

*Philippines – Taxes on Distilled Spirits*

**(DS396/DS403)**

**EXECUTIVE SUMMARY OF THE FIRST WRITTEN SUBMISSION  
OF THE PHILIPPINES**

**October 21, 2010**

## **I. INTRODUCTION**

1. This case involves the right of a developing country WTO Member to impose a tax regime that is best suited to achieve the fiscal objectives set out in its Constitution in light of the administrative and enforcement constraints it faces with respect to tax collection.

2. An important tenet of the Philippines' fiscal objective is equitable taxation. Article VI, Section 28(1) of the Constitution of the Philippines provides that "the rule of taxation shall be uniform and equitable. The Congress shall evolve a progressive system of taxation." This means, among other things, that taxation should be based on the taxpayer's individual ability to pay. Therefore, higher-priced goods, typically bought by wealthier consumers, should bear a higher absolute tax than lower-priced goods, typically bought by less affluent consumers. In the Congressional deliberations at the time of the adoption of Section 141 of the National Internal Revenue Code, it was stated that the proposed tax system would be fair as "It will be based on the ability to pay ... because the tax will depend on whether the product is high priced or low priced ... [This] will accommodate or answer the constitutional requirement of equitable taxation."

3. The jurisprudence of the WTO has long recognized the right of WTO Members to establish and apply their own tax policies. As WTO Members are "free to tax distilled alcoholic beverages on the basis of their alcohol content and price", they are equally free to tax distilled alcoholic beverages on the basis of the raw materials used.

## **II. FACTUAL BACKGROUND**

4. The materials-based excise tax system for distilled spirits in the Philippines is non-discriminatory, in law and in fact. It applies a specific tax on distilled spirits produced from designated raw materials, and a three-tiered tax on spirits produced from other materials. The distinction in tax rate is based on the objective criterion of raw materials and not on whether the products are domestic or imported. The language of the statute is clear on this point: Section 141(a) states that the specific rate applies to distilled spirits produced from the designated raw materials "provided such materials are produced commercially in the country where they are processed into distilled spirits."

5. The raw materials identified in Section 141(a) are grown in numerous countries in various parts of Asia, Australia, Africa, North America (United States), Central America and South America. According to the United Nations Food and Agriculture Organization, the

Philippines ranked 10th in the world in terms of production of sugar cane in 2008. Given the global availability of all of these materials, particularly sugar, the measure does not favour domestic producers. Thus, whether on a de jure or a de facto basis, the measure is origin-neutral.

6. The raw materials-based distinction in Section 141 can be traced to the American colonial period in the Philippines. The U.S. colonial administrators imposed a specific tax on distilled spirits “produced from sap of the nipa, coconut, or buri palm, or from the juice, sirup, or sugar of the cane.” Nearly a century later, Section 141 of the NIRC uses almost identical language, providing for a specific tax on distilled spirits “produced from the sap of nipa, coconut, cassava, camote, or buri palm or from the juice, syrup or sugar of the cane”. It is undisputed that the complainants in this case carry the burden of proving their claims that the Philippines has violated its obligations under GATT Article III:2. They cannot merely assert a violation; they must prove the elements of a violation. Both the United States and the EU have failed to discharge this burden in relation to all their claims concerning the products in question.

### **III. THE PHILIPPINES’ EXCISE TAX REGIME FOR DISTILLED SPIRITS IS CONSISTENT WITH ARTICLE III:2, FIRST SENTENCE**

#### **A. Non-Sugar-Based Distilled Spirits are Not “Like” Sugar-Based Distilled Spirits<sup>1</sup>**

7. The concept of “like products” under Article III:2 must be examined on a case-by-case basis, and the Appellate Body has stressed that this concept “must be construed narrowly so as not to condemn measures that its strict terms are not meant to condemn.” A very important element of “likeness” relates to the physical characteristics of the product in question. Market segmentation based on price is also a very important aspect in the determination of likeness under Article III:2, first sentence.

