



**Republic of the Marshall Islands:
A Holistic Approach to Reforming the Tax and Revenue
System**

**Tax and Revenue Reform and Modernization Commission
Republic of the Marshall Islands**

**Submitted to the Minister of Finance
Honorable Jack Ading**

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Foreword

Among its three main mandates approved by RMI Cabinet on July 11, 2008, the Tax and Revenue Reform and Modernization Commission (The Commission) core mandate is; “to deliver to the Government, a proposal for consideration to reform the current tax system and structure, that are appropriate and suitable for the purpose of meeting, the current and future financial needs of the Republic of the Marshall Islands, and a tax and revenue design conducive to current realities and circumstances.”

Accordingly, with the support of IMF and PFTAC in an advisory capacity, the Commission sets out to deliver this mandate. The Commission made presentations to members of the Chamber of Commerce, private sector on Ebeye, conducted radio interviews, solicited comments from the public using the Yokwe Online website and the Marshall Islands Journal. In short, a deliberated public engagement leading to this report has been achieved.

Resulting from the wide and long process of public engagement and numerous meetings of the Commission, the IMF and PFTAC Report was published on September, 2009. Then soon followed the Commission’s Report entitled “Republic of the Marshall Islands: A Holistic Approach to Reforming the Tax and Revenue System.”

On behalf of the Commission, I wish to express our Kommol Tata to the Honorable members of the Cabinet for allowing the Commission the opportunity to review, examine and make recommendations of a tax regime best conducive to the RMI as it navigates into the new millennium. I also wish to express gratitude to each Members of the Commission for their commitment and tireless efforts throughout the long two years in producing this report. Thank you to members of the Chamber of Commerce, Marshall Islands Journal, Mr. Aenet Rowa of the Yokwe.net, Ministry of Internal Affairs, Ebeye business community, the General Public, and staff of the Ministry of Finance, MalGov, EPPSO and MISSA for their cooperation and contribution. Lastly, I wish to give a big Kommol Tata to Honorable Minister Ading, Secretary Barton, and Chief Secretary Nemra.

Francis Carlos Domnick

Chairman, Tax and Revenue Reform and Modernization Commission

Executive Summary

The Commission appreciates the concise format of the Executive Summary in the PFTAC Report. We present below a summary of the recommendations of the Commission in the same format for easy comparisons.

Recognizing the unique aspects of the economy in the RMI, several of the PFTAC Report recommendations have been modified to be more appropriate to the social, business and political realities of the RMI.

RECOMMENDATIONS

1. *General*

- As per the mandate of the Commission, tax reform is to be revenue neutral to existing taxpayers as a group and thus not result in tax increases.
- Increased tax revenues should come from enforcement of those not currently paying or underpaying.
- Tax regulations are to be applied equally to the Private Sector, National and local governments and state owned enterprises.
- Broadening Tax Base to minimize tax burden and to include other items not currently taxable.
- Consideration for Introduction of the Revenue Authority of the Republic with a governing board of directors, which shall also oversee the mandate to provide for rules and approval of tax exemptions.

2. *Personal income tax*

Reform the personal income tax by:

- Expanding the range of taxed income to include allowances and in-kind benefits. Unlike the recommendations in the PFTAC Report, the Commission makes the recommendation to impose interest and dividends at a low rate at 3%.
- Expanding the tax free threshold to \$4,160 per year and apply it to all taxpayers.
- Adding an additional rate of tax of 16 percent for salary and wages greater than \$20,800 as opposed to the recommended 20 percent rate in the PFTAC Report which does not consider the tax revenue from taxing housing allowances.

Current Personal Tax Rates		Proposed Personal Tax Rates	
0-\$1,560	0 percent	0-\$4,160	0 percent
\$1,561-\$5,200	8 percent (with first \$1,560 being exempt)	\$4,161-\$10,400	8 percent
\$5,201-\$10,400	8 percent	\$10,401-\$20,800	12 percent
>\$10,400	12 percent	>\$20,800	16 percent

3. *Business net profit (Income) tax*

Replace GRT by introducing an income tax with the following features:

- Rate of approximately 20 percent to be determined by a confidential study of business net margins for neutrality to existing GRT revenues.
- Apply to all taxpayers with gross annual revenue greater than \$100,000 (including pooling of revenue of commonly owned businesses).
- Apply to professionals grossing less than \$100,000 where appropriate.
- Standard straight line asset depreciation rather than the PFTAC Report's recommendations of group and accelerated depreciation.
- Allow loss carry forward for 3 to 5 years.
- Resist pressure to introduce tax incentives. Any tax incentives should have "claw back" provisions for recovery in the event that businesses do not meet agreed upon criteria.

4. *Presumptive tax*

Retain the GRT as a presumptive tax for small businesses (that is those not covered by the income tax) with the following features:

- For businesses with gross annual revenue of less than \$10,000, retain the flat rate but consider increasing the amount.
- For businesses with gross annual revenue between \$10,000 and \$100,000 introduce two presumptive tax rates: 3 percent for trading enterprises and 6 percent for services recognizing that some professionals in this group should pay income tax.
- Allow small business taxpayers to opt into the net profits tax.

Clarify the law that wages and salaries or similar payments such as drawings are captured under the personal income tax.

5. *Consumption tax*

Introduce a consumption tax in the form of a sales tax (as opposed to VAT as recommended in the PFTAC Report) to replace the hotel and resort tax, standard rate import duties, and local government sales taxes with the following features:

- Rate of 10 percent assessed at first point of sale.
- Exemptions kept to a minimum and exports zero-rated.
- Applying to government purchases of goods and services.
- The national government collecting and administering the tax with the local and national governments entering into a revenue sharing arrangement.

6. *Excise taxes*

- Replace the existing import duties on alcohol, tobacco, motor vehicles, and fuels with excise taxes.
- Increase the rates to take account of the current local government taxes on these goods. Increase the existing low rates on alcohol, and decrease the existing high rates on beer to more nearly equalize taxation based on alcohol content.

