No Longer Special? An Analysis of the Withdrawal of Tax Incentives in Special Economic Zones and Its Legal Implications

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I. INTRODUCTION

Fiscal incentives have been used as effective tools to initialize economic growth in developing countries. As aptly put by the Harry Pasimio, "the primary objective of fiscal incentives is to influence investment decisions by either directly affecting the potential profit streams of projects or reducing the risks attached to it."[1]

Nevertheless, the use of tax incentives as a legislative measure to implement social and economic policies has long been the subject of debate among economists, government agencies, and legal scholars. On the one hand, despite direct benefits these tax incentives bring, critics see them as ineffective instruments that cause revenue losses, corruption among the ranks, and investor confusion. Because of this, the 13th Congress pushed for the rationalization of our fiscal incentive laws to remedy the above-mentioned concerns in the form of Senate Bill (S.B.) No. 2411 or what would have been the Consolidated Investments and Incentives Code of the Philippines.[2]

On the other hand, many investors are concerned with the possible implications and costs this rationalization measure may bring. By allowing the State to withdraw tax incentives business entities currently enjoy, is the State violating the non-impairment and due process clauses of the Constitution? Is the overriding need to rationalize fiscal incentive policy with regard to special economic zones justifiable? Will this initiative bring more investors to the country or will it drive them away instead?

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1. Senate Economic Planning Office, *Rationalizing the Fiscal Incentive System*, 2005 POL'Y INSIGHTS 1.

2. S.B. 2411, 13th Cong., 3d Sess. (July 24, 2006).

II. STATE INTERESTS

A. Fiscal Incentive Laws Unresponsive to Constitutional and Statutory Mandates

Under Article II, Section 20 of the 1987 Constitution, the State "recognizes the indispensable role of the private sector, encourages private enterprise and provides incentives to needed investments."[3] In light of this constitutional policy, Presidential Decree (P.D.) No. 664 created the Economic Processing Zone Authority. Through this law, the creation of a special economic zone was meant to encourage and promote the country's foreign exchange position, to hasten industrialization, to reduce domestic unemployment, and to accelerate the development of the country.[5] This was followed by Republic Act (R.A.) No. 7916,[6] which created the Philippine Economic Zone Authority (PEZA). The PEZA was created to integrate all the applications of business locators in economic zones located throughout the country.[7] Its policy centered on the notion that "the government shall actively encourage, promote, induce and accelerate a sound and balanced industrial, economic and social development of the country ... through the establishment, among others, of special economic zones ... that shall effectively attract legitimate and productive foreign investments."[8]

Prior to the integration of the economic zones under R.A. No. 7916, R.A. No. 7227[9] was also enacted to put to use all the lands left by the American government after the termination of the United States (U.S.) bases agreement. It declared the policy of the government to accelerate the sound and balanced conversion into alternative productive uses of the Clark and

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3. PHIL. CONST. art. II, § 20.

4. An Act Creating the Export Processing Zone Authority and Revising Republic Act No. 5490, Presidential Decree No. 66 (1972).

5. *Id.* §§ 1-2.

6. An Act Providing for the Legal Framework and Mechanisms for the Creation, Operation, Administration, and Coordination of Special Economic Zones in the Philippines, Creating for this Purpose the Philippine Economic Zone Authority (PEZA), and For Other Purposes [Special Economic Zone Act of 1995], Republic Act No. 7916, as amended (1994).

7. *Id.* § 3 (a).

8. *Id.* § 2 (b), ¶ 2.

9. An Act Accelerating the Conversion of Military Reservations into Other Productive Uses, Creating the Bases Conversion and Development Authority for this Purpose, Providing Funds Therefor and for Other Purposes [Bases Conversion and Development Act of 1992], Republic Act No. 7227 (1992).

Subic military reservations and their extensions to raise funds by the sale of portions of Metro Manila military camps, and to apply said funds as provided therein for the development and conversion to productive civilian use of the lands.[10] In order to facilitate such policy, it will encourage the *active participation of the private sector* in transforming the Clark and Subic military reservations and their extensions into other productive uses. Further, in creating the economic zone, the law declared it a policy to develop the zone into a "self-sustaining, industrial, commercial, financial and investment center."[11]

On 16 July 1987, the Omnibus Investments Code[12] was also enacted and declared amongst its policies, "[t]o encourage ... foreign investments in industry ... which shall ... meet the tests of international competitiveness[,] accelerate development of less developed regions of the country[,] and result in increased volume and value of exports for the economy."[13] Fiscal incentives that are cost-efficient and simple to administer shall be devised and extended to significant projects "to compensate for market imperfections, to reward performance contributing to economic development[,]"[14] and "to stimulate the establishment and assist initial operations of the enterprise."[15]

In *Commissioner of Internal Revenue v. Seagate Technology (Philippines)*,[16] the Supreme Court supplemented the above-mentioned polices, to wit:

> The Tax Code itself seeks the policy to 'promote sustainable economic growth ... increase economic activity; and ... create a robust environment for business to enable firms to compete better in the regional as well as the global market.' After all, international competitiveness requires economic and tax incentives to lower the cost of goods produced for export. State actions that affect global competition need to be specific and selective in the pricing of particular goods or services.
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> *All these statutory policies are congruent to the constiutional mandates of providing incentives to needed investments, as well as of promoting the preferential use of*

10. *Id.* § 2.

11. *Id.* § 12 (a).

12. The Omnibus Investments Code of 1987 [OMNIBUS INVESTMENTS CODE OF 1987], Executive Order No. 226 (1987).

13. *Id.* art. II, § 1.

14. *Id.* § 3.

15. *Id.* § 8.

16. Commissioner of Internal Revenue v. Seagate Technology (Philippines), 451 SCRA 132 (2005).

> *domestic materials and locally produced goods and adopting measures to help make these competitive. Tax credits for domestic inputs strengthen backward linkages. Rightly so, 'the rule of law and the existence of credible and efficient public institutions are essential prerequisites for sustainable economic development.'*[17]

As outlined above, fiscal incentive laws are guided by State policies. In order for these fiscal incentive laws and state policies to take shape, the means used by the government must be responsive to the very goals it intends to accomplish.

Nevertheless, the Philippines, which was once labeled as "Asia's Tiger," is now gradually being surpassed by neighboring countries due to the lack of stable and effective fiscal incentive policies. Although foreign investment has increased for the past few years, there have been questions as to these policies' economic efficiency.

Hence, despite the proliferation of tax incentives in special economic zones, their existence does not seem to address the economic woes experienced by the country.

B. Current Fiscal Incentive System Confuses Business Locator and Breeds Corruption

There are at least 10 Investment Promotion Agencies (IPA) managing investment activities and administering tax incentives. These include the Board of Investments (BOI), PEZA, Cagayan Economic Zone Authority, and Zamboanga Economic Zone Authority. The Bases Conversation Development Authority is the holding company in charge of Subic Bay Metropolitan Authority and the Clark Development Corporation, which in turn, are its operating arms. In Van V. Mejia's article, *Modern Foreign Investment Laws of the Philippines*,[18] he discusses the complexities of these bureaucratic institutions and the difficulties investors face when applying as a business locator, to wit:

> All these institutions have their own set of guidelines, rules, and requirements with respect to investing, registering as an ecozone enterprise, and minimum capitalization requirements. The rise of ecozones, however, has caused a concomitant expansion of bureaucratic institutions that may complicate or hinder the ease with which investments can be made in the economic zones. This poses great inconvenience to foreign investors since greater bureaucracy and differing rules for entry and eligibility may weigh against investing in the first place. Instead of 'dilly dallying' from one

17. *Id.* at 155-56 (emphasis supplied).

18. Van V. Mejia, *The Modern Foreign Investment Laws Of The Philippines*, 17 TEMP. INT'L & COMP. L.J. 467 (2003).

> agency to another, the investor could have spent such time and effort in improving his operations.
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> Also, too much bureaucracy also affords greater opportunity for corruption, bribery, and abuse within the system. Also as already mentioned, the redundancy of tax incentives from these agencies may cause them to compete against each other. For example, the ITH [Income Tax Holiday] system under the PEZA Law is identical to the ITH structure under the Omnibus Investments Code. Yet, two distinct organs, the PEZA and the BOI, administer these two incentives systems respectively.[19]

By streamlining our fiscal incentive laws, the government will have a better tax incentive system, which is more manageable and transparent for investors.

C. Evaluation of Fiscal Incentive Policies in Comparison with Other Countries

For the past few years, the Philippines has been lagging behind in terms of inflow of foreign investments. Despite having multiple investment policies, the Philippines has performed poorly in comparison with neighboring countries.

Out of a total of 102 countries in 2004 and 125 countries in 2006 in South East Asia, the Philippines was ranked 66th and 71st in terms of three sets of competitiveness indicators: growth competitiveness, macro environment, and public institutions indices.[20] As outlined by Rafaelita M. Adalba:

> The growth competitiveness index covers measures of competitiveness such as institutions, infrastructure, macroeconomy, health [and] primary education, higher education [and] training, market efficiency, technological readiness, business sophistication, and innovation. The macro environment index is based on macroeconomic stability, country credit risk, and wastage in government expenditures while the public institutions index is based on measures of the enforcement of contracts and law and degree of competition.[21]
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> ...