#### **1. Physical Characteristics**

8. The non-sugar-based distilled spirits originating in the EU and the United States are not “like” the sugar-based spirits produced in the Philippines. The physical differences are substantial and in turn affect the quality, price, brand reputation and other characteristics of the

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<sup>1</sup> Section 141(a) of the NIRC refers to specific materials, *i.e.*, “sap of nipa, coconut, cassava, camote, or buri palm or from the juice, syrup or sugar of the cane.” Because this phrase is cumbersome to use throughout the text, we refer to the spirits and liquors produced from the Section 141(a)-enumerated materials as “sugar-based” spirits and liquors. We believe that adopting such a convention will enhance the narrative discussion of the tax structure and the distinction between Section 141(a) and Section 141(b) without creating the misimpression that Section 141(a) refers only to sugar as a raw material, which it clearly does not. At other times in this submission, the use of the phrase “sugar-based” spirits and liquors will be restricted to those products produced from sugar as a raw material. This should be clear from the context, and should not cause confusion.

products.

9. The difference in raw materials causes differences in the production processes for sugar-based and non-sugar-based distilled spirits. The most important differences are found in fermentation, distillation and aging.

10. For sugar-based spirits, fermented sugar-cane molasses is subjected to continuous distillation so that it is completely stripped of congeners, which are the chemical compounds responsible for giving alcoholic beverages their taste, flavour and aroma. The resulting alcohol is a neutral spirit that does not retain any of the attributes (taste, colour or odor) of the raw material from which it came. Neutral spirits rely on flavouring extracts or concentrate, or natural, nature-identical or artificial flavours and essences, for their taste, flavour and aroma. Thus, for sugar-based spirits, ***the end goal of distillation is to come up with a neutral spirit, i.e., a spirit that is tasteless, odorless and colourless, and that is devoid of the attributes of the raw material from which it came.***

11. For non-sugar-based spirits, on the other hand, the fermented raw material is distilled in a way that permits retention of the congeners unique to the raw material, thus giving the resulting alcoholic beverage its distinctive taste, flavour and aroma. For these non-sugar-based spirits, the fermented raw material (*i.e.*, grape or fruit wine, or fermented mash of grain) is distilled only up to the point where the level of flavour desired by the distiller is achieved. ***The end goal of distillation is to balance, enhance, highlight, combine and/or contrast the different flavours naturally occurring in the raw material.*** Finally, while non-sugar based spirits undergo an aging process of differing duration, sugar-based spirits do not.

12. Physical differences are more specifically described as follows:

- ***Whiskey:*** EU and U.S. whiskey use grains or cereals as the primary basis for this product. By contrast, Philippine “whiskey”, like all other distilled spirits produced in the Philippines, is a sugar-based neutral spirit (ethyl alcohol) to which flavouring is added. ***Philippine sugar-based whiskey would be prohibited from being marketed as “whiskey” under both EU law and United States law.***
- ***Brandy:*** is a spirit based on wine, grape or other fruit – not sugar. There is a fundamental difference in the physical characteristics of sugar-based brandy produced in the Philippines and non-sugar-based brandy produced in the EU and United States. Once again, the sugar-based brandy is made from ethyl alcohol derived from sugar, stripped of

practically all congeners, to which the flavourings are added. ***Philippine sugar-based brandy would not be permitted to be marketed as “brandy” under the domestic laws of the EU or the United States.***

- ***Vodka*** produced from sugar molasses cannot be considered “like” vodka produced from grains or cereals. The Panel in *Japan – Alcoholic Beverages II* found that shochu and vodka were like products because they were “both white/clean spirits, ***made of similar raw materials*** and the end-uses were virtually identical.” Sugar-based vodka and grain-based vodka are not made from “similar raw materials.” The difference in raw materials affects the taste and flavour of the product.
- ***Gin***: Gas chromatography tests performed on non-sugar-based gin and sugar-based gin yielded results supporting the conclusion that gin made from different raw materials cannot be considered the same.
- ***Tequila*** is a distilled spirit made from agave, a plant that grows chiefly in Mexico. It is not “like” the tequila-flavoured spirits that are produced by Filipino distillers.
- ***Rum***: The Philippines does not contest that imported rum and locally produced sugar-based rum are made from the same raw material: sugar. Accordingly, the Philippines taxes all imported rums, properly declared to be made from sugar, at the tax rate under Section 141(a).

