

OFFICE OF THE NATIONAL PUBLIC AUDITOR
FEDERATED STATES OF MICRONESIA

**INSPECTION OF CHUUK STATE TAX AND REVENUE SECTION
FISCAL YEARS 2010 TO 2012**

REPORT NO. 2014-04



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National Public Auditor



FEDERATED STATES OF MICRONESIA

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December 10, 2013

His Excellency Manny Mori, President
The Honorable Members of the FSM Congress

RE: Inspection on Chuuk State Tax and Revenue

We have completed an inspection Chuuk State Tax and Revenue for Chuuk State covering the fiscal years of 2010 to 2012. The objective of our inspection was to determine whether the Tax and Revenue Office's compliance function implemented the efficient and effective processes to ensure taxpayers' compliance with Chuuk State tax system.

We found that the Chuuk State Tax and Revenue Office had implemented mechanism that would ensure the taxpayers' compliance with the tax system but a number of factors hindered the efficiency and effectiveness of such mechanism. There was no complete tax audit manual as well as there were lacking regulations that would provide detailed procedures and guidelines for the efficient and effective conduct of the tax audit function, and collection and enforcement of all taxes under the tax law. For example, we observed that the mechanism to enforce the collection of assessed tax liabilities from the delinquent taxpayers was not efficient and effective because delays in prosecuting delinquent taxpayers, non-implementation of tax collection strategies, lack of effective communication, and lack of regulations and internal control procedures.

As a result, the potential for tax revenue collections was not maximized, which in turn, has contributed to lack of government funds for urgent and needed public programs and services to improve the welfare of the citizens. We highlighted a number of areas of tax administration and collection that need improvement.

- About \$1.2 million assessed liabilities for sales taxes and penalties has long been pending for collection
- Two tax delinquent cases involving about \$ 661,000 referred for legal action not resolved in a timely manner

- Absence of strategic planning process to define priority and focus of tax audits
- Absence of tax audit manual resulted in lack of consistency in the delivery of tax audit services
- Absence of regulations that would improve the effective and consistent implementation of the tax law

To improve taxpayer compliance, the Chuuk State Tax and Revenue needs to consider developing a plan of action that includes:

- Strengthening the tax audit function and enforcement programs with the development of audit tools, improvement of internal control procedures and further strengthening of legal authority, to achieve operational efficiency and effectiveness in the enforcement of laws on tax collections.
- Collaboration between the Attorney General and the Director of the Department of Administrative Services to develop and implement the control procedures to ensure that decisions on tax cases referred for legal action are decisive and without unnecessary delay.
- Training and development for the management and the staff to:
 - Develop and implement strategic and operational plans to focus the office efforts on results-oriented tax audit activities
 - Implement performance measures to guide actions and monitor the achievement of tax revenue goals and objectives
 - Use tax gap analysis and risk assessment techniques to identify potential areas of taxpayers' noncompliance.
- Development and implementation of a tax audit manual to ensure consistency and quality in the delivery of tax audit services
- Development and promulgation of tax regulations, where appropriate, to implement the tax law

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We provided copies of this report to the Director of Department of Administrative Services (DAS) and to the Attorney General (AG) for their management responses. The AG did not prepare management response but indicated thru email that he would abide with whatever response the DAS Director would have regarding the audit recommendations regarding the tax cases forwarded to the AG's office. On the other hand, the DAS Director, in his management response, agreed with all the findings and recommendations in the report. We included such management response as part of this report.

Respectfully yours,



Haser Hainrick
National Public Auditor

Xc: Governor, Chuuk State
Lt Governor, Chuuk State
Members of the Legislature, Chuuk State
Director, Dept.of Administrative Services, Chuuk State
Attorney General, Chuuk State

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INTRODUCTION

Background

In 2005, Chuuk State Law No. 7-03-05 created the Department of Administrative Services (DAS). The law among others, merged six departments/offices to become the Divisions within the DAS headed by Chiefs - Budget, Commerce and Industry, Planning and Statistics, Public Affairs, Finance and Treasury and the Personnel Office, which is now called the Public Service Commission, an independent commission and no longer part of DAS. Before the merging, the Chuuk State Tax and Revenue was formerly a Division within the Finance and Treasury Division under a Chief. Today, it has become a section under a Supervisor.