Introduction: The Need for Reform

Outside advisory groups have recommended reform of the tax structure and tax administration of the RMI for several years. It is deemed to be archaic, inefficient, inequitable, and an impediment to the economic growth of the Republic. In short, to adapt to changing social and economic factors, the tax system needs to be modernized or reformed. It has additionally been reported that the system is been poorly administered, and tax collections are far below the levels that would result from universal and honest compliance practices including improvements in enforcement of tax laws. .

There have previously been a few consultative meetings with the private sector to discuss tax reform issues including an excellent “retreat” under the auspices of the ADB in August of 2005 with public and private sector stakeholders. None of these meetings resulted in any agreed upon conclusions in the RMI as to the best course of tax reform for the RMI. No group of informed people was specifically organized to evaluate the complex problems and options and to recommend the most appropriate course of action for the RMI prior to the establishment of the Tax Reform and Modernization Commission.

The deteriorating financial condition of the National Government has made reforms imperative. The payroll of the National Government has doubled, and is becoming unsustainable compared with 10 years prior, world market conditions have raised commodity prices to unprecedented levels with oil/fuel costs a particularly critical problem for the national budget. Downsizing at the US Army Base at Kwajalein has deprived the government of payroll taxes on furloughed employees. The downsizing has affected American and Marshallese employees working on the base that had earned high wages. The squeeze of increasing expenses and decreasing revenues has created the need to stabilize government revenue streams. At the initiative of the Minister of Finance, Hon. Jack Ading, on July 11, 2008, the Cabinet approved a Tax Reform and Modernization Commission to evaluate the problems, many alternatives for reform, and to recommend the best system of taxation for the RMI’s specific circumstances. The Tax Reform Commission was to be assisted and advised by a representative of the Pacific Financial Technical Assistance Centre (PFTAC), a regional organization within the International Monetary Fund. On April 22, 2009, also at the initiative of the Minister of Finance, a separate Comprehensive Adjustment Program Advisory Group was formed to address recommendations for expenditure reform.

Objective and mandate of the Tax Reform Commission

The underlying rationale of the commission is based on the following tenets (1) strengthen RMI Tax administration and Enforcement, (2) provide ways and means to ensure fiscal sustainability and (3) promote sustainable private sector growth.

The Cabinet endorsed the following objectives to the Tax Reform Commission:

1. To deliver to the Government a proposal for consideration to reform current tax system and structure that are appropriate and suitable for the purpose of meeting the current and future financial needs of the Republic of the Marshall Islands and a tax and revenue design conducive to current realities and circumstances;
2. To deliver to the Government a proposal for consideration to strengthen the capabilities and effectiveness of the revenue collecting administration, sufficient to implement the revenue and tax reforms and improve the level of (voluntary) compliance of RMI Tax Payers.
3. To take the role and responsibility of governing and oversight of the design to ensure effective implementation of these changes needed to enhance a sustainable revenue stream to the Government

To provide for an approach to making sound recommendations, the Tax Commission adopted the following guiding principles:

- Transparent and certain
- Effective and efficient to administer
- Simple and broad based
- Fair and equitable
- Financially neutral
- Low tax burden
- Promote private sector development
- Attractive to foreign investment

In short, the recommended system should be clear and simple for those paying and collecting taxes, and broad enough to capture taxes on all segments of the economy. It should be fair and equitable to all taxpayers, financially neutral to the existing taxpayers as a group, and the existing level of taxes should be redistributed among taxpayers in the fairest manner possible by recognizing an ability to pay. This system should be favorable to the private sector to encourage development and attractive to foreign investors.

The Tax Commission has been discussing options since its founding with the assistance of the PFTAC advisor and has come to some broad conclusions. The PFTAC advisor who was aided toward the conclusion of the project by another experienced advisor completed a report with recommendations and published it in September, 2009, as “Republic of the Marshall Islands: Reforming the Tax System” - Peter Mullins and Carson McNeill. We will refer to it as the PFTAC Report.

The purpose of this report by the Tax Reform and Modernization Commission is to explain our deliberations, conclusions, endorsements, and recommended revisions of the conclusions in the PFTAC Report.

This report should be read in conjunction with the PFTAC Report, as that report and its detailed tables will generally be referenced rather than duplicated herein.

The Challenge

Tax schemes are not “one size fits all” that can simply be applied everywhere. Taxation policies must be tailored to the specifics of each country’s economy and national goals. What works well in one country may be a failure in another.

The RMI has some unique aspects in its economy. Little is produced either for domestic consumption or export. As a result there are few locally originated products while most are imported. . Large amounts of financial assistance, resources and contributions come into the Republic from outside sources mostly from the Compact of Free Association with the U.S. Government, the Republic of China (Taiwan), and others including Japan, Australia, New Zealand and the EU. The government spends this for purchased products, services, construction, and government payroll. This allows local businesses to import and sell the vast majority of products sold in the country and to pay their own employees. Most of the proceeds from these sales leave the country immediately to pay for the imported products. Much of the profit from these sales in turn also leaves the country: (1) although there are no statistics, foreign businesses are presumed to be sending money elsewhere; (2) foreign expatriate employees send money home and take their local savings when they repatriate; (3) some local businesses invest their profits elsewhere; and (4) the majority of deposits in the overseas banks doing business in the RMI are often repatriated to their home country where the money is loaned and circulates in that economy. As a result there is little circulation of money in the RMI, and the ‘multiplier’ that economists discuss as a measure of this is very low here.

As the funding of the Compact decrements for grants and increases for the trust fund, less revenue money will be available for government spending thus creating hardships for a private sector currently dependent upon government spending.