19. *Id.* at 476-77.

20. *Id.* at 479.

21. Rafaelita M. Adalba, *FDI Investment Incentive System and FDI Inflows: The Philippine Experience* 25-26 (Philippine Institute for Development Studies, Discussion Paper Series No. 2006-20, 2006).

> [T]he Philippines together with Indonesia performed substantially more poorly than Malaysia and Thailand.[22]
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> A recent study by the Asian Development Bank-World Bank (2005) seems to confirm these findings. The ADB study indicated that macro instability in the Philippines remains a major concern for investors because of the country's serious fiscal problems. Moreover, the poor quality of key infrastructure services, a fragile and underdeveloped financial system, and a perception that contracting and regulatory uncertainty add[s] to the costs of doing business which also makes investors hesitant. The surveyed firms identified corruption and macroeconomic instability as the two biggest impediments to a good investment climate in the Philippines. Electricity supply, security and regulatory uncertainty also figured prominently.
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> The World Bank's doing business indicators showed the same concerns on costs of doing business as well as complexity and uncertainty in contract enforcement. The data show that in 2004 the Philippines was perceived as providing a less certain environment compared with Indonesia, Thailand, China, and Malaysia. In general, except for the time to enforce a contract indicator, the Philippines performed significantly below the other East Asian countries especially in terms of corruption-related indicators. It had the worst indicators for number of days to enforce a contract and employment laws index.[23]
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> To attract foreign investors to locate in the country, we tried to compete with other countries in providing tax incentives. However, these efforts resulted in a complicated investment incentive system. *A complex investment incentive system combined with poor investment climate explains why the Philippines has performed badly in attracting FDI inflows relative to its neighbors.*[24]

D. Foregone Revenue Through Redundant Tax Incentives

Studies conducted by the Department of Finance (DOF) show that revenues foregone from the provision of fiscal incentives guaranteed under various laws cost the government a total of ₱299.90 billion in 2003.[25] The largest losses come from value-added tax (VAT) exemptions (₱195.50 billion),

22. *Id.* at 26.

23. *Id.*

24. *Id.* at 29 (emphasis supplied).

25. Senate Economic Planning Office, *supra* note 1, at 4.

exemptions from customs duties for the importation of equipment, materials, and other inputs (₱56.10 billion) and exemptions from the payment of income tax (₱34.90 billion).[26] Had the government collected on these incentives, it would have had more than enough to finance the 2003 budget deficit of ₱199.90 billion.[27] In Sen. Ralph G. Recto's privilege speech, he said: "[i]n 2004, around 55% or ₱156.25 billion of the total tax incentives went to [the] BOI and ecozone investors. About ₱219.00 billion were in VAT exemptions, ₱34.00 billion were in duty exemptions and ₱27.00 billion were in income tax exemptions.[28]

As summarized,

> [The] National Tax Research Center (NTRC) estimated that the government lost an average of ₱55.60 billion annually from the provision of fiscal incentives or a total of ₱667.16 billion from 1998 to 2002.[29] It must be pointed out that the NTRC itself believes that its own estimate is conservative considering the gaps in documentation and reporting requirements.[30]

And according to the DOF, there are 40 fiscal incentive laws

> which are considered sources of undue revenue losses … These laws provide fiscal incentives to varied sectors and industries from the dairy, book publishing, leather goods industries, culture and sports development, to shipping, telecommunications, and agriculture. Amending special laws to remove the incentives is expected to generate some ₱11.3 billion in additional revenues, of which ₱9.4 billion will be coming from internal revenue taxes to be imposed on cooperatives. This is a small figure compared to the total losses from fiscal incentives because a big part of these foregone revenues stem from incentives provided in special economic zones (₱158.00 billion) and BOI incentives (₱26.80 billion).[31]

Senator Recto also lamented that the "long" list of redundant incentives:

> In terms of the income tax holiday, a total of ₱17.80 billion out of the ₱18.64 billion total ITH granted to BOI registered firms; in terms of the

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26. *Id.*

27. *Id.*

28. Ralph G. Recto, Rationalization and Harmonization of Fiscal Incentives, Sponsorship Speech (Sep. 11, 2006) *in* http://www.senate.gov.ph/press_release/2006/0911_recto1.asp (last accessed Aug. 23, 2010).

29. Senate Economic Planning Office, *supra* note 1, at 4.

30. *Id.*

31. *Id.* at 6.

> tax and duty exemptions on capital equipment importations, ₱1.87 billion of the ₱1.96 billion total tax and duty waivers; in terms of the tax and duty exemptions on raw material importations, ₱24.40 billion of the ₱25.55 billion tax and duty waivers. Of PEZA incentives, ten percent or ₱15.7 billion were redundant. At the SBMA, 17.5% of investments enjoyed redundant incentives, at ₱826.70 million. The figure was 36.3% or ₱1.60 billion at the CSEZ.[32]

He added that lost revenues could have been allocated to more immediate concerns such as the treatment of tuberculosis, the establishment of schools, and other programs which could alleviate poverty. He said that the "current fiscal incentive policy of the government runs counter to its economic policy of reducing the budget deficit."[33]

E. Other Economic Reasons Prompting Change

Another reason for rationalizing the fiscal incentive laws is the ineffectivity of several tax incentives. Felipe M. Medalla[34] cites several instances why an ITH may not be as effective as it was before, to wit:

> [Income tax holidays] may not be as effective as hoped for by its proponents since the corporate tax rate in the Philippines is about the same as that of the U.S. which taxes income of its corporations from all countries. Since the U.S. is unlikely to sign a 'tax sparing' treaty with the Philippines (which will treat taxes waived by the Philippines as though they have been actually paid for the purpose of computing the U.S. company's taxable income in the U.S.), a Philippine ITH actually increases the U.S. tax liability of U.S. companies that invest in the Philippines.
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> To make matters worse, ITH may create a lot of opportunities for illegal tax arbitrage. The ITH is not intended to be extended to the company's employees and officers or its affiliates. But what is to prevent transfer pricing to transfer profits between two companies that have common owners if one company is tax-exempt and the other one is not? Similarly, what is to prevent income-tax-exempt companies from replacing salaries by dividends through stock options (which are taxed at a lower rate than salaries for high income employees)? Finally, which applies not to income taxes but to indirect taxes and customs duties as well, tax free imports may be smuggled into the domestic market without paying taxes. (This is

32. Recto, *supra* note 28.

33. *Id.*

34. Felipe M. Medalla, *On the Rationalization of Fiscal Incentives* (Position Paper submitted to the Ateneo-Economic Policy Reform & Advocacy and the Department of Finance, 2006).

> explicitly prohibited by the PEZA law but newspaper accounts of reported violations [are] not uncommon.)[35]

Lastly, it is urged that the current Investment Priorities Plan (IPP)[36] be revised since the industries which are currently in the list have long been outdated.

III. TAXPAYER'S POSITION

A. Rationalization Measure Violates the Non-Impairment Clause and Due Process

It is enshrined in the Constitution that "[n]o law impairing the obligation of contracts shall be passed."[37] The purpose of the non-impairment clause is to safeguard the integrity of valid contractual agreements against unwarranted interference by the State.[38] This means that Congress should respect the intention of the parties and it should not in any way modify their rights through a passage of any law, rule, or regulation. The sanctity of contractual obligations lies in the fact that the obligation of a contract is the law, which binds the parties to perform the agreement.

Nevertheless, the law relating to the obligation of contracts does not prohibit every change in existing laws.[39] The change must be substantially enough to impair the obligation of an existing contract. In *Clemons v. Nolting,*[40] the Court said:

> [A] law which changes the terms of a legal contract between the parties, either in the time or mode of performance, or imposes new conditions or dispenses with those expressed, or authorizes for its satisfaction something different from that provided in its terms, is law which impairs the obligation of a contract and is therefore null and void.[41]

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35. *Id.*

36. The IPP is an annual list of "promoted areas of investments eligible for government incentives issued by the BOI."

    See Department of Energy Investment Promotion Office, Investment Priorities Plan available at http://www.doe.gov. ph/IPO%20Web/ipp.htm (last accessed Aug. 23, 2010).

37. PHIL. CONST. art. III, § 10.

38. ISAGANI A. CRUZ, CONSTITUTIONAL LAW 256 (2007 ed.).

39. Gaspar v. Molina, 5 Phil. 197, 202-03 (1905).

40. Clemons v. Nolting, 42 Phil. 702, 717 (1922).

41. *Id.*

Moreover, despite the impairment clause, a contract valid at the time of its execution may be legally modified or even completely invalidated by a subsequent law through the proper exercise of police power.[42] Each individual entering into a contract must abide with the provisions of existing laws and must always deal with the reserved police power of the State.[43]

Due to this impending rationalization measure, the non-impairment clause is again called upon to shed light with regard to the sanctity of contracts of the locators.

On the one hand, for the State, the grant of exemption is merely a spontaneous concession by the legislature, not connected with any service or duty imposed. As such, it is revocable by the power, which made the grant. On the other hand, for the business locator, even if an exemption from taxation does not confer a vested right and hence may be modified or repealed by the legislature, such modification or repeal must *not* impair the obligation of the contract if the State receives a consideration thereof.[44] However, whether a contract to exempt is based on a consideration or is a mere gratuity, is not always easy to determine.