Chuuk State Tax and Revenue Section

The primary role of the Chuuk State Tax and Revenue Office (T&RO) is to implement the state tax and revenue laws. The ‘State Tax Act of 2012’¹ was the applicable tax law. The T&RO ensures that citizens and businesses pay the correct amount of taxes and fees. There are two sub-sections overseen by the two managers within the T&RO. These two sub-sections are ‘Audit, Enforcing and Monitoring’ and ‘Debt and Collection’. The first sub section has four tax auditors while the other has two tax technicians.

The Audit, Enforcing and Monitoring sub-section performs the taxpayer compliance functions. It conducts tax audits, reviews pending cases and monitors tax due payments. Furthermore, it conducts visits to taxpayers on back taxes, analyzes old audit cases and reassesses these cases for close outs or referral to the State Attorney General Office. Lastly, it compares bills of lading against sales tax and from time to time, inspects containers of imported merchandises mostly at the main dock.

On the other hand, the Debt and Collection sub-section collects the payments from the taxpayers in the revenue collecting centers. It issues tax receipts and in addition, collects the airport departure fees at the Chuuk International Airport. Lastly, it assists in the collection of delinquent taxes and does inspections at the Post Office or the airport.

Types of Chuuk State Revenues

Chuuk State’s revenues can be broadly classified as program revenues and general revenues. The program revenues consist of Compact funding, investment income, and federal and other grants. On the other hand, the general revenues consist of FSM revenue share, taxes and fees, and others. Among the program revenues in FY 2011, Compact Funding contributed the most amounting to \$28.4 million (77.2%) to the total amount of \$36.9 million Chuuk State revenue. Under the general revenues, the taxes and fees represent a significant portion with the total

¹ TSL-5119, the State Tax Act, was amended in March 2012 by Act No. 11-16 (CSL11-12-07). This act may be cited as the State Tax Act of 2012.

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amount of \$7.3 million. The **Appendix A** page 14 shows the details of the general revenue as well as the non-revenue collections².

The FSM Taxation

The FSM tax system is set up both at the national and states levels. There are several types of taxes collected under this system: business gross revenue tax, income tax, import duty/tax, salary withholding tax, sales tax, service tax, sin tax, and others. Generally, both the national government and the states collect taxes separately, with each having its own authority to charge taxes. Although the national government does not have the right to interfere with the states taxation, it has the authority to charge and collect certain revenue taxes from within the states. Based on a mandated³ sharing percentage at the end of every quarter, the National government combines these collections and divides amongst the four States and the National governments. The shared taxes consist of business gross revenue tax, income tax, import duty/tax, withholding tax and others. Upon receipt of the shared taxes from the national government, the states classify these revenues in their financials in the line item for FSM Revenue share.

The significant source of tax revenue for Chuuk State is dependent on voluntary system of taxation. Under this system, the taxpayers compute, report, and remit taxes due within the first 15 days of every month and in the manner set by the state tax laws. Each year, difference may arise between what the taxpayer should pay and what is actually paid. This difference, which is a recognized measure of taxpayer compliance, is referred to as the “tax gap”.

In 2005, the FSM, thru the Tax Reform Task Force (TRTF), started to undertake appropriate steps in paving the way for the new tax reforms for implementation. Refer to **Appendix D** on page 16 for the overview of the new tax reforms.

Objective, Scope and Methodology

Objectives - We performed a survey to determine the focus of this inspection. The results of the survey indicated weaknesses in taxpayers’ compliance. Since the Tax and Revenue Office plays an important role in facilitating compliance and in ensuring that citizens and businesses pay the correct amount of sales and service taxes and the key in this regard is the compliance audit function, we focused this inspection on compliance function of the Tax and Revenue Office.

Thus, the objective of this inspection⁴ was to determine whether the Tax and Revenue Office’s compliance function implemented efficient and effective processes to ensure taxpayers’ compliance with the Chuuk State tax system.

² These refer to other collections like payroll deductions for overdrawn travel advances, reimbursement from the National government on federal programs.