The economy of the RMI needs to move from being based on government spending of outside funds to an economy driven by a healthy private sector producing products, services, profits, and employment. This is no simple task, and it will take years. There are many aspects of making the RMI more conducive to business, but a business-friendly tax policy is one of the more important. Encouraging and assisting local business is as important as attracting foreign investors as local businesses can more easily be enticed to keep their money in the local economy.

Salaries and wages are generally low particularly in the private sector. Unemployment is high, and the employed typically have to support large households.

The RMI is not rated highly in the annual World Bank's "Doing Business" report. The 2010 Report shows the RMI as 98th which is a twelve position drop from 2007 and below every other Pacific country except the FSM at 127th and the Solomon Islands at 104th.

The Commission has been looking at tax reform proposals in view of the above circumstances of the RMI, and as a result which will be detailed later in this report, believes that some of the excellent recommendations of the PFTAC Report should be modified accordingly to suit the circumstances and realities of the RMI.

Activities of the Commission

The Commission was formed with nine members, five from the private sector and four from the public sector. The members are:

Mr. Carlos Domnick, Chairman
Mr. Ben Chutaro, Vice Chairman
Mr. Ben Graham, Member
Mr. Phil Marshall, Member
Mr. Mr. Hermai Makroro – Proxy Jim McLean, Member

Mr. Bruce Bilimon, Secretary
Ms. Saane Aho, Proxy Bryan Edejer Member
Mr. Carl Hacker, Member
Mr. Joseph Batol, Proxy John Peralta Member

Support Staff:

Mr. Itibo Tofinga Chief of Revenue and Taxation, Mr. Daniel Timothy Chief of Customs and the Staff of the Ministry of Finance

Advising the Commission were:

Mr. Carson McNeill, PFTAC Revenue Administration and Policy Advisor and
Mr. Peter Mullins, International Monetary Fund.

The Commission reviewed a number of the more recent tax reform reports, including:

- Macroeconomic Issues and Fiscal Policy, 1995
- Taxation Issues, 1995
- Trade Policy, the Labor Market and Private Sector Development, 1995
- A Structure for a Value Added Tax, 1996
- Tax Reform other than VAT, 1996
- Revenue Collection - Administrative Issues, 1996
- Local Government and Proposed National Tax Reforms, 1997
- Tax Policy and Administration in The Republic of the Marshall Islands, 2006
- Country Analysis, 2006
- Selected Issues and Statistical Appendix, PFTAC 2008
- Republic of the Marshall Islands: Reforming the Tax System, PFTAC 2009

Solicitation of recommendations and comments from the public on a new system of taxes was considered critically important to attain trust and future compliance from businesses and individual taxpayers. Accordingly, the Commission published a notice of the Commission's establishment and a request for public comments in the Marshall Islands Journal. Public notices were also broadcast on V7AB, published on the Marshall Islands Journal and the Yokwe.net website. Mr. Bruce Bilimon was interviewed on V7AB on the topic of tax reform and the activities of the Commission.

As a result, the Commission published a notice of the Commission's establishment and a request for public comments in the Marshall Islands Journal. Requests were also broadcast on V7AB.

Mr. Bilimon traveled to Ebeye with a delegation from the Ministry of Finance, and he met with private sector people to discuss the coming tax reform.

On behalf of the Commission Mr. Bilimon made a presentation to the Chamber of Commerce on the subject of reform and the role of the Commission. He requested comments and recommendations. Members of the Commission met individually with many of the business owners and managers in Majuro.

The public and private sector Commission members evaluated alternatives and prepared separate proposals over many months of discussion from their differing perspectives, and the Secretary of the Commission prepared a comparative chart of these for public distribution and comment.

The Chamber of Commerce devoted part of a later meeting to a presentation of recommendations from one of the business owners in response to the varied recommendations presented in the comparative chart.

Following public engagements, the Commission met on number of occasions.

Results of Consultations with the Private Sector

Candidly, it was very difficult to get businesses to offer recommendations or comments. The reasons for this were twofold. First, the business community was involved in the project to reform immigration laws two years ago. When the final law was passed it contained several anti-business provisions, and the recommendations/comments of businesses during the law's discussions had been mostly ignored. This increased the distrust of the Government by the business community, and several cited this in their disinterest in working on a tax reform measure. They expected to be similarly ignored. Also, businesses saw no advantage in a new system expecting a similar lack of compliance by those not complying with the current system coupled with a similar lack of enforcement.

Discussions with members of the private sector, without exception, named the biggest problem with the existing system of taxes to be lax enforcement and smuggling. There is no way to minimize the importance of this issue to those who have been paying taxes, and voluntary compliance with a new system of taxes will be heavily reliant upon the perceptions of the private sector as to a commitment of the taxing agencies to enforcing tax laws and vigorously prosecuting violators. The lack of prosecutions was often cited, including some of the high profile cases such as one incident where a foreign business person was caught smuggling vodka in water bottles that was reported in the Marshall Islands Journal.

Nonetheless, Commission members were able to hold some fruitful discussions with members of the business community.

The Chamber meeting in which a member commented on the Commission's chart of its members' alternate proposals began with a display by the member and Chamber president of products easily purchased in Majuro for prices below the value of the taxes that should have been assessed and thus obviously smuggled. A picture of these two gentlemen and the products was on the front page of the Journal. Moving on to specific comments about the Commission's chart, there were several substantive objections. On the subject of personal taxes they believed that too many wage ranges and tax rates were included and that it should be simplified. The upper tax rates were too high and would be too costly to businesses to pay them. On the subject of consumption taxes, they were opposed to VAT as being inappropriate to the simple economy of the RMI. It would also require too much unnecessary work by businesses to comply. On the subject of business taxes, they objected to several proposed new increased taxes in the government list of proposals.

PFTAC Report and Recommendations of the Commission

In September 2009, the PFTAC "Republic of the Marshall Islands: Reforming the Tax System" was published.