B. Tax Incentives for Economic Benefits Provided by the Business Locator Sufficient Consideration under the Non-Impairment Clause

American jurisprudence provides that there is sufficient consideration if the exemption is granted in the charter of the corporation or in a general law in force at the time the charter is granted and accepted, for when the corporation furnishes a consideration in assuming duties and obligations imposed by the charter, presumably the State receives consideration therefrom.[45] In *Washington University v. Rouse*,[46] the charter of Washington University, granted on 22 February 1853, contained a provision about freedom of the corporation from taxation and from liability to have its charter interfered with at the discretion of the legislature.[47] The Court cited the same rationale in *Home of Friendless v. Rouse,*[48] where:

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42. *See* JOAQUIN G. BERNAS, S.J., THE 1987 PHILIPPINE CONSTITUTION: A COMPREHENSIVE REVIEWER 117-18 (2006).

43. *Id.*

44. THOMAS COOLEY, THE LAW OF TAXATION 1469-73 (4th ed. 1924).

45. Tomlinson v. Jessup, 82 U.S. 454, 458-59 (1872).

46. Washington University v. Rouse, 75 U.S. 439 (1869).

47. *Id.* at 439-40.

48. Home of the Friendless v. Rouse, 75 U.S. 430, 435-37 (1969).

> *The object of the charter in the one was to promote a charity, in the other encourage learning*. Both were public objects of advantage to the country, and which every government is desirous of promoting. Whether the endowment of a charity is of more concern to the State than the endowment of a university for learning, is within the power of the legislature to determine. If the legislature has acted in a manner to show that it considered both objects equally worthy of favor, it is not the province of this Court to pass on the wisdom of the measure.
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> On the contrary, it is the duty of the Court to carry out the intention of the legislature, if ascertainable, by applying to both charters the ordinary rules of construction applicable to legislative grants. In applying these rules to this charter, we find the existence of the same contract of permanent exemption from taxation, as in the charter of the Home of the Friendless. The State contracted in the one case as in the other, not to tax the property of the corporation, using the same words in both charters, to convey its meaning, and binding itself in the same terms, not to repeal or modify either charter in that regard. Both charters were passed by the same legislature, within a few days of each other, and neither charter is unusual in its provisions, except in this particular. The inference would, therefore, seem to be clear, that it was the legislative intention that both should, in this respect, be on an equality. *The public purposes to be attained in each case constituted the consideration on which the contracts were based*. The charter of the University, with its amendment (not material to notice, because not affecting this question), having been accepted, and the corporation, since its acceptance, having been actively employed in the specific purpose of which it was created, the exemption from taxation became one of the franchises of the corporation of which it would not be deprived by any species of State legislation.[49]

Hence, the benefit of the community arising out of the objects for which a charitable corporation was created is *sufficient consideration* for the grant to such corporation of an exemption from taxation.[50]

In *Northwestern University v. People*,[51] by virtue of its charter, Northwestern University's property of whatever kind or description was declared to be free from any form of taxation.[52] The Court struck down the enforced tax collection as it violated the contract.[53] The Court held that a

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49. *Washington University*, 75 U.S. at 439-40 (emphasis supplied).

50. *Id.*

51. Northwestern University v. People, 99 U.S. 309 (1878).

52. *Id.* at 319.

53. *Id.* at 325.

contract existed between the university and the State because the State received a consideration for an exemption from taxation granted after the corporation has been created, which a corporation accepts as an amendment of its charter binding it to pay a certain sum or *perform certain services* in lieu of taxation.[54] The Court said:

> In any view, *the exemption under consideration was clearly for school purposes*, and should be sustained as a proper exercise of the legislative power.
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> Such an institution as this university coming into life, without direct donations from the State itself, must have something more than the mere land on which the building stands. There must be a source of revenue which will support its professors, and keep the institution alive. *The one is much a necessity of its success, even of its existence, as the other; and the distinction, that the grounds and buildings thereon and furniture therein are clearly for 'school purposes,' while property used to erect more buildings, as necessity may require, and buy more furniture and pay teachers, is not for 'school purposes,' is one without reason, and is an unworthy foundation for an argument with which to sweep away a contract which reposes upon the faith of a great State, and had been confirmed by twenty years of practical acquiescence.*[55]

In *Bailey v. State*,[56] the North Carolina General Assembly established a variety of retirement programs to benefit the North Carolina State and local government employees in 1939.[57] For 50 years, the State granted tax exemptions on benefits paid to State and local government retirees.[58] The *Bailey* Court used the rationale in *Davis v. Michigan Dept. of the Treasury*.[59] Similar to the factual incidents in *Davis*, the North Carolina legislative assembly removed the tax exemption enjoyed by federal employees on their retirement benefits.[60] As a result, North Carolina taxed state and local employee retirement benefits for the first time.[61]

In its analysis, the *Bailey* Court tried to determine the existence of an enforceable contract created between the plaintiffs and the State by virtue of

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54. *Id.* at 321-22.

55. *Id.* at 313-14 (emphasis supplied).

56. Bailey v. State, 348 N.C. 130 (1998).

57. *Id.* at 136-38.

58. *Id.* at 138.

59. *Id.* at 153. *See also* Davis v. Michigan Dept. of Treasury, 489 U.S. 803 (1989).

60. *Bailey*, 348 N.C. at 138-39; *Davis*, 489 U.S. at 806.

61. *Bailey*, 348 N.C. at 139.

the original legislation exempting state employee retirement benefits from taxation.[62]

Basically, the argument raised by the State is that it can never surrender its power of taxation.[63] However, the Court ruled that the State's position would unduly create unfairness on the part of the retirees.[64] The Court pointed out that the State had *benefited from the tax exemption on retirement payments for many years by using it as an inducement for individuals to enter and remain in government employment.*[65] The Court ruled that after such a long history of accepting the benefits of the tax exemption, the State could not escape its responsibilities under the agreement. Similar to *Washington* and *Northwestern*, this rationale upholds the doctrine that the benefits derived in exchange for tax exemption are considered as sufficient consideration of the contract.

Also, the Court went on to say that the tax exemption must be included as a condition and a term included in the formulation of the contract.[66] The *Bailey* doctrine says that the State may make contracts for exemptions without contracting away the *power* of taxation as long as the contract is for a public purpose.[67] This in effect supports the argument that the State does not necessarily contract away its power of taxation. What the State can do though is to limit its exercise when public policy dictates.

It is argued that contractual tax exemptions, where the non-impairment guarantee can rightfully be invoked, "are those agreed to by the taxing authority in contracts, such as those contained in government bonds and debentures, lawfully entered into by them under enabling laws in which the government, acting in its private capacity, sheds its cloak of authority and waives its governmental immunity."[68]

From the point of view of the taxpayer, it is difficult to see how the consideration in government bonds and debentures can be different from the consideration in a contract granting tax incentives.

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62. *Id.* at 141-50.

63. *Id.* at 147.

64. *Id.* at 148.

65. *Id.* at 147.

66. *Id.* at 146.

67. *Bailey*, 348 N.C. at 147-48.

68. Manila Electric Company v. Province of Laguna, 306 SCRA 750, 760-61 (1999).

A consideration is something done, forborne, suffered or promised to be done, forborne, or suffered by the promisee in respect to the promise.[69] Both contracts stand in the same footing on the basis of the definition of what constitutes a consideration.

Moreover, the non-impairment clause never intended to limit itself to such transactions. As can be gleaned from its American origins, the framers of the U.S. Constitution included the *contract clause* to prevent state abridgement of *contracts*.[70] The U.S. Supreme Court through Chief Justice John Marshall, gave a broad reading to this provision, holding that the language encompassed both agreements among private parties and *contracts to which States were parties*.[71] In a series of cases, the U.S. Supreme Court ruled that the *contract clause* applied to legislative land grants,[72] tax exemptions,[73] corporate charters,[74] agreements between states,[75] and state bankruptcy laws.[76] In all of these cases, the elements of a contract do exist (i.e., consent, object/subject matter, and cause).

The development of these principles has likewise been seen in Philippine jurisprudence. In *Philippine Railway Co. v. Collector of Int. Rev.*,[77] a charter was granted to petitioner in 1906.[78] This was prior to the 1935 Constitution, which first gave the government the right to alter franchises.[79] In lieu of taxes of every name and nature, the grantee was to pay a one-and-a-half percentage tax.[80] In that case, the Court was faced with the question as to

69. Currie v. Misa, (1875) L.R. 10 Exch.153 at 162.

70. Douglas W. Kmiec & John O. McGinnis, *The Contract Clause: A Return to the Original Understanding,* 14 HASTINGS CONST. L.Q. 525, 529 (1987).

> The history of the contract clause "suggests that it was aimed at all retrospective, redistributive schemes in violation of vested contractual rights, of which debtor relief was merely a prime example."
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> *Id.* at 534.

71. *Id.* at 535.

72. Fletcher v. Peck, 10 U.S. 87 (1810).

73. State v. Wilson, 11 U.S. 164 (1812).

74. Trustees of Dartmouth College v. Woodward, 17 U.S. 518 (1819).

75. Green v. Biddle, 21 U.S. 1 (1823).

76. Sturges v. Crowninshield, 17 U.S. 122 (1819).

77. Philippine Railway Co. v. Collector of Int. Rev., 91 Phil. 35 (1952).

78. *Id.* at 36.