³ 50%-50% sharing between national and state

⁴ *Inspection* is an alternative type of study conducted by ONPA. The primary difference between an inspection and a GAGAS audit or attestation is that the standards established for conducting inspection are not overly prescriptive. It allows ONPA the flexibility to perform a quick study of a subject entity or matter. (Page 4 ONPA Audit Manual 2012)

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Because our inspection focused on Tax and Revenue Office's compliance function under the current tax system, the relevance and applicability of our recommendations based on this inspection may also work for the new tax reform whose adoption is under review and consideration both by the FSM national and state governments.

Scope - The scope of our inspection included historical information as well as the laws, processes, policies, and procedures related to revenue collections and the tax audit activities during the fiscal years 2010 to 2012. We also reviewed the relevant sections of the State tax code. We conducted our fieldwork at the office of Tax and Revenue, Chuuk State DAS.

We conducted this inspection pursuant to Title 55 of the FSM Code, Chapter 5, which states in part:

“The Public Auditor shall inspect and audit transactions, accounts, books and other financial records of every branch, department, office, agency, board, commission, bureau, and statutory authority of the National Government and of other public legal entities, including, but not limited to, States, subdivisions thereof, and nonprofit organizations receiving public funds from the National Government.”

We focused this inspection activity to the processes related to Chuuk state revenues from sales and service taxes. It did not include the processes for other fees and charges because the primary responsibility for their effective administration rests with other departments. The other fees and charges include court fines and filing fees under the Chuuk State Supreme Court, drivers' license fees and vehicle registration fees under the Department of Transportation, and others. Although under the responsibility of the DAS, we did not include the divers' permit fees and the airport departure fees in this inspection. We observed positive results, during our initial audit survey, in processing of airport departure fee following the implementation of the new Departure Fee Collection Procedures effective October 22, 2012.

Methodology - To determine whether the Tax and Revenue Office's compliance function implemented efficient and effective processes to ensure taxpayers' compliance with the Chuuk State tax system, we obtained and reviewed relevant tax laws, regulations, policies, and procedures. We interviewed the Director of DAS, Chief of Finance, Supervisor of Tax and Revenue, Tax Advisor, and the Attorney General's designee. In addition, we gathered, reviewed and analyzed the related tax audit plans and accomplishments. Lastly, we reviewed and observed processes to evaluate the efficiency and effectiveness of the tax audit or enforcement function.

We performed this inspection in accordance with the 2011 *Quality Standards for Inspections and Evaluations* established by the U.S. Council of the Inspectors General on Integrity and Efficiency (CIGIE). Accordingly, we included such tests of records, transactions, and other inspection procedures that may be necessary to achieve our objectives.

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Prior Audit Coverage

This is the first review conducted by the ONPA related to taxes collected by the state government.

Conclusion

In conclusion, we found that the Chuuk State Tax and Revenue Office has implemented mechanism that would ensure the taxpayers' compliance with the tax system in terms of paying the correct amount of taxes due to the government, but the efficiency and effectiveness of such mechanism was hindered by a number of factors. We noted the absence of an audit manual that provides detailed procedures and guidelines for the efficient and effective conduct of the tax audit function; and collection and enforcement of all taxes under the tax law. For example, we observed that the mechanism to enforce the collection of assessed tax liabilities from the delinquent taxpayers was not efficient and effective because of delays in prosecuting delinquent taxpayers, non-implementation of tax collection strategies, lack of effective communication, and lack of regulations and internal control procedures.

As a result, the potential for tax revenue collections was not maximized, which in turn, has contributed to the lack of government funds for urgent and needed public programs and services to improve the welfare of the citizens. We noted the following:

- About \$1.2 million assessed liabilities for sales taxes and penalties has long been pending for collection
- Two tax delinquent cases involving about \$ 661,000 referred for legal action not resolved in a timely manner.
- Absence of strategic planning process to define priority and focus of tax audits
- Absence of tax audit manual resulted in lack of consistency in the delivery of tax audit services
- Absence of regulations that would improve the effective and consistent implementation of the tax law

To improve taxpayer compliance, the Chuuk State Tax and Revenue needs to consider implementing plan of actions that include:

- Strengthening the tax audit function and enforcement programs with the development of audit tools, improvement of internal control procedures and further strengthening of legal authority, to achieve operational efficiency and effectiveness in the enforcement of laws on tax collections.