This excellent report draws upon previous tax reform reports, the deliberations of the Tax Commission, and the authors' own research and extensive expertise in international taxation.

In broad terms, the Commission members agree with the conclusions of the PFTAC Report. The Commission had moved toward the three basic conclusions: (1) a consumption tax was likely to be necessary; (2) personal tax brackets should provide relief for the working poor; and (3) business taxation should be on a net income basis. We have several material differences regarding the details of these taxes as proposed in the PFTAC Report. We feel that the proposed taxes should be appropriate to the RMI.

The authors use the terminology of Commonwealth countries. There are some minor differences as compared with the American terms in common use in the RMI. To avoid confusion, this report will use the terms that are familiar here. Income Tax, with which

we are familiar, is called a Net Profits Tax in the PFTAC Report. The term “revenue” in use in the RMI is called “turnover” in the PFTAC Report.

For each category of taxation, this report will offer some of the discussion points on alternate views debated by the Commission, and the reasoning behind the conclusions of the Commission.

High Tax Rate vs., Low Tax Rate Scenarios

The PFTAC Report presents tables showing the tax ramifications of a high and a low tax rate scenario. (Table 1. Summary of Estimated Fiscal Impact of Tax Reform Package). One of the basic founding principles of the Commission was that tax reform was to be neutral, collectively, to the current taxpayers and would redistribute the tax burden equitably. The Commission therefore can not recommend the high rate scenario. It is worth mentioning that the low rate scenario raises taxes by 1.4% of GDP on businesses and employees representing an additional \$2 million in taxes. The PFTAC projected taxes do not take into account increased taxes from additional definitions of income to be taxed (to be discussed later) or increased collections from those currently evading or underpaying taxation. The following is from the PFTAC Report: “taxpayer non-compliance is broadly estimated to be in a range of 40 – 60 percent.”

From the Final Report of The Comprehensive Adjustment Program Advisory Group: “Currently tax revenues are equivalent to 17-18% of GDP and the IMF suggest the optimal range should not be above 20% GDP. Raising taxes beyond this could further weaken the economy.” Enforcement of tax laws may well raise taxes as a percentage of GDP above 20% without the additional taxes contemplated even in the PFTAC Report’s Low Rate Scenario.

Table 3. Regional Comparison of Tax Revenue, 2007
(as a percent of GDP)

	Fiji 1/	FSM	Kiribati	Marshall Islands	Palau	Samoa 1/	Solomon Islands	Tonga 1/	Vanuatu
Tax revenue	22.4	11.7	19.7	17.9	18.3	26.2	31.1	26.8	18.9
<i>Income taxes</i>	<i>8.1</i>	<i>2.3</i>	<i>7.8</i>	<i>7.4</i>	<i>4.3</i>	<i>4.5</i>	<i>10.0</i>	<i>5.9</i>	<i>n.a.</i>
PIT/Wages and salaries tax	4.2	2.3	4.8	7.4	4.3	-	4.9	-	n.a.
Corporate tax	4.0	n.a.	3.0	n.a.	n.a.	-	5.1	-	n.a.
<i>Domestic goods and services taxes</i>	<i>10.2</i>	<i>2.6</i>	<i>n.a.</i>	<i>3.9</i>	<i>6.0</i>	<i>17.0</i>	<i>11.3</i>	<i>11.6</i>	<i>11.6</i>
VAT/CT	8.6	n.a.	n.a.	n.a.	n.a.	10.4	n.a.	11.5	11.6
GRT	n.a.	2.6	n.a.	3.9	6.0	n.a.	n.a.	n.a.	n.a.
Sales Tax	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9.5	n.a.	n.a.
Excises	1.5	n.a.	n.a.	n.a.	n.a.	6.6	1.8	0.1	-
<i>International trade taxes</i>	<i>4.0</i>	<i>4.0</i>	<i>11.9</i>	<i>6.2</i>	<i>4.5</i>	<i>3.9</i>	<i>9.7</i>	<i>9.3</i>	<i>6.5</i>
Imports	3.8	4.0	11.9	6.2	4.5	3.9	3.7	9.3	6.5
Exports	0.2	n.a.	n.a.	n.a.	n.a.	n.a.	6.0	n.a.	n.a.
Other	n.a.	2.9	n.a.	0.3	3.6	0.7	0.0	n.a.	0.8

Source: Mission compilation based on Ministry of Finance data in each country.

1/ 2006 data - Republic of the Marshall Islands: Reforming the Tax System Report by IMF.

By rearranging the data in the PFTAC table, it is easier to see the effects of the proposed tax changes. Tax figures are expressed as percentages of GDP.

Tax Changes	Existing Taxes	Low Rate Scenario	Increase - Decrease
Income Tax Replacing GRT:			
GRT	3.9		
Net Income Tax		3.7	
Presumptive Tax		0.1	
Totals	3.9	3.8	-0.1
Modifying Personal Income Tax			-1.0
VAT Replacing Import Taxes And Local Gov't:			
Import Taxes	5.6		
Fuel Taxes	0.6	0.6	
Local Governments	1.9		
VAT		7.0	
Excise Taxes (Alcohol, Tobacco, Other)		3.1	
Totals	8.1	10.7	2.6
New Taxes:			
Interest and Dividends		0.5	0.5
Total Revenue Impact			2.0
Less: Change in Price Effect of Government Spending		-0.7	-0.7
Net Fiscal Impact			1.3

As seen in the above comparisons:

A nearly neutral tax effect results from replacing GRT as business taxation with an income tax.

There would be a decrease of 1.0% of GDP by modifying personal income taxes.

Replacing import taxes and Local Government taxes with VAT and excise taxes results in an increase of 2.6% of GDP.

New taxes, in the form of interest and dividend taxes, raise an additional .5% of GDP.