79. 1935 PHIL. CONST. art. XIV, § 8 (superseded 1971).

80. *Philippine Railway Co.*, 91 Phil. at 37.

whether the tax exemption in the franchise, a special law, can be affected by a tax provision in a subsequent general law.[81] The High Court answered in the negative by quoting the following provisions:

> Said Act No. 1510 is a charter granted to the plaintiff company by the Government of the Philippine Islands. *It is in the nature of a private contract. It is not a law constituting a part of the machinery of the general government. It was adopted after careful consideration of the private rights of the plaintiff in relation with the resultant benefits to the State. It stands upon a different footing from general law.* When a charter is created it constitutes a certain property right. Charters of special laws, such as Act No. 1510, stand upon a different footing from general laws. *Once granted a charter becomes a private contract and cannot be altered nor amended except by consent of all concerned, unless the right is expressly reserved.* The reason for the rule is clear. The legislature, in passing a special charter, has their attention directed to the special facts and circumstances which the Act or charter is intended to meet. The Legislature consider and make provision for all the circumstances of the particular case in granting a special charter, it will not be considered that the Legislature, by adopting a general law containing provisions repugnant to the provisions of the charter, and without making any mention of its intention to amend or modify the charter, intended to amend, repeal, or modify the special act.[82]

Although this case would have been within the control of the State by virtue of the reservation clause under Article XI of the 1987 Constitution,[83] it is interesting to note here how the Court illustrated the contract between the State and the private entity. The Court adopted the view that the charter was a private contract in which the State receives certain resultant benefits.[84]

This is likewise evident in *City Government of San Pablo Laguna v. Reyes.*[85] In *City Government,* by virtue of the enactment of Section 193 of the Local Government Code,[86] tax exemptions or incentives granted to, or presently enjoyed by all persons with the exception of other entities, were effectively withdrawn.[87] Consequently, the province or city now had the

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81. *Id.* at 39.

82. *Id.* at 40-41 (citing Lewis v. Cook Country, 74 Ill. App. 151, Philippine Railway Co. v. Nolting, 34 Phil. 401, 403-04 (1916)) (emphasis supplied).

83. PHIL CONST., art. XII, § 11.

84. *Philippine Railway Co.*, 91 Phil. at 40.

85. City Government of San Pablo, Laguna v. Reyes, 305 SCRA 353 (1999).

86. An Act Providing for a Local Government Code of 1991 [LOCAL GOVERNMENT CODE OF 1991], Republic Act No. 7160, as amended (1991).

87. *City Government*, 305 SCRA at 361.

power to impose a franchise tax on a business enjoying a franchise.[88] Private respondent invoked the non-impairment clause of the Constitution to justify its exemption from local tax.[89] Although the invocation of the private respondent of the non-impairment clause was unavailing because of the reservation clause under the present constitution, it is important to note here the following assertions of the Court:

> It is true that the phrase *in lieu of all taxes found in special franchises has been held in several cases to exempt the franchise holder from payment of tax on its corporate franchise imposed by the Internal Revenue Code, as the charter is in the nature of a private contract and the exemption is part of the inducement for the acceptance of the franchise, and that the imposition of another franchise tax by the local authority would constitute an impairment of contract between the government and the corporation.*[90]

Hence, despite the existence of the limitation of the regulation of the State, such fact does negate the existence of a contract.

C. The Consideration in Tax Incentives

For example, under Section 39 of The Omnibus Investments Code of 1987, all registered enterprises shall be granted incentives such as Income Tax Holiday, Additional Deduction for Labor Expense, Tax and Duty Exemption on Imported Capital Equipment, Tax Credit on Domestic Capital Equipment, etc., just to name a few.[91] However, the enjoyment of these tax incentives is subject to several considerations as prescribed under the said law. For example, an Income Tax Holiday is subject to the conditions that: (1) [t]he project meets the prescribed ratio of capital equipment to number of workers set by the Board; (2) [t]he utilization of indigenous raw materials at rates set by the Board; and (3) the net foreign exchange savings or earnings amount to at least US$500,000.00 annually during the first three (3) years of operation.[92] As soon as these requirements are met, the law mandates the State to grant the tax incentive in favor of the business entity.

On the one hand, most business entities consider tax incentives as the *principal consideration of the contract* with the government. In fact, the use of

88. *Id.* at 361-62.

89. *Id.* at 358.

90. *Id.* at 362 (emphasis supplied).

91. OMNIBUS INVESTMENTS CODE OF 1987, § 39.

92. *Id.* § 39 (a).

fiscal incentives by different governments is based on the premise that the provision of incentives is a major consideration of investors in deciding where to locate their investments. Estimates suggest that a two percent rise in foreign direct investments (FDIs) is proportional with a one percentage point reduction in corporate income tax (CIT).[93] Likewise as mentioned by Harry Pasimio, the BOI estimates that for every ₱1 of fiscal incentives availed by investors, ₱10.1 worth of investments was generated from 1995 to 2001.[94] Thus,

> [t]he positive effect was especially apparent in industries engaged in agricultural production and allied services, woodbased products and services, and clothing and fashion accessories, where investors put in ₱113.40, ₱51.80, and ₱44.00 respectively for every ₱1.00 of fiscal incentives made available to these industries. The study also shows that the country earned ₱21.10 in exports for every ₱1.00 of fiscal incentives availed by exporters from 1995 to 2001.[95]

As aptly put by Medalla,

> [i]ncentives are viewed as signals to a foreign investor about the country's very open and welcoming attitude towards foreign investment. Moreover, to the extent that other countries with similar economic and cost structures as the Philippines offer *generous fiscal incentives, it could be that the fiscal incentives may turn out to be the 'clincher' that could decide where the MNCs will locate their plants*. In short, the Philippines has to offer fiscal incentives since other countries which compete with the Philippines also offer incentives that are even more generous than what the Philippines offers.[96]

On the other hand, the State would not have surrendered its taxing power had it not seen the benefits these investments may grant to the national economy. Direct benefits such as job generation, infrastructure development and export competitiveness are relied upon by the government and are the primary reasons why these tax incentives were given in the first place. By surrendering its power of taxation, the State was in the view of upholding its State policies under its fiscal incentive laws.

In the case of ecozones, tax incentives have generated 83% of the total foreign investments from 1995-2005.[97] In 1997, exports originating from

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93. Senate Economic Planning Office, *supra* note 1, at 1.

94. *Id.* at 3.

95. *Id.*

96. Medalla, *supra* note 34, at 8.

97. Christine S. Trinidad, Zero-Rating, Revisited: The VAT Consequence of Ecozone Transactions under the Cross-Border Doctrine (2006) (unpublished

ecozones accounted for 45% or almost one half of the country's total exports.[98] From $431.00 million in 1988, such exports grew to $11.31 billion in 1997.[99]

Furthermore, ecozones generate jobs.[100] As mandated by their charter, PEZA-registered enterprises are required to give priority to hiring workers from the immediate community to prevent and mitigate the migration of workers to other areas.[101] The 2005 PEZA investments were expected to generate some 71,792 jobs by way of direct employment.[102]

Lastly, the operations of ecozones enhance the growth of local communities as business locators are required to remit 1% of income to a Development Fund for the development of cities and municipalities outside and contiguous to the ecozone.[103] Are these benefits not sufficient to constitute a valuable consideration on the part of the State?

In sum, business entities registered under the special economic zones are attended by special facts and circumstances which within their charters they are intended to meet. They are substantially different from other areas in the country since the tax impositions and policies there are more liberal and more investor-friendly than that of the country's tax laws. Relying upon and on the strength of these privileges, the business entity is empowered to fully realize its investment, which in return, the State benefits from.

D. The Passage of R.A. No. 9400 and R.A. No. 9399 and Their Implications

R.A. No. 9399[104] granted a one-time tax amnesty to business establishments at Clark and other freeport zones which incurred tax liabilities after the

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J.D. thesis, Ateneo de Manila University) (on file with the Professional Schools Library, Ateneo de Manila University).

98. *Id.*

99. *Id.*

100. Ecozones generated the most jobs in the first half of 2010. *See* Abigail L. Ho, Ecozone exports surged 40% in 1st half, *available at* http://business.inquirer.net/money/topstories/view/20100815-287004/Ecozone-exports-surged-40-in-1st- half (last accessed Aug. 23, 2010).

101. Rules and Regulations Implementing the Special Economic Zone Act of 1995, pt. IX, rule XXIII, § 4.

102. *Id.*

103. R.A. No. 7916, § 24.

104. An Act Declaring a One-Time Amnesty on Certain Tax and Duty Liabilities, Inclusive of Fees, Fines, Penalties, Interests and Other Additions Thereto,

Supreme Court ruled in *John Hay Peoples Alternative Coalition v. Lim*[105] against the constitutionality of the tax incentives and duty privileges granted to businesses located within the Clark economic zone.[106] R.A. No. 9399 also provides that business enterprises in the said areas are required to pay ₱25,000.00 within six months from the effectivity of the law. R.A. No. 9400,[107] in turn, expressly declares several areas such as Bataan, Poro Point, Morong and John Hay as special economic zone with the same tax and duty privileges as expressly provided in R.A. No. 7227 but with some minor changes.

