

THE REPORT

The Philippines 2012

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Legal Framework

Different ways of setting up shop locally
Licensing requirements for foreign companies
Comparison of subsidiary and branch operations
Transferability of shares, liability and continuity





A subsidiary or a branch may qualify for tax and other incentives

Clear and simple

A look at the legal aspects of doing business locally

The subject of foreign corporations doing business in the Philippines is perhaps better understood in the context of their involvement in the flow of capital, goods and services into the country. In this context, a business is a vehicle through which such a flow is carried out by the foreign corporation concerned.

In the Philippines, a common business vehicle is either a domestic subsidiary in the form of a stock corporation, or a local branch of a foreign corporation. In the case of a branch, it is the foreign corporation itself that conducts business, considering that the local branch is merely an extension of the juridical personality of the head office abroad – since the branch and the head office are one and the same juridical entity.

Under the National Internal Revenue Code (NIRC), such juridical entity is categorised as a “resident foreign corporation” (a foreign corporation engaged in trade or business within the Philippines). In contrast, a domestic subsidiary acquires a separate juridical personality distinct from its foreign parent corporation. The foreign corporation has been domesticated or naturalised through its local subsidiary. However, since the subsidiary has a juridical personality of its own, separate from the parent foreign corporation, the latter is categorised as a “non-resident foreign corporation” (a foreign corporation not engaged in trade or business in the Philippines), while the former is classified as a “domestic corporation”.

In instances where a foreign corporation’s economic contact with the Philippines is only occasional or episodic, the establishment of a business vehicle may not be warranted. A business presence seems appropriate only when the entry by a foreign corporation into the economic processes of the country is relatively continuous and permanent in nature. In fact, the tax treaties of the Philippines would call a business presence here through a branch a “permanent establishment”. Whether or not a foreign corporation has to establish locally a business presence depends on whether or not it is intent on “doing business” in the

Philippines as that term is defined in the Foreign Investments Act of 1991.

A FOREIGN CORPORATION: Under Section 123 of the Corporation Code, a foreign corporation is “one formed, organised or existing under any laws other than those of the Philippines and whose laws allow Filipino citizens and corporations to do business in its country or state”. The concept of reciprocity is folded into the definition of a foreign corporation. However, this only means that a company incorporated outside the Philippines will not be allowed to do business in this country if its jurisdiction of incorporation does not grant a reciprocal right to a Philippine corporation. In other words, the concept of reciprocity in Section 123 is meant to be a condition for the issuance of a licence to do business in the Philippines. It does not affect the status of the foreign corporation as a juridical person. If there is absence of reciprocity, the foreign corporation will simply not be allowed to come in. Reciprocity is also not a condition for the right of a foreign corporation not doing business in the Philippines to file a suit in the Philippines.

DOING BUSINESS: The Supreme Court has applied the continuity test in determining whether or not a foreign corporation is doing business in the Philippines. As early as the case of the *Mentholatum Co., Inc., et al. v. Mangaliman, et al.*, (1941), it was ruled that the term “doing business” implies “a continuity of commercial dealings, and contemplates, to that extent, the performance [by the foreign corporation] of acts or works or the exercise of some of the functions normally incident to, and in progressive prosecution of, the purpose and object of its organisation”.

This broad concept has found its way into Section 3(d) of the Foreign Investments Act of 1991, which specifies continuous commercial dealings, along with certain other acts or activities, as constituting doing business in the Philippines. Thus:

- a) Soliciting orders, [or] service contracts;
- b) Opening of offices or branches;