The net effect to employees and business is taxes of an additional 1.3% of GDP. There is a minor difference in this table and that of the PFTAC Report (1.4%) due to a footing error in the PFTAC Report that is presumably from rounding.

Reforming Personal Income Tax: Relief for the Poor

The Commission recommends that all forms of allowances be defined as taxable income. There is some contention in the business community on housing allowance, however, which in theory is paid to foreign workers to help defray the high costs of living in the RMI. Eliminating the exclusion from taxation would drive up employers' costs as employees seek pay increases to compensate. The private sector believes that this would affect them particularly as private sector salaries and wages are generally lower than those of the public sector and thus would be more subject to pressure. Nonetheless, we believe that housing allowance, too, should be taxable income as should be housing directly provided. Over the years, housing allowance has also become a method of evading taxes as it is often paid to residents solely for the tax exclusion in addition to payments to legitimate foreign workers. Another form of excluded income that should be addressed is domestic per diem. Under the law, Per diem is excluded from taxation provided that reasonable per diem and travel allowance to the extent that they do not exceed any comparable Government rates. The Commission believes that the current definition need to be more elaborated to specify taxable amount applied to per diem. The Commission deems that some companies, recognizing the loophole, are paying management and employees part of their salaries/wages as per diem in Majuro to avoid some taxes.

The Commission believes that the current taxation of the lowest earning taxpayers is an inequitable hardship on those struggling to provide for themselves and their families. As a result, we are recommending that the first \$4,160 of annual income be exempted from taxation - this is the level of the minimum wage. The Commission debated several revisions to tax brackets and rates, but agrees with the private sector opinion that such brackets should be limited for simplicity. This same opinion is expressed in the PFTAC Report.

The Commission does believe, however, that the tax rate of 20% proposed in the PFTAC Report for the highest tax bracket is too high. The PFTAC Report does not include the impact of including housing allowance as taxable income. This is significant for many of the approximate 11% of taxpayers in the proposed highest bracket, and it would result in not only higher rates but higher income subject to taxation. The Commission estimates that a highest bracket tax rate of 16%, inclusive of housing allowances, will yield the same tax revenue as the proposed 20% in the PFTAC Report which ignores housing allowance. For most taxpayers the additional tax burden individually should not be excessive at the 16% rate.

Taxation of Dividends and Interest

The PFTAC Report recommends the taxation of dividends and interest. The Commission believes that this is inappropriate for the RMI given the limited amount of capital retained in the country and the need to attract outside investment. Adding taxes on dividends and interest would create disincentives to savings and investment in the Republic making alternative locations more attractive.

The traditional argument against taxing dividends is that they are distributed from after-tax corporate earnings, and such additional taxation raises total taxes to an unacceptable level. Consider this from the standpoint of corporate business owners. If a corporation's profits were taxed at 20% and dividends were taxed at 8-10%, then the total tax on profits paid to the business owners would be 28-30%.

Taxing interest would similarly be a disincentive for savings in the Republic and potentially drive deposits elsewhere.

On these topics, the following are excerpts from "Tax Policy and Administration in The Republic of the Marshall Islands", by Dr. Fuat M. Andic, Ph.D:

"The system also is not necessarily conducive to foster economic development. There are no provisions to encourage savings and reinvestment, nor are there specific tax incentives to encourage foreign investment. It is of paramount importance to realize that with a fairly low income level in the country capital formation cannot be financed only by internal savings alone."

"For the sake of encouraging savings, exemption of interest income from tax may be considered. This exemption is justifiable as a development policy."

Although the Commission recognizes the arguments in favor of exemption of dividends and interest from taxation to attract investment, it believes that a compromise low tax rate of 3% can raise revenue without unduly affecting investors negatively. We do have a minority opinion; however, that dividends and interest should remain tax exempt for the reasons discussed

Reforming Business Taxation: Replacing GRT

GRT is generally considered as an inequitable form of business taxation in that it imposes tax at a uniform rate on revenues with no regard to profit and ability to pay. It under-taxes high margin businesses, overtaxes low margin business, and helps force money-losing business into receivership. There is no need here to list all of its deficiencies that are adequately covered in the PFTAC Report, but a relevant point noted in the PFTAC Report is that, unlike income tax, GRT is not generally recognized as a form of taxation for which foreign governments allow tax credits in their own tax systems causing an investment disincentive for the RMI.

Net profit tax (Income tax) has been proposed previously as the most equitable form of business taxation. In consultations with the business community, the Commission has received mostly negative feedback, however. There are three aspects to this. First, the net profit tax was implemented early in RMI history, and it was a failure with tax collections dropping off dramatically. This resulted in the re-implementation of GRT. The tax changes had been rushed into implementation with inadequate training of the government employees responsible for its enforcement as well as inadequate preparation of the business community. The well-considered three year implementation period proposed in the PFTAC Report should prevent a re-occurrence of the previous problems

Secondly, the business community sees the net profit tax as having onerous filing requirements. This seems to stem from the net profit tax requirements in developed countries with which many business people are familiar. Required forms for filing income taxes in the RMI can, and should be, relatively simple with data easily obtainable from the financial statements and books of businesses. This makes filing and auditing of taxes easier for all concerned.

Thirdly, businesses believed that net profit tax would be easier to evade than the current GRT. The implementation period proposed in the PFTAC Report should provide time for adequate hiring and staff training for those businesses that need it and the Ministry of Finance. Hopefully there will be a commitment to beef up enforcement by Finance and the Attorney General in bringing businesses into voluntary compliance with a resulting increase in tax revenue.

The Commission believes that net profit tax is the best and most equitable form of business taxation and if properly implemented and administered will be accepted as beneficial by the business community. This will also make the RMI a more attractive investment location. It should also be noted that the RMI private sector is dramatically different today from what it was when income taxation was first tried. Today, businesses have the ability to keep records and calculate income taxes.