It is argued that R.A. No. 9399 and R.A. No. 9400 effectively cured any tax liabilities incurred by businesses located in these economic zones. Hence, there is no problem to speak of.[108] Nevertheless, the passage of these laws was in effect an *admission* there was an impairment of contracts.

Had the State enacted these curative statutes, billions of pesos worth of investments and infrastructures would have been lost. The cumulative projected employment from projects with foreign interest approved in 2006 was estimated at 128,753 jobs, 28.3% higher than the 100,342 jobs posted in 2005[109] would have been enormously reduced since majority of these foreign investments are located in economic zones. Projects such as Subic-Clark-Tarlac Expressway Project (SCTEP), the Bataan Technology Park, Poro Point's seaport, industrial park, domestic airport, and tourism-commercial

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Incurred by Certain Business Enterprises Operating Within the Special Economic Zones and Freeports Created under Proclamation No. 163, Series of 1993; Proclamation No. 120, Series of 1991; and Proclamation No. 984, Series of 1997, Pursuant to Section 15 of Republic Act No. 7227, As Amended, And for Other Purposes, Republic Act No. 9399 (2007).

105. John Hay Peoples Alternative Coalition v. Lim, 414 SCRA 356, 377-78 (2003).

106. Juliet Labog-Javellana, *Arroyo Signs 2 Laws for Clark Development*, PHIL. DAILY INQ., Mar. 21, 2007, *available at* http://newsinfo.inquirer.net/inquirerheadlines/nation/view/20070321-56072/Arroyo_signs_2_laws_for_Clark_development (last accessed Aug. 23, 2010).

107. An Act Amending Republic Act No. 7227, As Amended, Otherwise Known as the Bases and Conversion Development Act of 1992, and for Other Purposes, Republic Act No. 9400 (2006).

108. Interview with Atty. Cristina Lenon, Legal Consultant of the Bases Conversion and Development Authority (Apr. 25, 2007).

109. National Statistical Coordinating Board, Approved Foreign Direct Investments down by 52.3 percent in the last quarter of 2006, but cumulative January to December 2006 FDIs up by 73.1 percent *available at* http://www.nscb.gov.ph/pressreleases/2007/Apr23_FDI_Q4.asp (last accessed Aug. 23, 2007).

area would have been considerably delayed and additional costs would have been incurred by these investors.

If the tax incentives are merely privileges then why did the State go through such lengths to pass R.A. No. 9399 and R.A. No. 9400?

Furthermore, during the committee deliberations of the subject rationalization measure, Rep. Mauricio G. Domogan made a categorical assertion as to the nature of the tax incentive granted by the State through the BCDA. When asked by Rep. Rolex T. Suplico if the *tax incentive* was part of the terms and conditions which had been *published to invite investors* to be partners in the development of former U.S. bases under the BCDA, Representative Domogan replied in the affirmative.[110] Furthermore, he stated that "when the bidding was done and the contracts were executed between these locators and the BCDA, it is part and parcel of the contract that in lieu of all other taxes, these locators or investors will pay [5%] of their gross income."[111]

Representative Domogan added that "investors have been complying with the *terms* and *conditions* of the contract they signed with the [BCDA]" and that said contract, under existing laws, the *law* is between the parties.[112]

Representative Domogan claimed that it was a wrong perception to say that the government will lose revenues if ever the bill would have been approved because what would happen is that "if the government will insist on implementing the decision of the Supreme Court the investors pursuant to their *contracts with the BCDA, will ask the BCDA to pay whatever tax liabilities they have since it was clear in the contract that they only pay five percent of their gross income*."[113]

E. Substantial Impairment Unreasonable, Whimsical, or Arbitrary: State Blatantly Disregards Taxpayer's Losses

In view of the definition of impairment, the prohibition against impairment of obligations cannot be absolute and unqualified. A law impairing the obligation of a contract can nevertheless be constitutional if it was exercised within the limits provided for by law. As held in *Abella v. National Labor*

110. 66 RECORD OF PLENARY PROCEEDINGS 670, 13th Cong., 1st Reg. Sess. (May 29-31, June 5, 2006).

111. *Id.* at 671.

112. *Id.*

113. *Id.* (emphasis supplied).

Relations Commission,[114] "[t]he prohibition is general, affording a broad outline and requiring construction to fill in the details. It is not to be read with literal exactness like a mathematical formula, for it prohibits unreasonable impairment only."[115] In doing so, the unreasonableness of a law must be determined on a case to case basis.

As already mentioned, where the State can impair contracts, the U.S. Supreme Court has indicated that the intensity with which the justification for the statute will be scrutinized depends on several factors: (1) whether the statute impairs the State's own contract or a private contract (impairment of the State's own contracts will be more strongly scrutinized than the impairment of private contracts);[116] (2) the degree of impairment; (3) whether the statute impairs contracts incidentally to a broader purpose or is specifically directed toward contract impairment, and; (4) the extent of the statute's application — that is, whether it was aimed at a particular party.[117]

From the point of view of the taxpayer, the impairment is characterized as unreasonable since the tax incentive originally contemplated was withdrawn without due regard to the additional costs these businesses will face. The business entity was induced to pour in millions of pesos worth of investments in exchange for the tax incentive.

From the point of view of the State, however, notwithstanding interference with the existing contract, the economic interest of the State may justify the exercise of its continuing and dominant protective power. The economic interest being protected here is the building of an investor-friendly investment, create tighter tax administration and streamline investment promotions strategies appropriate for the country's development. This is because by virtue of its police power, the State can still regulate such contracts. For not only are existing laws read into contracts in order to fix the obligations as between the parties, but the reservation of essential attributes of sovereign power is also read into contracts as a postulate of legal order. Thus, all contracts made with reference to any matter that is subject to regulation under the police power must be understood as made in reference to the possible exercise of that power.

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114. Abella v. National Labor Relations Commission, 152 SCRA 140 (1987).

115. *Id.* at 145 (citing Anucension v. National Labor Union, 80 SCRA 350, 368 (1977)).

116. Henry N. Butler & Larry E. Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611, 637-39 (1988).

117. Chicago Bd. of Realtors, Inc. v. City of Chicago, 819 F.2d 732, 741-45 (7th Cir. 1987).

The test to determine the validity of a police regulation is whether the interests of the public generally, as distinguished from those of a particular class require the exercise of the police power, and whether such *means employed are reasonably necessary for the accomplishment of the purpose* and not unduly oppressive upon individuals.[118] In other words, the ends must not justify the means. As held in *Pilipinas Kao, Inc. v. Court of Appeals*,[119] if the statutory purpose is clear and unambiguous, the law should be construed, not to defeat its purpose, but to carry it out into effect.[120] The Court continued that "[f]or a statute derives its vitality from the purpose for which it is enacted and to construe it in a manner that disregards or defeats such purpose is to nullify or destroy the law."[121] Its motive, policy, and objectives must be compelling enough to justify such impairment of contracts.

The impairing statute in question is one geared towards the rationalization of the fiscal incentive system. To repeat, the State policy enunciated in S.B. No. 2411 provides,

> SEC. 2. *Declaration of Investment Policies*. — The national economy shall be developed so as to enhance its competitiveness in the global economy and encourage investments that promote countrywide development, generate employment and foreign exchange.
>
> Accordingly, the following are declared policies of the State:
>
> (1) The State shall pursue a market responsive investment regime and to that end shall ensure that the incentives shall promote substantial social and economic spillovers, equitable development across income classes and across provinces, are fiscally sustainable, financially and economically justifiable, and are consistent with international treaties. The State shall therefore provide the means for ascertaining that these objectives are being attained.
>
> (2) The State shall grant the necessary incentives that encourage long-term and recurrent investment, are simple to administer, are time-bound and whose performance and outcomes are easily verifiable.
>
> (3) The State shall devote resources to monitoring enterprises benefiting from incentives, and shall vigorously prosecute abuses. The State shall also closely monitor the level of tax expenditures arising from the

118. United States v. Toribio, 15 Phil. 85, 93 (1910).

119. Pilipinas Kao, Inc. v. Court of Appeals, 372 SCRA 548 (2001).

120. *Id.* at 572.

121. *Id.*

provision of incentives and shall ensure that concerned government agencies are well-informed of these developments.

(4) In the granting of fiscal incentives, the State will make efforts to ascertain that the incentives are not redundant: that the investments they benefit require and are truly motivated by the incentives or that the incentives, as much as possible, are not given to investors who would have made the investments even in the absence of incentives.

(5) The State shall vigorously promote investments in basic infrastructure such as, but not limited to power, roads, airports, water ports and housing.

(6) The State recognizes that industrial peace is essential to attracting investments.

(7) The State shall undertake investment promotion activities.

It is argued by the State that this is line with the foreign investment policy of the Philippines as outlined in the Constitution and its current FDI laws. However, a perusal of the provisions of the rationalization measure will show otherwise.

F. S.B. No. 2411: From 5% to 15% and the NOLCO Incentive

Despite the State's insistence that the reduced tax rate of 15% and the Net Operating Loss Carry Over (NOLCO) are more efficient ways to facilitate the starting operations of a foreign investor,[122] such does not depart from the fact that the terms and conditions of the contract were altered. If a foreign investor registered under PEZA forecasted its operations on the basis of the five percent tax incentive, an alteration of the terms of the tax incentive would substantially change the viability and efficiency of the investment.