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- Collaboration between the Attorney General and the Director of the Department of Administrative Services to develop and implement control procedures to ensure that decisions on tax cases referred for legal action are decisive and without unnecessary delay.
- Training and development for the management and the staff to:
 - Develop and implement strategic and operational plans to focus the office efforts on results-oriented tax audit activities
 - Implement performance measures to guide actions and monitor the achievement of tax revenue goals and objectives
 - Use the tax gap analysis and risk assessment techniques to identify potential areas of taxpayers' noncompliance. This will allow the tax audit resources to be allocated to such areas where they will directly raise the greatest revenue and/or through improved voluntary compliance.
- Development and implementation of a tax audit manual to ensure consistency and quality in the delivery of tax audit services
- Development and promulgation of tax regulations to implement the tax law where appropriate.

We present the detailed findings and recommendations on the subsequent pages.

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FINDINGS AND RECOMMENDATIONS

Finding 1 – About \$1.2 Million Assessed Liabilities for Sales Taxes and Penalties Has Been Long Pending for Collection

Chuuk State Tax Act (CSTA) of 2012 provides various remedies to enforce collection of unpaid taxes. Refer to **Appendix B** on page 14 for the specific requirements and nuances of the existing law.

1. **Installment Payment/Written Agreement** - The DAS Director may enter into a written agreement, shall require the taxpayer to furnish any form of security, and shall cause filing of lien and may pursue any remedies available to the state. (CSTA Section 19.3)
2. **Compromise of Tax Payment and Closing Agreements** - The DAS Director may compromise the asserted tax liability by entering into a written agreement, which shall be identified as a closing agreement and is subject to the proper approval of the Attorney General of the Government of Chuuk (CSTA Section 20.1)
3. **Enforcement of Collection** – The DAS Director may proceed to enforce collection of the tax as if the agreement had not been made or may proceed against the security provided (CSTA Section 19.5)
4. **Closing of Business**. The business establishment shall be closed and opened only until the execution of a closing agreement or installment agreement as approved by the Attorney General. (CSTA Section 18.8)
5. **Liens and Levy** - Taxes levied shall constitute liens in favor of the State upon all property and rights to property, whether real or personal belonging to any person, business, association or corporation liable for the tax, and such taxes and penalties may be collected by levy upon such property and rights to property in the same manner as the levy of an execution. (CSTA Section 22)

We found that out of the 26 accounts that were tax audited, five accounts with a total amount of \$1.2 million (refer to **Appendix C**, page 15) assessed liabilities for sales taxes and penalties have been pending for collection since FY 2010 and yet the Chuuk State Tax and Revenue Section has not initiated any remedy to enforce tax collections. There was no written agreement executed, furnished security, or tax lien lodged that could help secure the collection of assessed tax liabilities.

The DAS has issued final demand letters yet some of these businesses not paying the assessed tax continue to operate instead of being closed as required by law. Although, two of the accounts, with about \$661,000 in unpaid taxes, were referred to Attorney General but legal action has been pending for long time (refer further to Finding 4 on the discussion of tax cases referred to the AG's office).

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As a result, the \$1.2 million in uncollected tax revenues significantly reduced the amount of government funds to support government operations and to finance the essential public programs and services in the state. In addition, the law abiding taxpayers who are dutifully and voluntarily complying with tax requirements in the state could be de-motivated to pay their taxes by the actions of the non-paying taxpayers.

Cause and Recommendations

The DAS Director did not adequately monitor the collection of tax receivables and not effectively enforcing the state's tax requirements.

We recommend that the DAS Director should consider the following:

- 1) Require the Tax Supervisor to provide monthly status report on all outstanding tax cases.
- 2) Develop and implement appropriate internal control procedures to enforce the state's tax laws **consistently, fairly and timely**. Furthermore, other tax collection strategies allowed by law should be implemented such as:
 - a) Levy against taxpayer's deposits in financial institutions e.g. bank deposits.
 - b) Levy against taxpayer's assets held by a third party
 - c) Use of collection agencies to collect past-due taxes
- 3) Request an amendment to strengthen the existing tax law to authorize the implementation of other tax collection strategies such as:
 - a) Seize and sell the taxpayer's personal properties;
 - b) Corporate officer liability- hold officers, members, and managers responsible for business taxes and be liable for the unpaid taxes, related penalties and interest; and,
- 4) Improve its working relationship with the Attorney General's Office and other entities to ensure that tax administration and collection efforts are effectively coordinated toward the taxpayers' compliance and/or the immediate resolution of unpaid tax assessments.