The Commission generally agrees with the excellent net profit tax proposal described in the PFTAC Report. We do have a few comments. The PFTAC Report mentions capital gains but makes no recommendations as to tax treatment. The Commission suggests that capital gains should be taxed at a lower rate than net income.

The Commission agrees with the PFTAC proposal that tax losses be allowed to be carried forward to offset future income. No mention is made of tax loss carry back, but the Commission does not recommend this although it is allowed in some countries.

The PFTAC Report recommends that \$100,000 in gross revenue is an appropriate amount above which income tax should be mandatory and that this captures 96% of the current GRT payments and thus presumably would capture a similar percentage of income tax. This is excellent reasoning and a solid proposal. The report further recommends that companies grossing less may opt into net profit tax if they wish or pay a presumptive tax similar to GRT. The Report recommends retaining the 3% rate for companies selling

goods and establishing a 6% rate for those selling services. This too is a solid proposal, but the Commission recommends considering a higher tax rate or required income tax filing for some service businesses below the \$100,000 threshold which have relatively lower costs of doing business absent the cost of goods sold. Consider a lawyer or consultant grossing \$90,000. Such a person might have office expenses of \$12,000 and MISSA employer payments of \$2,100 netting \$75,900 in profit. At 6 % GRT this person would pay just \$5,400 in presumptive income tax rather than \$15,800 at the Report's proposed 20% business tax rate and \$12,767 at the personal income tax rates proposed in the PFTAC Report. Such service businesses have the expertise to file income taxes. The Commission recommends that criteria or regulation be established so that such personal businesses pay their fair share of taxes.

Minor issues in the PFTAC Report

The PFTAC Report recommends group depreciation of assets for tax purposes. The commission believes that this is inappropriate from an accounting standpoint and can lead to errors and audit difficulties. The PFTAC Report also recommends accelerated depreciation. The Commission believes that this offers limited business benefit and that taxation should be strictly on a book basis, and thus not require book-to-tax reconciliations and separate tax bases for assets to complicate tax filings and audits.

In the section on anti-avoidance measures, the PFTAC Report recommends limiting interest deductions to prevent a business from unnecessary borrowing just for the deduction. The Commission finds it highly unlikely that a business would do so especially at a relatively low 20% tax rate. A business suffering decreased profits could find itself unable to deduct interest from prudent previous borrowing. We do not endorse this idea.

The PFTAC Report recommends avoiding the offering of tax incentives to entice new business in the RMI. Replacing GRT with net profit tax removes the largest problem that would require a tax holiday since, unlike GRT, RMI net profit tax would likely be a deductible tax credit in the home countries of investors, therefore an incentive for investors. Nonetheless, the Commission believes that tax incentives can be a useful tool as long as they are not offered for unreasonable lengths of time as has been done in the past. Any tax holiday offer should contain "claw back" provisions so that taxes waived would be recovered if the business does not meet specific criteria such as duration of investment or numbers of employees.

The biggest uncertain issue is probably the proposed rate of business net profit tax. This is the most difficult of the proposals in the PFTAC Report to predict as there are no reliable statistics of the profit margins of businesses in the Republic. The PFTAC Report predicts that a proposed 20% tax rate will be approximately revenue neutral to the current 3% GRT. For this to be accurate businesses would have to net 15% of their gross revenue as pre-tax profit. This is so critical to the success of implementing net profit tax that the Commission recommends a confidential study of the net profit margins of the businesses above the \$100,000 threshold. A significant error could result in excessive

taxation or tax revenue shortfalls which doomed the previous attempt at implementing income tax.

The Commission notes that some countries consider that a nation that has a business tax rate of less than 25% represents a tax haven. This is becoming a negative assessment that may further influence the setting of the business tax rate. The current estimated net profit tax rate to replace GRT is 20%, although this may change with a study of businesses margins. In light of the tax equivalency, implications of tax haven status should be easily deflected. It is worthy of note that of the thirty OECD countries, nine have net profit tax rates below 25% and seven have rates of 20% or less. In the event that outside opinions influenced an increase in domestic RMI income taxes (a disadvantage for the business community) other taxes would need to be decreased to avoid exceeding total reasonable taxation.

One additional recommendation comes from complaints from the business community. Businesses which do business with national and local governments report lengthy delays in collections. These businesses, on standard accrual basis accounting, could be required to pay income tax to the government although they had not yet received payment from the government(s). The Commission recommends that unpaid receivables from national and local governments be excluded from taxable income until such time as they are collected. The Commission recognizes the reconciliation issues but this inequity needs to be addressed. Alternately, new tax laws could allow businesses to offset government accounts receivables against tax payables.

Replacing Import Taxes: Consumption Tax

The Commission believes that import taxes are an effective and flexible form of taxation with the advantage of relatively easy enforceability and variable tax rates. It is expected, however, that trade agreements will eliminate import taxes requiring suitable tax substitutes that are acceptable to the standards of the international community and the expected trade agreements.

The Commission has discussed many alternatives for the replacement of import taxes and came to the conclusion that the most appropriate are a combination of consumption tax on most goods and services and specific excise taxes for some high value goods. It is worth mentioning at this point that such consumption taxes are applied directly to the goods and services and paid by the consumer. Many of the reports that the commission has read including the PFTAC Report equate consumption taxes with VAT. In fact, VAT is merely one form of a consumption tax and one that we feel is inappropriate to the specific circumstances of the RMI economy as well as potentially an unnecessary burden on its businesses and its government auditors.