Furthermore, the NOLCO incentive is merely a deductible expense from the business locator's gross income.[123] This is in sharp contrast with the availment of an ITH, which contemplates a total exemption from income tax. Likewise, the conditions imposed under the NOLCO incentive are more burdensome compared to the ITH.

G. The Trust and Liability Account

A unique feature of the proposed rationalization bill includes the establishment of a Trust Liability Account (TLA).[124] Under Section 17 of

122. S.B. 2411, § 14 (a) & (b).

123. *Id.* § 14 (b).

124. *Id.* § 17.

S.B. No. 2411, the Bureau of Treasury (BTR) will facilitate the immediate processing, clearance, and release of VAT refunds through the TLA.[125] All VAT payments on the importation of registered export enterprises of capital equipment and raw materials shall be deposited in the TLA for the purpose of funding valid VAT refund claims.[126] Registered export enterprises can claim their VAT refunds before the Philippine Investment Promotion Administration (PIPA) which is tasked with processing, approving, and releasing the refunds.[127] S.B. No. 2411 continues that the "VAT paid on imported capital equipment may be refunded provided the capital equipment is being used by the registered export enterprise pursuant to its registered activity."[128]

From the point of view of the State, there is no actual payment of the VAT since the business entity can apply for a tax refund from the moment it can show proof of exportation. S.B. No. 2411 does not intend to tax the exporter but to plug the leakages in the existing process, of outright tax and duty exemption upon importation that have been abused and given rise to smuggling activities.[129] From the point of view of the business entity, there is impairment since a tax refund is not properly characterized as a tax exemption.

By forcing a business entity to pay before availing of the exemption, additional conditions not originally contemplated by the parties, are in effect being imposed. The possibility of delay and abuse in remitting the amount paid is more prominent than it was before. Furthermore, there is no proper standard in the bill, which identifies how the State can regulate this. In effect, the advance payment of the business entity is more burdensome and costly both on the part of the State and the business entity.

Although most parts of the bill seem sound as to its economic viability, the change of the terms and conditions, which materially and substantially affect the rights of the business entity, point to the conclusion that the provisions under S.B. No. 2411 are not reasonable impairments. While the Author agrees with the need to rationalize the current fiscal incentive system, the means that will be used must not contravene the fundamental

125. *Id.*

126. *Id.*

127. *Id.*

128. S.B. 2411, § 17.

129. Recto, *supra* note 28.

rights of the business locator. Only by adhering to such strict policy will the State be able to fully accomplish its policies.

H. Leveling the Playing Field

By equalizing opportunities with all other entities, the State removes substantial distinctions between a business locator in the economic zone and an ordinary investor. The original incentives enjoyed by the business locator will be diminished and his competitive edge over other businesses will be reduced because the business locator in the economic zone specifically chose that location because of the incentives offered in that area.

By imposing new conditions or fees that affect the profitability of the venture, the government is driving foreign investors away from potential investments and in effect forces them to choose other countries which would otherwise give them a stable tax incentive package.

I. Unreasonable Impairment Due to Incurred Losses, Whether a Law is Passed or Not

In his article *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment,*[130] Kyle D. Logue illustrates how transition losses can occur whether the new tax law or new interpretation applies nominally retroactively or nominally prospectively.

> Under a nominally retroactive tax-law change, the change applies not only to income that is earned after the date of enactment but also to income earned before the date of enactment. Under a nominally prospective income tax change, however, the new law applies only to income earned after the date of enactment and, often, only to income earned after the end of the year of enactment. *Under either type of transition, if the change applies to income earned on pre-enactment investments and is not anticipated by taxpayers, transition losses will occur.* [131]

This was evident after the rulings of *John Hay* and *Coconut Oil Refiners Association, Inc. v. Torres,*[132] were laid down since most businesses were obligated to pay VAT for goods entering the said economic zones. Even if R.A. No. 9399 has been passed, the amount these investors have paid will

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130. Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129 (1996).

131. *Id.* at 1133-34 (emphasis supplied).

132. *See* Coconut Oil Refiners Association, Inc. v. Torres, 465 SCRA 47, 63-75 (2005).

not be recovered easily since a tax refund must be filed first before the Bureau of Internal Revenue (BIR). The implications of these miscalculated errors by the government add to the building concern of businesses.

As Logue's article adds,

> If Congress were to repeal an incentive tax credit without providing transition relief (either in the form of a grandfathered effective date for an installment credit or in the form of a nominally prospective effective date for an up-front credit), taxpayers who invested in reliance on the credit would suffer a transition loss. That possibility gives rise to the main point of this section: because taxpayers who relied on the repealed incentive credit were 'burned' by the government, future incentive credits would have to be more generous (for example, the credit percentage would have to be greater) to achieve the same amount of increased investment in the targeted asset or activity. This increase in the cost of the incentive credit can be understood as a default premium, the premium taxpayers demand to compensate them for the possibility that the government will repeal the incentive subsidy (in this example, the incentive credit) without providing transition relief.[133]

If the State were to make a practice of actively inducing taxpayers to rely on incentive subsidies only to repeal those provisions retroactively, there would be additional costs. Tricking taxpayers in that way, even if such an approach were efficient in a narrow sense, in a broader sense, might be inefficient; for example, it might engender distrust and antipathy toward the government.[134] That reaction in turn could undermine individuals' willingness to comply with tax laws as the system's success depends heavily upon a large degree of voluntary compliance or self-assessment on the part of taxpayers.[135] How could the taxpayer rely on a system that doesn't work?

J. Credit Rating Impaired

Credit rating is defined as the degree of creditworthiness assigned to a person based on credit history and financial status.[136] A credit rating is a useful tool not only for the investor, but also for the entities looking for investors. An

133. Logue, *supra* note 130, at 1139.

134. Frank I. Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1223-24 (1967).

135. MICHAEL J. GRAETZ, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES, 92 (2d ed. 1988).

136. Reem Heakal, What Is A Corporate Credit Rating?, *available at* http://www.tmcofne.com/tmcdictionary.htm (last accessed Aug 23, 2010).

investment grade rating can put a security, company or country on the global radar, attracting foreign money and boosting a nation's economy. Indeed, for emerging market economies, the credit rating is key to showing their worthiness to take money from foreign investors. Further, because the credit rating acts to facilitate investments, many countries and companies will strive to maintain and improve their ratings, hence ensuring a stable political environment and a more transparent capital market.[137]

Due to the withdrawal of tax incentives, the credit rating of both the sovereign and business entity is impaired. Although potential foreign investors might be lost because of the advent of the withdrawal of tax incentives, the losses incurred by existing business locators are more costly since operations of their business will be considerably delayed. This will be reflected in their credit history and financial status, which in turn might affect their viability in other investments.

IV. RECONCILING STATE INTERESTS WITH TAXPAYER RIGHTS

A. Existing Contract between the State and the Business Locator

To fall within the protection of the non-impairment clause, all of its four elements must be clearly established, i.e., there must be a contract, a law, an obligation, and an unreasonable impairment.

To reiterate, a lawful tax on a new subject or an increased tax on an old one, does *not* interfere with a contract or impair its obligation within the meaning of the constitution. The only exception to this rule is when a law grants a tax exemption in exchange for a valuable consideration.

As previously discussed, the use of fiscal incentives by different governments is based on the premise that the provision of incentives is a principal consideration of investors in deciding where to locate their investments. The business entity would not have spent millions of pesos had it not been for the tax incentive. On the part of the State, direct benefits such as job generation, infrastructure growth, local government development and export competitiveness are the primary reasons why these tax incentives were given in the first place. This is line of with the rulings in *Home of Friendless, Washington, Northwestern,* and *Bailey* where the benefits of the community arising out of the objects for which a corporation was created was held as sufficient consideration for the grant to such corporation of an exemption from taxation.

137. *Id.*

The consent of the State was further concretized in several documents, memoranda, laws, decrees and regulations and acts (the passage of R.A. No. 9399 and R.A. No. 9400) where the State categorically considered the tax incentive as a contract. The State is now estopped in claiming otherwise since the business entity was made to rely on the promise made in the contract in exchange for a valuable consideration. Furthermore, since the terms and conditions of the contract are the law binding the parties, the business entity had every right to expect the performance of the obligation embodied in the contract.

Hence, on the basis of such doctrinal and jurisprudential pronouncements, it has been established that the contract is denominated by a valuable consideration; therefore, business entities can properly seek refuge under the non-impairment clause.

B. Difference with Franchises

As already mentioned above, if the position of the business entity is upheld, how would the tax incentives granted to franchises differ? In terms of the consideration, there is none. A tax incentive granted to a franchise performs a public function similar to a business entity, which has been granted a tax incentive. This is in line with the rulings in *Washington, Northwestern* and *Bailey* as cited by the taxpayer. However, the manner of regulation is different between these two. There is a difference since a franchise has an explicit reservation clause placed under Article XII of the Constitution[138] while a tax incentive in the form of a tax exemption is contained under Article VI of the Constitution (Congressional approval, 2/3 vote).[139] Likewise, a tax incentive dwelled on the common law rule that if tax exemption has been given for a valuable consideration, the contract cannot be repealed because of the non-impairment clause. Still, the limitations imposed under the Constitution do not depart from the fact that there was a *consideration* in the contract.