## 2. Consumer Tastes and Preferences

13. In considering the perceptions and behaviour of consumers, it is important to stress that the market in the Philippines for non-sugar-based distilled spirits and sugar-based distilled spirits is highly segmented. The purchasing power of the vast majority of Philippine consumers is very low. This means that the tastes and habits of consumers are objectively determined and constrained by the amount of disposable income available to be spent on alcohol consumption. This important factor is critical to assessing the tastes and preferences of consumers in the market segments in the Philippines. There exists at least two different groups of “consumers” in the Philippines, each with a different set of tastes, habits, perceptions and behaviour and levels of disposable income. Neither the United States nor the EU has presented any credible evidence to suggest that the distilled spirits sold in these different market segments in the Philippines are interchangeable. Indeed, the United States did not make any arguments regarding consumer

tastes and preferences.

### 3. Tariff Classifications

14. The Philippine Tariff and Customs Code (TCC) distinguishes between each category of distilled spirits. More specifically, it uses individual categories for each of the non-sugar-based distilled spirits; and, uses a *separate category* for sugar-based liquors. Thus, each type of distilled spirit, internationally distinguished and identified by the different raw materials used in their production, has its own individual tariff line. The EU has misunderstood the TCC when it asserts that “[a] whisky, a vodka, a gin/geneva and a rum fall always within a specific sub-heading, irrespectively of whether they were produced with *e.g.*, sugar cane, coconuts, grapes, wheat, potatoes etc.” It is only when they are made from sugar that they will fall within heading 2208.40. The United States did not offer any evidence on tariff classification in support of its argument that certain distilled spirits are like products.

### 4. End-Uses

15. The end-use of the products at issue is objectively the same in that they are alcoholic beverages that will be ingested for the same purpose, *i.e.*, relaxation. However, that does not mean that they are “like products.” The Panel in *Japan – Alcoholic Beverages II* stressed that “the term ‘like products’ suggests that for two products to fall under this category they must share, apart from commonality of end-uses, essentially the same physical characteristics.” Thus, any overlap in end-use for non-sugar-based distilled spirits and sugar-based distilled spirits is insufficient to overcome the clear differences in physical characteristics.

16. When the elements of “likeness” are considered in their totality, including physical characteristics, consumer tastes and habits, market segmentation, tariff classifications and end-use, non-sugar-based distilled spirits cannot be considered “like” sugar-based distilled spirits.

#### B. Level of Taxation

17. The Philippines considers that as the first part of the test under Article III:2, first sentence, has not been met, *i.e.*, the products are not “like”, there is no need to proceed to the analysis of the second part of the test, namely, whether one group of distilled spirits is taxed “in excess of” another group of distilled spirits.

#### IV. THE PHILIPPINES EXCISE TAX REGIME FOR DISTILLED SPIRITS IS CONSISTENT WITH ARTICLE III:2, SECOND SENTENCE

##### A. Non-Sugar-Based Distilled Spirits and Sugar-Based Distilled Spirits are Neither “Directly Competitive” Nor “Substitutable”