VAT originated in countries whose economies are characterized by multiple steps from raw materials through manufacture to final sales. VAT, taxing at each step and also crediting taxes at each step, provides tax revenue throughout these processes over a period of time rather than only at the point of sale. Many other countries with more

simple economies have adopted VAT as well often for other reasons. This requires careful recordkeeping at each step and not just for the filing, collection, and payment of taxes at each step but filing for tax credits at each step. The business environment of the RMI is vastly different. Most economic activity is the result of imported products being sold retail in one step or in imported products being sold wholesale and then retail in two steps. Significant activity in the RMI such as construction involves importing products (or buying from an importer) and incorporating them along with labor into a final billing that represents two or three steps. Import to final sale is in a short period of time. The Commission believes that the additional recordkeeping of VAT is an unnecessary imposition of work for the businesses likely to require the costs of additional labor and an unnecessary complication for government auditors more of whom presumably must also be hired to administer VAT. There is no clear benefit to the adoption of VAT in the limited economy here. The PFTAC Report argues that VAT is superior because it eliminates tax cascading, but this is otherwise easily prevented. From the Report on justifying VAT: “While the problems from cascading and the impact of taxes on exports may not be currently significant in RMI, due to the small amount of exports and short production chains; removing these distortions will be important so as not to constrain future economic development.” The Commission feels that it is difficult to reasonably forecast long production chains for prospective new businesses in the RMI.

From “Tax Policy and Administration in The Republic of the Marshall Islands”, by Dr. Fuat M. Andic, Ph.D: “When all the above recommendations are implemented the possibility of a general sales tax at the retail level of, say, 5% should be considered. This will be in lieu of the local sales tax and proceeds will be shared between the national and local governments according to an established formula. It is imperative, however, that local governments forgo their right to impose local sales taxes. Those items which are considered as basic food items (similar to those items that will be exempted from customs duties), medicines and books may also be exempted.”

“Possibility of VAT instead of a sales tax is worthy of consideration. Several reports previously prepared argued strongly in favor of VAT and against the general sales tax. Certainly there are several advantages of VAT and many developing countries and most of all developed countries opted for VAT. This Report wishes to emphasize that given the prevailing conditions in RMI, instituting a VAT immediately may very well be premature. After some years of good experience in administering of and complying with the provisions of the sales tax by the taxpayers VAT may very well be a viable option.”

The traditional argument against consumption taxes is that they disproportionately affect the poor, who must spend all of their disposable income on necessities. To minimize the impact on the poor, many countries with consumption taxes in the developed world exempt certain necessary products from consumption tax, as noted above, and additionally have social welfare programs providing monetary support to the poor in part to compensate for consumption taxes otherwise paid by the poor. The Commission recommends that consumption taxes in the RMI be as low as possible to minimize the effects on the poor.

The Commission believes that a consumption tax in the form of a national sales tax at 10% is a simple and easily implemented alternative more appropriate to the economy of the RMI. This would replace import taxes on those general items not subject to excise taxes, replace Local Government taxes, and thus have no additional effect on the poor any more than the taxes that they replace. A person earning a minimum wage receives only \$208 in income tax benefit from the proposed income tax revisions so it is important then to not add an additional tax burden by increasing consumption taxes. As detailed in the PFTAC Report, National Government would share this National Sales Tax revenue with the local governments in the same fashion as would be done with VAT.

For businesses in Majuro, a national sales tax could be implemented immediately with little change as they are already paying MALGOV sales taxes of 4%. These taxes are collected at the first point of sale so there has been no cascading of taxes that the more complicated VAT is to prevent. The implementation in Kwajalein would be more complicated than in Majuro but still far more simple than VAT.

The PFTAC Report mentions implementation of VAT in other Pacific countries noting particularly Tonga and Samoa and their higher VAT rates of 15%. In consultative meetings with the Commission the success of VAT in Niue was also mentioned. These are very different economies than the RMI as they are heavily dependent on remittances by expatriate citizens sending money home to families from overseas employment. 80% of families in Tonga receive such remittances, and a similar rate is probable in Samoa. 1,500 people remain in Niue while over 10,000 have emigrated to New Zealand many of whom send money home. Taxing such remittances would be unacceptable but VAT effectively taxes this money earned elsewhere but spent locally. The RMI has in fact a slight net remittance outflow so the examples of VAT rates in Tonga, Samoa and Niue are inappropriate in comparison to the RMI.

Replacing the import taxes on high value items with excise taxes as proposed in the PFTAC Report is an excellent idea and simple to achieve as the mechanism would be the same. The Commission believes that if the importation of betel-nut is to continue to be allowed it should be taxed at a level similar to tobacco or alcoholic beverages. Many people in the business and general communities have complained for years that hard liquor is under-taxed as compared to beer and thus encourages more irresponsible drinking. Additionally there appears to be widespread smuggling of inexpensive vodka. The PFTAC Report addresses this with proposed increased excise taxes on liquor although it does not compute the additional tax revenue. Many people have also noted that beer is overtaxed, liquor is under taxed, and have expressed to Commission members the opinion that as liquor taxes increase beer taxes should correspondingly decrease keeping the tax revenue neutral but normalizing the respective taxes. This is worthy of consideration.

A couple of final comments on the PFTAC Report regarding VAT recommendations. The report recommends VAT also being assessed on the items subject to high excise taxes. This is the sort of cascading that the PFTAC Report otherwise has sought to

prevent. The Commission recommends that these items be exempted from the National Sales Tax as is currently done with MALGOV tax.

MISSA

The Commission did not evaluate MISSA taxes, investment income, expenses, disbursements, or actuarial assumptions as being outside of the scope of the Commission's mandate. MISSA has its own tax revenues and specific expenditure requirements and is unrelated to the RMI national accounts.

Several people have recommended to the Commission that small business owners should not be subject to paying both employer and employee taxes for themselves as the double taxation is too burdensome to such small business owners. Payments at the point of retirement would be actuarially reduced for the lesser payments. This would increase compliance while still providing retirement benefits. The Commission believes that this is an excellent recommendation to assist small business owners.

Revenue Administration

The Commission supports the recommendation of the IMF/PFTAC Report to consider establishing an independent revenue authority.