Finding 2 - Two Delinquent Tax Cases Involving About \$661,000 Referred for Legal Action Not Resolved in a Timely Manner

The Chuuk State Tax Act (CSTA) of 2012 Section 25 authorizes the Tax and Revenue Office to collect the amount of tax due by civil suit brought by the Attorney General.

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“...Any taxes imposed or authorized under this Act may also be collected by civil suit brought by the Attorney General of the State, either in the name of the State or in the name of the Director of the Department of Administrative Services. In such civil suit a written statement of the Director or Chief as to the amount of tax due, the fact that is unpaid, and who is authorized to collect it, shall be sufficient evidence to create a rebuttable presumption that the taxes are owing.”

In addition, fundamental principles in tax administration dictate that (1) tax administrators owe it to all taxpayers who voluntarily comply with the tax laws to enforce the laws against those who do not comply. Furthermore, because taxes affect all citizens, residents, and income-earners, (2) there must be fair and consistent tax enforcement policies and applications.

Furthermore, because the integrity of the tax system is the key to taxpayers’ compliance, prudent practices require that if tax cases are forwarded to the Attorney General’s Office, the following basic norms should be observed:

- Tax and Revenue Office should take responsibility to manage cases referred to assure timely actions and maintain case files that reflect the status of the cases referred.
- The Attorney General should keep the referring Department informed of all the developments through periodic case status reports. The Tax and Division Office’s case files should reflect the status of the cases referred.
- The Attorney General should quickly evaluate, decide and inform whether legal action should be taken or declined. The basis for such decision should be sufficiently documented.

The Tax and Revenue Office referred two tax cases involving a total amount of about \$661,000 (\$402,000 tax assessment plus \$259,000 in penalty fees) to the Attorney General Office but the cases have been pending for legal action. One of these tax cases was referred on March 3, 2010 while the other on January 27, 2012.

When interviewed, the Tax Supervisor informed us that the Attorney General Office had not communicated with them since they referred those tax cases. He further said that without any instruction from the AG, the Tax and Revenue Office was unable to proceed with further action.

On the other hand, the Assistant AG informed us that legal action has been pending on the two tax cases because (1) the DAS closed down one of the businesses with tax case and (2) legal issues requiring legislative action need to be addressed first on the second case.

The long delay in the resolution of delinquent tax cases creates more difficulties in collecting the taxes due to the government. While the legal action is pending, the total amount of assessed tax liability including penalties and interest is accumulating.

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Cause and Recommendations

The conditions above occurred because of several factors such as the absence of guidelines in handling of delinquent taxes referred to the Attorney General Office, the lack of clear responsibilities and accountabilities of the Attorney General Office and the Tax & Revenue Office with regard to cases referred, and the lack of communication/coordination between the two offices. Furthermore, the effective collection of past due taxes did not appear to be an urgent priority.

We recommend that the Director of the DAS and the Attorney General should consider collaborating to develop and implement control procedures to ensure that decisions on tax cases referred for legal resolution are decisive and without any unnecessary delay. This will ensure the taxpayer's confidence in the integrity of and compliance with the tax system.

Finding 3 - Absence of Strategic Planning Process to Define Priority and Focus of Tax Audits

Prudent management practice requires that tax agencies should focus its tax enforcement (audit) activities, cope within limited work force, and survive within budget that is not enough to deal with all risks in the system. This necessitates the use of a management tool that should not only be cost-effective but also results-oriented⁵. Such management tool would be the strategic planning process, which would allocate limited resources more efficiently and effectively to ensure that resources are spent wisely only on meritorious tax audit activities. The process should produce strategic and annual operational plans that include key components such as vision, mission, goals and objectives, strategies and performance measures to gauge the achievement of the goals and objectives relative to the tax and revenue administration in the state.