C. Means Employed in S.B. No. 2411 Contrary to Constitutional and Statutory Mandates

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138. PHIL CONST., art. XII, § 11 ("Neither shall any such franchise or right be granted except under the condition that it shall be subject to amendment, alteration, or repeal by the Congress when the common good so requires.").

139. PHIL CONST., art. VI, § 28 (4) ("No law granting any tax exemption shall be passed without the concurrence of a majority of all the Members of Congress.").

The withdrawal of the tax incentives under S.B. No. 2411 is likewise contrary to its statutory and constitutional mandate. Its recognition that *the national economy shall be developed so as to enhance its competitiveness in the global economy and encourage investments that promote countrywide development, generate employment and foreign exchange* will not be realized since the means used in withdrawing the tax incentives within the economic zones create an uncertain environment which discourages investments.

According to the proposed bills, the objective of the State is to enhance its competitiveness in the global economy and to encourage investments that promote countrywide development and generate employment. In the minds of our legislators, there is a public need for it. Similar to the cases of *ABAKADA Guro Party List v. Ermita*,[140] *Alalayan v. National Power Corporation*,[141] etc., these are economic interests of the State which are justifiable reasons for the exercise of its continuing and dominant protective power.[142] Hence, on its face, the policy statement to rationalize the fiscal incentive system must be given due weight.

However, not only must the statute be supported by a significant purpose, it must be based upon reasonable conditions and be appropriate to further that purpose.[143] Hence, in testing the validity of a tax statute, as mentioned in the dissenting opinion of Justice Tinga in *ABAKADA*, it is recommended that one should go beyond a facial examination of the statute and seek to understand how exactly it operates.[144]

If the State is allowed to withdraw tax incentives without observing the proper legal parameters, the losses incurred will result in investor upheaval. Considerable losses will be incurred by these business entities because there is no discernible pattern of the withdrawal of tax incentives. With no consistent policy on tax incentives, the country ends up making decisions on an *ad hoc* basis. As such, lawmakers misalign the integrity of the government in providing stable economic policies. Pessimistic as it may sound, legislators may be tempted from time to time to act opportunistically, perhaps when the need for additional revenue is especially acute (for example, during a movement for tax reform or deficit reduction) or when the public's attention

140. ABAKADA Guro Party List v. Ermita, 469 SCRA 1 (2005).

141. Alalayan v. National Power Corporation,24 SCRA 172 (1968).

142. *ABAKADA*, 469 SCRA at 145; Alalayan, 24 SCRA at 182.

143. Jacobsen v. Anheuser-Bush, Inc., 392 N.W. 2d 868, 872 (1986).

144. *ABAKADA*, 469 SCRA at 276 (J. Tinga, dissenting and concurring).

is not focused on the decision or when, for whatever reason, the party that stands to suffer the transition loss is the taxpayer.[145]

Even if the rulings in *John Hay* and *Coconut Planters* will not apply in this case since the erroneous interpretation of the law will not save those who relied on it, the implications of these errors by the government add to the building concern of businesses. If the State could not address such concerns, the State is in effect not upholding its constitutional mandate of providing incentives to needed investments,[146] as well as promoting the preferential use of domestic materials and locally produced goods and adopting measures to help make these competitive.[147]

D. Response to the Saving Clauses of S.B. No. 2411

Under Section 37 of the proposed senate bill, incentives enjoyed by enterprises registered with the BOI, PEZA, other IPAs, and under existing investment laws shall continue to be legally binding in accordance with the terms and conditions stated in their respective registration certificates.[148] However, existing enterprises registered with the BOI, PEZA and other IPAs may opt to register with the Philippine Investment Promotion Administration (PIPA) and be governed by the provisions of said act prior to the expiration of their existing contracts.[149] Upon expiration of their contracts, all business locators with the exception of Subic, Cagayan and Zamboanga will fall within the purview of the said bill.[150]

On its face, it seems that this provision of the law preserves the rights and privileges enjoyed by these business locators. Likewise even absent such provision, the rights and privileges of the business locators must be respected since "[t]he actual existence of a statute, prior to such determination of repeal, is an operative fact and may have consequences which cannot justly be ignored."[151] Furthermore, it is within the prerogative of the business entity, whether or not he would want to avail of the incentives under the

145. Finn E. Kydland & Edward C. Prescott, *Rules Rather than Discretion: The Inconsistency of Optimal Plans*, 85 J. POL. ECON. 473, 484-85 (1977).

146. PHIL. CONST. art. II, § 20.

147. PHIL. CONST. art. XII, § 1, ¶ 2, § 12.

148. S.B. 2411, § 37.

149. *Id.*

150. Recto, *supra* note 28.

151. Municipality of Malabang v. Benito, 27 SCRA 533, 540 (1969) (citing Chicot Country Drainage Dist. v. Baxter State Bank, 308 U.S. 371, 374 (1940)).

said law. Nevertheless, even if the incentives previously enjoyed are respected, such saving provision *does not depart from the pernicious change of circumstances that the said bill has effected.*

The impairment contemplated by the law is a change of original rights of either of the parties to his prejudice.[152] In the case of the withdrawal of tax incentives, the additional conditions and subsequent effects of such withdrawal were not originally contemplated by the business entity since the tax incentive was promised for a valuable consideration. A project contracted which is expected to run for 10 to 20 years will be considerably delayed since new rules will be introduced in the middle of operations. This departs from the rule that from the moment of perfection of the contract, the parties are bound not only to the fulfillment of what has been expressly stipulated but also to all the consequences which, according to their nature, may be in keeping with good faith, usage and law.[153] How will this be possible if new conditions render it so difficult to make such contracts effective? Neither could this change be labeled as *force majeure* since it is not an event which is beyond the reasonable control of a party and which makes a party's performance of its obligations under the contract impossible or so impractical as to be considered impossible under the circumstances. This control is within the powers of the State, which unfortunately it refuses to exercise properly.

By giving investors an option to register under the PIPA prior to the expiration of their contracts, the State unduly interferes with the enforcement of the contract. If an investor stays with his existing tax regime, he is duly prejudiced because there is a possibility that those similarly situated as him but who opted to register under the new tax law, will have more incentives under the proposed bill. On the other hand, if the investor opted out of the contract, the implementation of such contract will be considerably delayed. Either way, the enforcement of the contract becomes reasonably impaired because the State has not complied with the original terms of the contract. Is this in consonance with the original intent of the parties?

Also, the sovereign credit rating suffers when the country fails to provide a secure investment environment.[154] The sovereign credit rating is important

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152. CRUZ, *supra* note 38, at 246.

153. An Act to Ordain and Institute the Civil Code of the Philippines [CIVIL CODE], Republic Act No. 386, art. 1315 (1950).

154. *See* Reem Heakal, What is a Corporate Credit Rating?, *available at* http://www.investopedia.com/articles/03/102203.asp (last accessed Aug. 23, 2010). ("A sovereign credit rating provides the latter as it signifies a country's

because it is the first thing most institutional investors will look at when making a decision as to whether or not to invest money abroad. This rating gives the investor an immediate understanding of the level of risk associated with investing in the country. So to attract foreign money, most countries will strive to obtain a favorable sovereign rating. However, because of this change in rules, the credit rating of the business locator will likewise be affected. If the business entity incurs losses because of the withdrawal of tax incentives, his creditworthiness will weaken as this will be reflected in his credit history and financial status.

In sum, all of these changes have substantially and unreasonably impaired the original intention of the business locator when the contract was perfected. By allowing the State to change the rules of the game in the guise of public interest is to commit an outright confiscation and violation of property rights.

E. From the Non-Impairment Clause to the Due Process Clause

The decline of the viability of the contract clause through the years is a sad fact. This does not mean, however, that the business is left without any recourse. As the use of the non-impairment clause has been waning, the liberty of contract as protected by the due process clause has emerged. In fact these are compatible with each other in the sense that they represent two sides of the same commitment to opening markets and preserving economic opportunities.

Indeed, it is difficult though to put into quantifiable terms how onerous a taxation statute must be before it contravenes the due process clause.[155]

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overall ability to provide a secure investment environment. This rating reflects factors such as a country's economic status, transparency in the capital market, levels of public and private investment flows, foreign direct investment, foreign currency reserves, political stability, or the ability for a country's economy to remain stable despite political change.").

155. Justice Isagani Cruz offers the following examples of taxes that contravene the due process clause:

> A tax for example, that would claim [80%] of a person's net income would clearly be oppressive and could unquestionably struck down as a deprivation of his property without due process of law. A property tax retroacting to as long as fifty years back would be tyrannical and unrealistic, as the property might not have been then in the possession of the taxpayer, nor, presumably, would he have acquired it had he known of the tax to be imposed on it.

CRUZ, *supra* note 38, at 85.

After all, the inherent nature of taxation is to cause pain and injury to the taxpayer for the greater good of society. Likewise when statutes are enacted by a representative legislature, after due consideration and deliberation of the limitations imposed by the Constitution and existing statutes, they would be taken as valid and fair on their face. However, in testing the validity of a tax statute as against the due process clause, it is recommended that one should go beyond a facial examination of the statute and seek to understand how exactly it would operate.