To complement the tax policy changes it is suggested that an omnibus Revenue Administration Act (RAA) be drafted to include the administration law of all taxes and revenues administered by the DRT. This is to achieve commonality and standardizing of all procedures for both tax and customs.

A framework of headings and considerations for a RAA follows:

Administration scope and principles

Through a governing board, the Authority shall derive its strategic directions from the tax laws and policies developed by the board of directors. The Board of Directors will report to the Minister of Finance.

Some RAA's incorporate a purpose or philosophy for the tax administration as a guide for managers and staff as they go about their business. This has an intended effect of influencing management and staff decisions in areas of developing and implementing tax compliance strategies and effective use of resources.

One country example where the purpose of the revenue administration is drafted as -
The obligation to administer the law in such a way as to collect the highest net revenue over time as is practicable within the law, having regard to promoting voluntary compliance, compliance costs to the taxpayer and the resources available

Self assessment

Consideration needs to be given to adopting self assessment processes in which the taxpayer takes self responsibility for preparing returns and paying taxes based on their own self calculation. Compliance risks are managed through assistance to taxpayers, risk based audits and other methods to encourage voluntary compliance behaviors.

Full self-assessment would require adequate assistance to taxpayers, the removal of discretions from the substantive provisions of the income tax (other than anti-avoidance provisions), an effective penalty regime that encourages voluntary compliance but does not punish genuine attempts to comply, and a binding ruling system.

Taxpayer objection and dispute resolution

This provision provides the rights and process for a taxpayer to dispute the assessment of tax made by the Secretary of Finance. The assessment of additional taxes can arise following an audit of a taxpayer's business affairs. A suggested objection and disputes resolution process is discussed later in this report, which if adopted, would need to be provided for in the RAA.

Collection powers

Powers of collection will need to be provided for including the personal liability of directors, preference of debt, distress and seizure, caveats and business closure in the case of default on wages and salaries withheld taxes.

Investigation powers

This provision relates to powers of access to information and property and the retention of records. Common law privileges are dealt with under this provision including professional privilege.

Refunds

Refunds are an important and common occurrence, particularly for exporters where refunds arise because of the consumption tax zero rating of exports. Refunds for consumption tax are normally delayed until after processing the return for the following period, when any remaining balance is then refunded.

Credits will also arise from overpaid installments of net profits tax where the taxpayer will request the overpayment be credited to another payment due or refunded. A provision is needed to allow the DRT to transfer credits between the different revenues and periods.

It is important that a separate appropriation is made to ensure there are sufficient funds to finance the refunds.

Conclusion

All these recommendations presume that both the private and public sectors are to be treated equally regarding taxes. This is imperative for a tax reform system to work. Everyone has to carry his own weight.

Businesses that are evading taxes at the expense of those paying taxes should be penalized to the fullest extent of the law. The recommendations set forth in this report address this problem. The government and its employees should pay their fair share of the taxes and be reasonable to tax-paying companies whom they owe. A tax reform system that is just, fair, transparent, efficient, low in tax burden, promotes private sector development, and attracts foreign investment will bring the Republic to a greater state of financial stability and security.

Annex:

1. RMI current Taxation Structure.

Overview of the current system

The three main sources of tax revenue in RMI are the wages and salaries tax, the gross revenue tax (GRT) and import duties. There are a number of other smaller taxes including the hotel and resort tax, immovable property tax, and non-resident gross income tax. Local governments have also been given authority to collect certain taxes with some local governments imposing a general sales tax in addition to the national government taxes. Social contributions are also required to be made to the retirement and health funds.¹ Box 1 sets out the main taxes in the RMI tax system.

Tax Type	Tax Rate
Wages and salaries tax	Wage income: 0-\$1,560 0 percent \$1,560-\$5,200 8 percent (with first \$1,560 being exempt) \$5,200-\$10,400 8 percent (no exemption for first \$1,560) >\$10,400 12 percent
GRT	\$80 if gross revenue less than \$10,000 3 percent of gross revenue if greater than \$10,000
Import duties	Standard rate 8 percent Food & public transport 5 percent (some basic food is exempt) Fuel: - Gasoline 0.25 cents per gallon - Jet and Diesel 0.08 cents per gallon Motor vehicles Greater of \$1,500 or 15 percent of Kelly's Blue Book value (if no Blue Book value then \$2,500 for new and \$1,500 for used vehicles) Tobacco: - Cigarettes \$1 per pack of 20 rolls - Cigars 151 percent - Other \$2.75 per 34.2 grams Alcohol: - Beer \$0.50 per can or 12oz unit - Wine \$2.75 per gallon - Spirits \$12 per gallon - Mixed drinks 26 percent
Immovable property tax	3 percent of gross income from leased property
Hotel and resort tax	8 percent of the daily room rate
Non-resident gross income tax	10 percent of the gross income earned on non-resident contracts
Local government sales taxes (the local governments also raise revenue from business license fees and other minor taxes and fees)	Majuro Local Government (MALGOV): - General sales tax 4 percent - Sales tax on alcohol 35 percent of c.i.f. value - Sales tax on tobacco 35 percent of c.i.f. value - Fuel tax 4 percent - Hotel room tax \$3 per room per day

¹ Social contributions are collected by the Marshall Islands Social Security Administration (MISSA).

Kwajalein Atoll Local Government (KALGOV):

- Wholesale sales tax 10 percent
- Sales tax on alcohol Specific rates
- Gross rent tax 4 percent
- Fuel tax \$0.06 per gallon
- Hotel room tax \$2 per room per day

Retirement fund contribution	Employer	7 percent of gross wage and salary
	Employee	7 percent of gross wage and salary
	Self Employed	14 percent of presumed wage (twice highest paid employee or if no employees, 70

percent

of gross turnover)

Health fund contribution	Employer	3.5 percent of gross wage and salary
	Employee	3.5 percent of gross wage and salary
	Self Employed	7 percent of presumed wage