During the fiscal years 2010 through 2012, the Tax and Revenue Section completed 26 tax audits that yielded a total amount of about \$1.5 million in total tax assessment and penalties, or a yearly average of eight audits with a total of about \$500,000 in total tax assessment. However, we found that the tax audit activities lacked the means of determining the overall effectiveness of the state's tax compliance/audit function because of the absence of performance measures to gauge the success of or to decide whether to continue or eliminate an audit activity. Furthermore, the selection of tax audits was determined by the Tax Supervisor based on direct analysis of taxes remitted to the office and comparing with expected tax remittances. The Tax and Revenue Section did not use formal or methodical risk assessment or tax gap analysis to assist in tax audit selection. For example, the Tax and Revenue Section has not been conducting tax-gap analysis to estimate the total difference between taxes owed and taxes paid to measure the extent of taxpayers' compliance with tax obligations and hence, may not be selecting areas/sectors with the greatest tax gaps as focus of tax audits.

⁵ expected results have been obtained

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As a result, the state's tax audit resources were utilized inefficiently and ineffectively. For example, of the 26 tax audits conducted, significant efforts and time were spent on four audits with a combined minimal tax assessment amount of only \$3,474. We believe that the time and resources spent on those audits could have been allocated to areas that could yield a higher return and improve taxpayers' compliance.

Cause and Recommendations

Management failed to adopt and implement strategic planning processes and other management tools to provide sound direction to the state's tax audit function towards achieving cost-effective and results-oriented tax audits.

We recommend that the DAS Director should consider:

- A. Developing and implementing strategic and operational plans starting of fiscal year 2014-15 to focus the office efforts on results-oriented tax audit activities.
- B. Implement performance measures to guide actions and monitor the achievement of tax revenue goals and objectives
- C. Use the tax gap analysis and risk assessment techniques to identify potential areas of taxpayers' noncompliance. This will allow the tax audit resources to be allocated to such areas where greatest tax revenue could be raised and/or improvement in voluntary compliance with the tax law would be realized.
- D. If necessary, the DAS Director should also consider obtaining relevant and appropriate training for the head and staffs of the Tax and Revenue Section to deliver the above recommendations.

Finding 4 - Absence of Tax Audit Manual Resulted in Lack of Consistency in the Delivery of Tax Audit Services

Prudent practices require that a tax audit organization should maintain an audit manual of operating procedures to provide guidance to the staff in the delivery of quality tax audit services. Such tax audit manual should provide (1) consolidation of policies and procedures; (2) a reference guide for tax auditors; (3) a training tool; (4) consistency in audit approaches; (5) and the means to support quality assurance, governance and accountability. Furthermore, all tax audits should be carried out in accordance with the requirements of the tax audit manual and other related instructions.

The Tax and Revenue Office has no formal tax audit manual. Rather, the Tax and Revenue Section uses a tax training manual to assists them in their audits. However, such tax-training manual is not sufficiently detailed to serve as a complete tax audit manual. Consequently, tax

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audits lacked consistency and hence, were not performed effectively. For instance, we noted the following weaknesses during the review of the 14 tax audit folders:

- All folders/files had no table of contents. Thus, we could not determine if the tax auditors filed all the required working papers.
- All folders/files had no tax audit plan. Thus, we could not determine whether the auditors satisfactorily followed all the methodologies, procedures and timeframes to obtain appropriate and sufficient tax audit evidences.
- Working papers did not document the audit procedures performed, the source of information/data, the date of preparation and identity of the staff who prepared the working paper, the date of review and identity of the supervisor who reviewed the working paper and the audit conclusion reached (if necessary) based on the audit procedures.
- Formal audit reports were not issued after the completion of each audit. Thus, the opportunity to improve the weaknesses identified by the tax auditors, which could have brought about necessary improvements, was not reported.

Furthermore, we found that there were no written tax audit procedures or audit program guides in use to guide the tax auditors in gathering of audit evidence. The tax auditors relied only on the instructions from their consultant and/or tax supervisor during the actual tax audits. For example, there were no standard procedures for the following:

- Audit Procedures for Cigarette Taxes - audit procedures related to permits, records, reports and pre-audit research (survey) information regarding cigarette taxes.
- Audit Procedures for Cigar and Tobacco Product Taxes – audit procedures related to permits, records, reports and pre-audit research (survey) information regarding tobacco product taxes.
- Audit Procedures for Grocery Stores – sales tax topics and related audit procedures unique to grocery/convenience store industry.
- Audit Procedure for Hotel Occupancy Tax – audit procedures related to the characteristics unique to the hotel industry.
- Sampling procedures – sampling procedures and information that are applicable to tax auditing

As a result, the risk for performing sub-standard tax audits increased. In addition, errors that could erode the taxpayers' confidence in the tax system are likely to occur.