The scenario cited in *La Buga-B'Laan Tribal Association, Inc. v. Ramos*[156] is similar to the scenario in the case of special economic zones. It is worth noting here the pronouncements of the High Tribunal regarding the manner by which the State has arbitrarily exercised its regulatory power. The Court said,

> In contrast, the mining contractor will have sunk a great deal of money (tens of millions of dollars) into the ground, so to speak, for exploration activities, for development of the mine site and infrastructure, and for the actual excavation and extraction of minerals, including the extensive tunneling work to reach the ore body. The cancellation of the mining contract will utterly deprive the contractor of its investments (i.e., prevent recovery of investments), most of which cannot be pulled out.
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> To say that an FTAA [Financial and Technical Assistance Agreement] is just like a mere timber license or permit and does not involve contract or property rights which merit protection by the due process clause of the Constitution, and may therefore be revoked or cancelled in the blink of an eye, is to adopt a well-nigh confiscatory stance; at the very least, it is downright dismissive of the property rights of business persons and corporate entities that have investments in the mining industry, whose investments, operations and expenditures do contribute to the general welfare of the people, the coffers of government, and the strength of the economy. Such a pronouncement will surely discourage investments (local and foreign) which are critically needed to fuel the engine of economic growth and move this country out of the rut of poverty.[157]
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> . . .
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> In order to come anywhere near profitability, the contractor must first extract and sell the mineral ore. In order to do that, it must also develop and construct the mining facilities, set up its machineries and equipment and dig the tunnels to get to the deposit. The contractor is thus compelled to expend funds in order to make profits. *If it decides to cut back on investments and expenditures, it will necessarily sacrifice the pace of development and*

156. La Bugal-B'laan Tribal Asscoiation, Inc. v. Ramos, 445 SCRA 1 (2004).

157. *Id.* at 210-11.

> *utilization; it will necessarily sacrifice the amount of profits it can make from the mining operations*. In fact, at certain less-than-optimal levels of operation, the stream of revenues generated may not even be enough to cover variable expenses, let alone overhead expenses; this is a dismal situation anyone would want to avoid. In order to make money, one has to spend money. This truism applies to the mining industry as well.[158]

Similar to the case of a mining contractor, a business entity has already spent millions of pesos in developing the area through established structures and facilities. Allowing the State to change the terms of the agreement will utterly deprive the investors from reaping their investments. What is worse is that additional expenditures will be charged to the account of the investor. The pace and development of the operations will be delayed which in turn can sacrifice the amount of profits the business entity can make from the business venture. Revenues generated by these entities may not be enough to cover the expenses for such arbitrary withdrawal by the State. It is highly disturbing for the State to countenance such a practice. It is highly confiscatory and downright dismissive of the property rights of businesses and corporate entities who had every right to rely on the promise of the government.

F. State Not Contracting Away its Power of Taxation

The power to tax necessarily comes with the power not to tax. It is within the prerogative of the State whether or not it desires to tax a particular entity, transaction or activity. Hence, when it sees the propriety of granting a permanent tax exemption for the business entity, it is within its power to do so provided that it is exercised within the limits provided for in the Constitution, i.e., due process, uniformity, and procedural requirements.

On the one hand, the taxpayer is saying that when the State contracts with a business entity for a tax exemption, it is not completely surrendering its power of taxation since that would be nugatory to the existence of a state. The State here only submits to a restriction of its sovereign rights under the principle of self-limitation. On the other hand, from the point of view of the State, by limiting the realm of taxation under contract law, the State is hindering such exercise and would in effect be surrendering its power at the mercy of opportunistic creditors. Without the power of taxation, it is difficult for a state to exist since such is the lifeblood of the government.

The proponent agrees with the taxpayer that the State is not contracting away its power of taxation when it undertakes to contract with a business

158. *Id.* at 213 (emphasis supplied).

entity for a tax incentive. Taxation is and will always be an element of the State, which cannot be taken away by the legislature. However, taxation will always remain a high prerogative of the State. No person or citizen can ever question this exercise unless the State has overstepped the bounds of the law and the Constitution.

For its protection though, it is never presumed, and any reduction or diminution thereof with respect to its mode or rate must be strictly construed and the same must be couched in clear terms. Hence, the general rule is that any claim for exemption from tax statutes should be construed strictly against the taxpayer. However, if the construction of the tax statute is a liberal construction in favor of a tax incentive, the law must be interpreted in that manner so as to give effect to such provision.

As held in *Seagate*, since the exemption from local and national taxes granted under R.A. No 7227 is *ipso facto* accorded to ecozones, in case of doubt, conflicts with respect to such tax exemption privilege shall be resolved in favor of the ecozone.[159] Hence, when the State honors the tax incentives as indicated in their respective contracts, the State merely follows the policy it formulated. There is neither abdication nor surrender of any element of the State.

G. The End Does Not Justify the Means

The Author adopts the position of the sponsors of S.B. No. 2411 that there is an imminent need to rationalize our fiscal incentive laws. Corruption, investor confusion, and foregone revenues are just few of the concerns that this bill intends to address. By streamlining our fiscal incentive laws into to a simple, time-bound and performance-based system, a foreign investor would have a better gauge of what to expect from his investment. However, the State could not, under the guise of police power, withdraw tax incentives without observing the fundamental rights of the business locator. The substantial distinctions of a special economic zone must be respected by the State since these were the principal considerations of the foreign investor upon the perfection of the contract. This can be accomplished by going beyond a facial examination of the statute and seeking to understand how exactly it operates.

The Author agrees with the Bill's assertion of a fiscal incentive system that is time-bound. Through the use of this pre-commitment device, there is a good chance of preventing the opportunistic repeal of tax incentives. On

159. *See Seagate*, 451 SCRA at 151; R.A. No. 7227, § 12, ¶ 2 (c).

the part of the taxpayer, since the termination date of the tax incentive is set in advance, the taxpayer can immediately discover whether the provision will apply to a particular investment. In the case of fiscal incentives which cover long term investments (5% of GIT), the law could explicitly and categorically state that the enjoyment of the tax incentive will run during the entire duration of the business entity within the economic zones which cannot be altered except in cases when strong public interest requires such change. In this manner, contract law principles are applied and both the State and the taxpayer's rights will be preserved. Also, the grandfather rule adopted by the sponsors of the Bill[160] is a useful tool in ensuring that registered enterprises in economic zones will be protected. Nevertheless, it bears stressing that upon the expiration of their respective contracts, business locators will now be covered by the new fiscal incentives law. The State must address this concern since the tax incentives which originally contemplated as their competitive advantage will no longer be available to them.

Most of the provisions in the Senate Bill are quite investor-friendly. In fact, most of the tax incentives are far more generous than the ones presently enjoyed by special economic zones. However, the provisions relating to the substitution of the ITH to a NOLCO and the creation of a Trust Liability account must be carefully re-examined since substantial losses will be incurred by the business locator. Reforms on monitoring and not the withdrawal of tax incentives are needed to fully realize the potential of special economic zones.

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160. Under Section 37 or the Transitory Provisions of S.B. No. 2411:

> The incentives already granted to enterprises registered with BOI, PEZA, other PAS and under existing investment laws shall continue to be legally binding in accordance with the terms and conditions Stated in their respective registration certificates. Existing enterprises registered with BOI, PEZA and other PAS may opt to register with PIPA and be governed by the provisions of this Act prior to the expiration of their existing contracts. For activities or entities, whether government or private, whose tax and/or duty exemptions or preferential treatment under special laws are Withdrawn or repealed by this Act, the pertinent provisions of the National Internal Revenue Code of 1997 (Tax Reform Act), as amended; the Tariff and Customs Code, as amended; and the Local Government Code of 1991, shall apply.

The State will never succeed in attracting FDIs if it is unable to increase investor confidence in the domestic economy. The government must therefore re-evaluate its reactive policy of using fiscal incentives in attracting FDIs and instead be proactive and concentrate its efforts on developing measures and safeguards which are conducive to the long-term growth and development of the country.

H. Cooperation from Private Sector Needed

Indeed, many enterprises affected by the proposed rationalization of fiscal incentives will most certainly be resistant to the initial efforts of government to overhaul the existing incentive system. It is thus important for the State to properly communicate the objectives of rationalizing the country's fiscal incentive system and how in the long run, this can be more beneficial to investing firms and enterprises.

V. TOWARDS A FULLER REALIZATION OF SPECIAL ECONOMIC ZONES

In simplest terms, rationalization means good reason, validation, and explanation. If the State sees that rationalization will effectively develop the national economy so as to enhance its *competitiveness in the global economy and encourage investments that promote countrywide development, generate employment and foreign exchange*, then all the more must the *means* used be sound, just, and consonant with its avowed State policy. To reiterate, the State will never succeed in attracting foreign direct investment if it is unable to increase investor confidence in the domestic economy. The government must therefore re-evaluate its reactive policy of using fiscal incentives in attracting FDIs and instead be proactive and concentrate its efforts on developing measures and safeguards, which are conducive to the long-term growth and development in the country. Allowing a contract to run its course would be a good start.