriers appeal for the provision of immediate remedy, that is, eliminating the CCT through change of interpretation by the BIR, that is, by allowing foreign air carriers to exercise the option of changing tax type from percentage to VAT.

The DOF argues that such option cannot be given to foreign air carriers because of two reasons. First, there is no law exempting from percentage taxes those transactions or taxpayers which are covered by VAT. Hence, if DOF is to allow an international common carrier to register as a VAT taxpayer, such will not exempt it

[6] Source: Department of Tourism

[7] Computed using the multipliers of tourism-related industries derived from the NSCB input-output table for the Philippines.

from the CCT. Second, businesses that were allowed to be covered by VAT instead of a percentage tax were "marginal traders" who turn in less than P1.5 million in gross sales yearly.

We believe that the first argument contravenes the principle of business taxation, that a business entity should only be subject to one type of tax regime, either percentage tax or VAT. There is no need for a law or a provision in the existing law to state such exemptions from percentage taxes once taxpayers are covered by VAT. Hence, once a foreign air carrier becomes covered by the VAT regime then it should no longer be subject to percentage tax.

Second, we believe that the provisions of RR No.16-2005 and RMC Circular No.46-2008, to the effect that international air carriers do not have the option to register for VAT, contravene the provisions of the Tax Code, specifically Section 236(H) of the 1997 Tax Code which states that any taxpayer who is not required to register for VAT under subsection (G) of Section 236 of the 1997 Tax Code may elect to register for VAT. These regulations likewise have no basis under the deliberations of Congress in the enactment of R.A. No. 9337.

Under R.A. No. 9337, the legislature intended to amend the provision on optional VAT registration by expanding the coverage of persons or entities entitled to optional VAT registration to all persons or entities not mandatorily required to register for VAT. If the legislature intended to allow optional VAT registration under Section 236(H) of the Tax Code only to persons or entities with gross annual sales of less than Php1,500,000.00, which is the BIR's position in RR 16-2005 and RMC 46-2008, R.A. No. 9337 would have just deleted Sections 109(a), (b), (c), and (d) in the enumeration of the persons entitled to optional VAT registration under the Tax Code of 1997 and retained only Section 109(z), now Section 109(V), which pertains to VAT-exempt sales or lease of goods or properties or performance of services with gross annual sales not exceeding Php1,500,000.00.

The deletion by R.A. No. 9337 of the following provision in Section 236(H) of the 1997 Tax Code: "In any case, the Commissioner may, for administrative reasons, deny any application for registration including updates prescribed under Subsection (E) hereof" shows that the legislature took out the authority of the CIR to deny any application for VAT registration even for administrative purposes.

Therefore, any foreign air carrier is entitled to register as a VAT taxpayer as a person engaged in "transport of passengers and cargo by air or sea vessels from the Philippines to a foreign country" which was included by R.A. No. 9337 as among the services subject to 0% VAT.

4.2 **Elimination of the CCT and GPBT through legislation in order to avert the continued erosion of foreign and eventually Philippine carrier flights** that will

benefit the other Asian economies in terms of business and employment opportunities.

There are existing bills in Congress that require the attention of the Office of the President. These are House Bill 4302 (Representative Hermilando Mandanas) and House Bill 4444 (Representative Jerry Trenas).

- **HB 4302**

HB 4302, entitled as "An Act Recognizing the Tax Exemptions under Tax Treaties and International Agreements to which the Philippines is a signatory" has already been indorsed for second reading. Further, Sections 1 and 2 of HB 4302 amend Sections 28A(3) and 118, respectively, of the 1997 Tax Code, as amended, with the introduction of a provision titled "recognition of tax exemptions under tax treaties and international agreements."

Comments

A review of our countries' bilateral tax treaties with the Philippines reveals that there are indeed no specific provisions on tax exemptions (income or business) under those treaties. Thus, we fear that the bill will still not grant automatic relief to foreign air carriers whose governments already grant such relief to Philippine carriers in international routes. The BIR will interpret the provision as valid only in cases where there are explicit provisions on tax exemptions, which unfortunately do not exist under the current tax treaties.

HB 4302 introduces the phrase "where pursuant to the principle of reciprocity." However, we fear that the provision will still not provide for automatic relief to foreign air carriers since the pursuit of reciprocity is tied up with the clause "tax treaties and international agreements entered into by the Philippines provide for such exemption."

Proposed Amendments to HB 4302

The Committee Report No. 678 already indorses HB 4302 for second reading. Thus the plenary debate seems to be our only avenue for clarification and proposed amendments. We hope that the Office of the President and Congress will certify as urgent our *proposal to remove the requirement that tax exemptions will be granted only if tax treaties and international agreements provide for such exemptions. Instead, we recommend the introduction of the provision in HB 4302:*

- *In cases where reciprocal exemptions are not provided for in existing international agreements and tax treaties entered into by the Philippines, the Philippine government, pursuant to the principle of reciprocity, shall grant tax exemptions to international carriers whose governments already provide for*

such exemptions to Philippine carriers, by virtue of their national tax laws or any other policy; Provided, further, that this grant of tax exemptions shall apply even in the absence of international operations by Philippine carriers. Any contracting party may issue exchange of notes through diplomatic channels for the purpose of implementation of this provision.

HB 4444 is still due for public hearing.

The International Air Transport Association estimated gains of between USD 38 to 78 million for the Philippine economy from increased tourism on the first year that these taxes will be removed. Other benefits include: an additional number of jobs in the tourism industry of 70,000 jobs worth USD 132 million in employee compensation, an additional US$ 1 billion revenues in air cargo revenues. The figures can then be higher as foreign air carriers are motivated to resume or expand their operations to the Philippines, thereby creating more connections to the international business community, OFW's, ship crewing and tourism markets. Relations to several European countries and cities can be reactivated and reconnected.