- c)Appointing representatives or distributors domiciled in the Philippines or who in any calendar year stay in the country for a period or periods totalling 180 days or more;
 - d)Participating in the management, supervision or control of any domestic business, firm, entity or corporation in the Philippines; and
 - e)Any other act or acts which imply a continuity of commercial dealings or arrangements, and contemplate to that extent the performance of acts or works, or the exercise of functions normally incident to, and in progressive prosecution of, commercial gain or the purpose or object of the business organisation.
- However, the following acts do not constitute doing business in the Philippines under the implementing rules of the Foreign Investments Act of 1991:
- 1)Mere investment as a shareholder by a foreign entity in domestic corporations duly registered to do business, and/or the exercise of rights as such investor;
 - 2)Having a nominee director or officer to represent its interest in such corporation;
 - 3)Appointing a representative or distributor domiciled in the Philippines which transacts business in the representative's or distributor's own name and account;
 - 4)The publication of a general advertisement through any print or broadcast media;
 - 5)Maintaining a stock of goods in the Philippines solely for the purpose of having the same processed by another entity in the Philippines;
 - 6)Consignment by a foreign entity of equipment with a local company to be used in the processing of products for export;
 - 7)Collecting information in the Philippines; and
 - 8)Performing services auxiliary to an existing isolated contract of sale which are not on a continuing basis, such as installing in the Philippines machinery it has manufactured or exported to the Philippines, servicing the same, training domestic workers to operate it, and similar incidental services.

Item 1 above considers "mere investment as a shareholder by a foreign entity in domestic corporations duly registered to do business" as not doing business in the Philippines by such foreign entity. Thus, a foreign corporation that establishes a local subsidiary is itself not doing business in the Philippines.

Similarly, equity investment by a foreign corporation in a local affiliate company will not constitute doing business. In either case, it is the subsidiary or affiliate (each a juridical entity in its own right) that will be doing business locally. On the other hand, item 2 clarifies that having nominee directors or officers in the subsidiary or affiliate will not be deemed doing business. It would be a different matter, however, if the investing company itself were to become the management company of the subsidiary or affiliate. That would be directly "participating in the management, supervision or control" of a domestic corporation – which is an act of doing business under Section 3(d) of the Foreign Investments Act of 1991. The "continuity test" was defined in a

Supreme Court ruling *B. Van Zuiden Bros., Ltd. v. GTVL Manufacturing Industries, Inc.* (2007). There, the Supreme Court ruled that: "Actual transaction of business within the Philippine territory is an essential requisite for the Philippines to acquire jurisdiction over a foreign corporation and then require the foreign corporation to secure a Philippine business licence." Accordingly, even if there is "a series of transactions implying a continuity of commercial dealings", the foreign corporation will not be doing business in the Philippines, if "the perfection and consummation of these transactions were done outside the Philippines". This ruling was reiterated by the Supreme Court in *Cargill, Inc. v. Intra Strata Assurance Corporation* (2010).

DIMENSIONS: The concept of "doing business" in the Philippines arises in three contexts or dimensions. The first relates to the qualifications of the foreign enterprise for its formal entry into the Philippine economy. This touches on the licensing requirement. The second aspect concerns the amenability to suit of a foreign corporation. The third dimension has to do with the tax treatment of the foreign enterprise as a resident or a non-resident foreign corporation.

LICENSING REQUIREMENT: A foreign corporation will have the right to transact business in the Philippines after it has obtained a licence for that purpose from the Securities and Exchange Commission (SEC). This licence is necessary because a foreign corporation has no legal existence in the Philippines unless it is recognised in the country as a legal entity. Recognition is evidenced by the licence issued by the SEC.

In certain cases, the SEC will not issue the licence without a favourable endorsement from the government agency that has supervision over the contemplated business activity of the applicant. The endorsement will be in the form of a certificate of authority from, for instance, the Bangko Sentral ng Pilipinas (BSP) for banks, or the Insurance Commission for insurance companies. The primary franchise of the foreign corporation's business vehicle in the Philippines is its SEC licence, while its secondary franchise is its certificate of authority from any other relevant government agency (such as the BSP or the Insurance Commission).

Aside from a subsidiary or a branch, there are four other ways by which a foreign corporation may establish a presence in the Philippines. It may set up a representative office, a regional area headquarters (RAHQ), a regional operating headquarters (ROHQ), or a domestic partnership.