18. The ordinary meaning of the term “directly” is “completely, absolutely, exactly.” Thus, products can only be regarded as “directly competitive” if the “degree of proximity” in the competitive relationship between the sugar-based and non-sugar-based products is such that they could be considered to be in “complete, absolute, or exact” competition with one another. Moreover, the appropriate place to examine whether products are “directly competitive or substitutable” is the marketplace. The need for a case-by-case examination, based on the peculiarities of the individual marketplace means that prior cases are of limited relevance in determining whether non-sugar-based distilled spirits and sugar-based liquors can be considered as directly competitive or substitutable. *In none of the three prior WTO alcohol cases were the Panels presented with the type of highly segmented market that exists in the Philippines, in which sugar-based spirits are produced for low-income consumers, and where high cost non-sugar-based spirits are priced out of reach for the vast majority of the population.*

##### 1. The Philippine Market

19. In the specific context of the Philippine market, sugar-based domestic liquors, which are sold at very low prices, do not offer an “alternative way[] of satisfying the same consumer demand in the marketplace” as that offered by high-priced non-sugar-based spirits. There is no “close”, “direct” or “proximate” competitive relationship between these products. Non-sugar-based spirits cannot offer such an alternative even for the foreseeable future, given the magnitude of the gap in purchasing power in these different market segments. *Such non-sugar-based distilled spirits are simply too expensive to be an affordable option for the vast majority of Philippine consumers – regardless of any tax.*

##### 2. Price and Elasticity of Substitution

20. The Philippine market for alcoholic beverages is stratified in such a way that non-sugar-based distilled spirits at their pre-tax prices are simply not an affordable option for the vast majority of consumers, given their low income. This means that non-sugar-based distilled spirits and sugar-based spirits are not in direct competition in the Philippine market.

21. The gap between the average pre-tax price of non-sugar based spirits and sugar-based spirits is simply insurmountable for the vast majority of Filipinos. This gap is so great that the

price of non-sugar-based spirits prevents their purchase, as indicated in the Euromonitor Consumer Preference Survey which found that “[e]ven at a 40% price decrease of imports and a 100% to 200% price increase in domestics, imported brands are typically more than twice as expensive as domestic ones.”

22. The University of the Philippines econometrics study shows very low price elasticity and a very weak degree of substitutability. The United States points to the Euromonitor survey as an indication of price elasticity. However, these findings reflect that any competitiveness between sugar-based and non-sugar-based distilled spirits is limited to a very small and highly unrepresentative segment of the Filipino market. Moreover, even for these individuals, it took dramatic decreases in the prices of non-sugar-based spirits, coupled with even more significant increases in the prices of sugar-based products, to affect consumer choices. Thus, even for the class of Filipinos who have the option of buying non-sugar-based spirits, there was very weak elasticity of substitution.

### 3. Distribution channels

23. That sugar-based spirits and non-sugar-based spirits are sold in structurally different markets, and are not directly competitive or substitutable, is also reflected in their manner of distribution. In the Philippines, non-sugar-based distilled spirits and sugar-based spirits are sold through distribution channels that *are almost entirely different*. Periodic retail trade audits show that *sari-sari* stores consistently accounted for roughly 85% of off-premise sales of sugar-based spirits. By contrast, non-sugar based spirits are almost *never* sold in *sari-sari* stores. Another price survey which covered 43 *sari-sari* stores located all over Metro Manila, revealed that *not a single sari-sari store carried non-sugar-based spirits. No market exists for non-sugar-based spirits through this principal distribution chain.*

24. Distribution channels for sugar-based and non-sugar-based spirits also differ when it comes to on-premise sales. Sugar-based spirits are generally not sold in hotels, high-end restaurants and bars where non-sugar-based spirits are sold. Instead, they are sold in *carinderias*, *lugawans* and *gotohans*, and in beer gardens, beer houses and *ihaw-ihaws* (grilled meat stalls), where, in turn, non-sugar-based spirits are not sold.

### 4. Physical Characteristics

25. The products in the present case are indeed “physically quite different”, as described in the section on “like” products, and this places a “higher burden” on the EU and the United States to establish that, despite these differences, there is a competitive relationship between them.