- a)Representative office: A representative office acts as a message centre between its head office and the Philippine customers, as well as promotes the products and services of the head office and its affiliates. These activities are non-income producing. All transactions generated by the promotional efforts of a representative office are to be booked offshore by its head office or its affiliates. From a tax viewpoint, the only income of a representative office is in passive income, such as interest on deposits.
- b)RAHQ: A RAHQ acts as an administrative branch of a multinational company. It principally serves as a



supervision, communication and coordination centre for the multinational's subsidiaries, branches or affiliates in the Asia-Pacific region and other foreign markets. Unlike a representative office, however, RAHQs are not subject to Philippine income tax and enjoy certain other incentives under the Omnibus Investments Code and the NIRC.

- c) ROHQ: A ROHQ is a multinational company's branch which is allowed to derive income in the Philippines solely by providing qualifying services to the multinational's affiliates in the Asia-Pacific region and other foreign markets. The qualifying services are the following: general administration and planning, business planning and coordination, sourcing or procurement of raw materials and components, corporate finance advisory services, marketing control and sales promotion, training and personnel management, logistics services, research and development services, product development, technical support and maintenance, data processing and communication and business development. A ROHQ is not allowed to perform general business activities in the Philippines. It is prohibited from (i) offering qualifying services to entities other than the multinational company's affiliates, branches or subsidiaries, as declared in its registration with the SEC; (ii) directly or indirectly soliciting or marketing goods and services whether on behalf of its mother company, branches, affiliates, subsidiaries or any other company; and (iii) directly or indirectly engaging in the sale and distribution of their goods and services. A ROHQ is subject to a preferential income tax rate of 10% on taxable income and enjoys certain other incentives under the Omnibus Investments Code.
- d) Partnership: A partnership has a juridical personality of its own, distinct and separate from that of its partners. While there is no prohibition against a partnership being partner in another partnership, for a corporation to be a partner, a specific statute or its charter must authorise it to enter into a partnership. Furthermore, a foreign corporation will not be allowed to act as general partner in a Philippine partnership, unless it establishes a branch or subsidiary in the Philippines to act as the general partner.

AMENABILITY TO SUIT: Under Section 133 of the Corporation Code, if a foreign corporation transacts business in the Philippines without a licence, it will not be permitted to maintain or intervene in any action, suit or proceeding in any Philippine court or tribunal. However, it may be sued or proceeded against before any such court or tribunal.

Section 133 of the Corporation Code is not meant to provide local enterprises with a way to avoid complying with their contractual obligations to unlicensed foreign corporations. In *Rimbunan Hijau Group of Companies and Niugini Lumber Merchants Pty., Ltd. v. Oriental Wood Processing Corporation* (2005), the Supreme Court ruled that: "Considerations of fair play dictate that after having contracted and benefitted from its business transactions with [the petitioning foreign corporations], [the respondent local company] should be

barred from questioning [the foreign corporations'] lack of licence to transact business in the Philippines."

TAXATION: In terms of taxation we can make the following comparisons between a subsidiary and a branch:

- a) Taxability of income according to source: While a local branch of a foreign corporation is subject to Philippine income tax only with respect to income derived from Philippine sources, all the income of the local subsidiary is subject to Philippine income tax for the year in which the income is earned, from all sources within and outside the Philippines. Subject to this distinction, one will note that a local branch and a domestic subsidiary are both amenable to the taxing powers of the Philippines.
- b) Applicable tax rates: Domestic corporations and branches of foreign corporations are subject to the same rate of income tax, which is currently 30% of net taxable income. The difference in tax treatment lies in the fact that the tax rate is applied in respect of a branch (which is considered a resident foreign corporation) on the net income from all sources within the Philippines, while, in respect of a subsidiary, on the net income from all sources within and outside the Philippines. Any profit remitted abroad by a branch to its head office is subject to a tax of 15%. In this respect, interest, dividends, rents, royalties including remunerations for technical services, salaries, wages, premiums, annuities, emoluments or other fixed or determinable annual, periodical or casual gains, profits, income and capital gains received by a foreign corporation during each taxable year from all sources within the Philippines will not be considered as branch profits, unless they are effectively connected with the conduct of its trade or business in the Philippines.
- c) Items of deduction: A local subsidiary, being a domestic corporation, is entitled to claim all business deductions allowable under the NIRC. These deductions from gross income include business expenses, interest, taxes, losses, bad debts, depreciation and charitable contributions. On the other hand, a Philippine branch of a foreign corporation, which is required to include only its income from Philippine sources in the computation of its gross income subject to Philippine tax, is correlatively restricted in the deductions which it may claim in arriving at its taxable income. Generally, a foreign corporation engaged in trade or business in the Philippines may deduct only such items as are specifically allocable or directly related to its Philippine income.
- d) Applicability of tax credit: If a domestic corporation that is a subsidiary of a foreign corporation is engaged in business outside the Philippines and taxed by a foreign country on its income earned outside the Philippines, such foreign income tax may be treated, subject to certain limitations, as a credit against its Philippine income tax. A foreign corporation is not entitled to claim credit for the taxes imposed by or paid to a foreign country to offset its Philippine income tax liability. Where the local subsidiary to be set up in the Philippines is designed to

conduct business activities not only in the Philippines but in other countries as well, the availability of foreign tax credit with respect to its Philippine income tax may be of some significance. Obviously, the availability of foreign tax credit is of no consequence if the proposed operations (whether through the medium of a branch or a local subsidiary) are intended to be confined solely to the Philippines.

- e) Tax incentives: In certain cases, a subsidiary and a branch might qualify for tax and other incentives under, for instance, the Philippine Economic Zone Authority Law or the Omnibus Incentives Code.

ADVANTAGES OF A CORPORATE FORM: A subsidiary has a distinct advantage over the other business vehicles in terms of limited liability, continuity of existence, and easy transferability of interests.

- a) Limited liability: The head office is liable for the obligations of its branch, but not for the liabilities of its subsidiary. Indeed, a major advantage of a subsidiary (as a stock corporation) is the limited liability of the stockholders. This means that the stockholders are not liable beyond the amount of their equity investments in the corporation. Consequently, their assets are insulated from the claims of corporate creditors. Compared to a partnership, the general partners are liable with all their property to the creditors of the partnership, after all the partnership assets have been exhausted. There is an exception to this rule. From time to time, when corporate personality is used as a shield for wrongdoing, or when a corporation is merely an alter ego or a conduit of one or more persons, courts have ignored the corporate entity and imposed personal liability on the stockholders for corporate debts or obligations. It must be noted, however, that this does not result in the revocation of the primary franchise of the corporation or its certificate of incorporation. It only means that, for the questioned act or transaction and solely for that, the corporation is treated as a mere association of persons. However, in respect of its other acts or transactions, the corporation remains as a juridical person separate from its stockholders.
- b) Continuity of existence: In the absence of a stipulation to the contrary in the articles of partnership, the partnership is dissolved by the death of a partner. However, the death of an individual stockholder, or the dissolution of a corporate stockholder, does not affect the existence of the corporation. The corporation continues as a juridical entity during its specified term of existence, which is normally up to 50 years, renewable for periods not exceeding 50 years in any single instance, by amendment of its articles of incorporation.
- (c) Transferability of shares: A partner can transfer his or her share of the profits of the partnership to a third person. However, his or her status as a partner cannot be transferred to a third person, unless the proposed transferee is acceptable to the other partners. This is known as *delectus personarum*. On the other hand, shares of stock in a corporation are personal property transferable by the indorsement of