## 5. End Use and Advertising

26. Any overlap in end-uses cannot by itself overcome the clear physical differences in the products, or, more significantly, market segmentation caused by very material price differences. It follows that any overlap in advertising strategies is also of limited relevance. The EU points to instances where the producers of sugar-based products have sought to market their products by making references to the country where the spirit is traditionally made, or referring to traditional appellations or ingredients. However, this only confirms that the marketing campaigns are attempting to overcome differences in perceptions affecting economic decisions held by consumers between non-sugar-based distilled spirits and sugar-based distilled spirits.

## 6. Tariff classification

27. The classification of these products under the Philippine Tariff and Customs Code tariff schedule also supports the conclusion that these products are not directly competitive or substitutable. As noted above, the TCC uses individual categories for each of the non-sugar-based distilled spirits, but a separate category for sugar-based liquors.

28. In sum, the complainants have failed to prove that the products in question are directly competitive or substitutable in the Philippine market.

### **B. Non-Sugar-Based Distilled Spirits and Sugar-Based Spirits are “Similarly Taxed”**

29. Should the Panel find, despite compelling evidence to the contrary, that non-sugar-based spirits and sugar-based spirits are directly competitive or substitutable, the *de minimis* difference in the relative tax burdens borne by the products at issue is permissible under Article III:2, second sentence.

30. The comparison to be made is not between the nominal tax rates applied to non-sugar-based and sugar-based products, but rather their relative tax burdens.

31. The concept of *de minimis* for the purposes of Article III:2, second sentence, is defined by the extent to which the tax burden affects the competition of products in the market in question. If the difference in tax burden has little or no impact on consumer decisions, it is appropriately deemed to be *de minimis*. As noted above, the average net retail price of the non-sugar-based spirits indicates that, regardless of the tax rate imposed, the vast majority will not be able to afford these products. In other words, the difference in the level of taxation has no effect in the Philippine market on the decision to purchase or not to purchase, as affirmed by both the complainants’ Euromonitor Consumer Preference Survey and the University of the Philippines

econometrics study.

32. Moreover, as there is “no set level of tax differential which can be considered *de minimis* in all cases” the Panel has a certain amount of discretion in determining where the line for *de minimis* taxation will be drawn. In exercising this discretion, a Panel must take into account the particular market situation. In the case of the Philippines, weight should be given to the fact that the Philippine taxation system has the effect of taxing those who can afford what are effectively luxury goods at higher levels than those who cannot.

### **C. The Excise Taxes are Not Applied “So As to Afford Protection” to Domestic Production**

33. Should the Panel find, despite compelling evidence to the contrary, that the products in question are directly competitive or substitutable and the difference in taxation is more than *de minimis*, both the history and the current use of the materials-based excise tax system refute the notion that it has been applied “so as to afford protection.”

34. Section 141(a) provides this designated rate for all distilled spirits made from sugar, whether they are imported or locally produced. If the legislators had intended to “protect” the domestic distilled spirits industry, this preferential rate would not have been accessible for imported products. The significance of the fact that both imported and distilled spirits can access the preferential tax rate is illustrated by the fact that rums constitute one of the most popular distilled spirits in the Philippines, making up over one-fourth of the total distilled spirits market.

35. More importantly, *none of the materials eligible for the lower tax rate are found exclusively in the Philippines*. Indeed, as noted, the raw materials listed in Section 141(a) are grown all over the world.

36. GATT Article III protects equality of competitive conditions. This logically means that if the measure does not in fact impact on competitive conditions, it cannot violate GATT Article III. The competitive opportunities for non-sugar-based distilled spirits in the Philippines are determined by the high price of such products and the low purchasing power of the vast majority of consumers – not the excise tax. This is a “real fact in a real case in the real world.” Thus, the Philippines submits that any dissimilarity in the level of taxation is not imposed “so as to afford protection” to domestic producers of sugar-based liquors.

## **V. CONCLUSION**

37. For the reasons set forth above, the Philippines requests the Panel to reject all of the complainants’ claims under GATT Article III:2.