Domestic firms and foreign branches are subject to a tax rate of 30%

the underlying stock certificates. The indorsement may be made (i) on the form of assignment printed on the dorsal side of the stock certificate itself, or (ii) on a similar form known as a “stock power” or an “assignment separate from certificate”. If such indorsement is done and the pertinent stock certificate is delivered to the transferee, then the share transfer is valid between the transferee and the transferor even in the absence of a more formal or elaborate deed of assignment or transfer of shares. No such transfer, however, will be binding on third persons, unless it is recorded in the stock and transfer book of the corporation “so as to show the names of the parties to the transaction, the date of the transfer, the number of the certificate or certificates and the number of shares transferred”. The transfer will not be recorded if the corporation holds any unpaid claim against the shares transferred, when these shares are not yet fully paid by the transferring stockholder. The corporate secretary will not record the transfer and issue new stock certificates to the transferee unless the certificate authorising registration is submitted to him or her. It is issued by the Bureau of Internal Revenue, once the capital gains and stamp tax are paid. For listed shares, the stock transaction tax applies, not capital gains. If the shares are uncertificated, they can be transferred between parties by appropriate book entries in the stock and transfer book held by the corporate secretary or a transfer agent.

THE NEGATIVE LIST: Under the Foreign Investments Act of 1991 non-Philippine nationals may own up to 100% of the equity of a domestic enterprise, unless foreign participation in the activity is prohibited or limited by the negative list. For example, foreigners cannot own more than 40% of a landholding firm. In a financing firm and an investment house this can reach 60%.

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Rafael Morales, Managing Partner, SyCip Salazar Hernandez & Gatmaitan

Fighting corruption

OBG talks to Rafael Morales, Managing Partner, SyCip Salazar Hernandez & Gatmaitan

What is your outlook on the ongoing move for constitutional change, and how will this affect the investment atmosphere of the country?

MORALES: There is a good chance that constitutional change may be effected during the current administration. In this respect, foreign investors would probably be indifferent to the proposal to change our system of government from presidential to parliamentary. I presume that they would be more interested in amendments affecting the economic provisions of the constitution, such as the one relaxing or removing the restriction on foreign ownership of land. This type of amendment would likely be acceptable to foreign investors, being beneficial to them.

How will the push towards improved corporate governance and eliminating corruption have an influence on the business sector?

MORALES: President Benigno Aquino's push in this direction is commendable and should be welcomed and supported by the business sector. Corruption and poor governance are perennial problems that weaken investor confidence in the country. Therefore addressing these issues in a meaningful way would be a positive development for the business sector.

However, the president's drive to make erring persons accountable should be conducted with scrupulous observance of due process, so as not to result in political instability that could eventually be counter-productive to his programme of good governance in the public – as well as the corporate – sector.

What can the Philippines do to further support political stability in the country?

MORALES: The days of coup attempts appear to be over, but the country continues to witness political events that might lead to constitutional crisis. The impeachment proceedings against the chief justice and another member of the Supreme Court should be conducted in ways that do not emasculate the third

branch of the government. An independent judiciary is indispensable to political stability in the country. Preserving the independence of the judiciary would foster political stability in the Philippines.

How should the country's leadership address corruption disputes from past administrations?

MORALES: Some sectors see the moves of government as less than acceptable from the vantage point of due process. The government can avoid this perception by putting together a team of litigators steeped in constitutional and commercial law to manage the process. All is not fair in litigation. There are rules that must be observed. Moreover, it is essential that the judiciary must not be weakened in the process.

How can the Philippines work to ease the legal disputes between the national government and the local government units (LGUs)?

MORALES: Federalism is often proposed as the solution to these disputes. I am not certain, however, if abandoning our unitary system of government is the correct answer. Indeed, federalism might be a recipe for the break-up of our republic.

To be sure, however, the perceived rift between the two might go away, if the internal revenue allotments of LGUs are released expeditiously by the national government, thereby enhancing local financial autonomy.

What steps can the Philippines take to attract foreign investment in the country?

MORALES: Foreign investors are looking for a good investment climate and, therefore, the Philippines should provide that environment to attract investments, particularly foreign direct investments.

This can be achieved by improving our infrastructure (especially in areas such as transport, telecommunications and power) and streamlining business regulations by cutting red tape to the bone. Needless to say, corruption should be controlled, if not eliminated.