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Cause and Recommendations

The DAS management failed to prioritize the development of a tax audit manual. In addition, the management did not require issuance of formal tax audit reports.

We recommend that the DAS Director should consider requiring the Tax Supervisor of the Tax & Revenue Office to:

1. Develop and implement a tax audit manual no later than the end of Fiscal Year 2014.
2. Provide training to improve the staff skills and competencies in tax auditing like report writing and working paper preparation and documentation,
3. Require the issuance of formal tax audit reports

Finding 5 - Absence of Regulations for the Effective and Consistent Implementation of the Tax Law

Section 23 of the Chuuk State Tax Act requires the development and implementation of regulations to implement the state tax act.

“..The Director of the Department of Administrative Services, with the approval of the Governor, shall prescribe (such) regulations as may be necessary for the conduct of all inspection, collection and the enforcement of all taxes levied under this act.”

Some provisions of the tax law are required to be implemented in accordance with regulations, which currently are lacking. For example, the following tax law provisions were referring to rules and regulations for their proper implementation:

- Execution of sales tax agreement and prepayment of taxes due (CSTA Section 7)
- Compromise of taxes and closing agreement (CSTA Section 20.1)
- Furnishing of security for payment of taxes due (CSTA Section 20.3)

We observed that DAS has no existing rules and regulations for the effective implementation and enforcement of the collection of taxes.

As a result, the implementation of the some of the provisions of the tax law may not be clear and consistent.

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Cause and Recommendation

The DAS management did not develop and implement the regulations that would assist DAS to properly enforce the tax law.

We recommend that the DAS Director should consider developing and promulgating tax regulations in order to implement effectively the Chuuk State Tax Act.

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APPENDIX

Appendix A- Chuuk State Revenue

Table 1 Chuuk State Revenue Collection Fiscal Year 2010-2012					
Type of Revenue	2010	2011	CFY/PFY	2012	CFY/PFY
FSM Revenue Share	\$ 2,930,383	\$ 3,160,984	108%	\$ 3,078,288	97%
Taxes	2,292,927	3,162,543	138%	3,406,744	108%
User Fees	496,544	500,358	101%	466,074	93%
Airport Departure Fee	339,800	343,320	101%	359,242	95%
Others	163,747	164,343	100%	187,633	114%
Sub-Total	\$ 6,223,401	\$ 7,331,549	118%	\$ 7,497,981	102%
Non-Revenue Collection	399,883	300,222	75%	234,190	78%
Total	\$ 6,623,284	\$ 7,631,771	115%	\$ 7,732,171	101%

Source – Tax and Revenue, unaudited (CFY- Current Fiscal Year / PFY- Previous Fiscal Year)

Appendix B- Chuuk State Tax Act (CSTA) of 2012

1. **Installment Payment/Written Agreement** - *The DAS Director may enter into a written agreement with the taxpayer to make a monthly installment payment of tax due (CSTA Section 19). At the time of entering into installment, the DAS Director shall require the taxpayer to furnish any form of security. In addition, the DAS Director shall cause a notice of lien to be filed and may pursue any remedies available to the state. Once the installment agreement has been agreed upon, a penalty shall be computed prior to the consumption of the installment agreement and no further penalty shall be imposed during the period of the agreement unless the taxpayer fails to comply with the installment agreement (CSTA Section 19.3)*

2. **Compromise of Tax Payment and Closing Agreements** - *If after the assessment has been issued, the (DAS) Director has reasonable doubt as for the taxpayer's ability for payment of the tax, he may compromise, pursuant to rules and regulations implementing the provisions of this section, the asserted liability by entering into a written agreement with the taxpayer. Such agreement shall be identified as a closing agreement and is subject to the proper approval of the (DAS) Director and the Attorney General of the Government of Chuuk (CSTA Section 20.1)*

3. **Enforcement of Collection** - *If the installment payments are not made on or before the times specified in the agreement, or if any condition in the agreement is not met, or if the taxpayer does not pay any other taxes as they fall due, the DAS Director may proceed to enforce the collection of the tax as if the agreement had not been made or may proceed against the security provided (CSTA Section 19.5)*

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4. **Closing of Business.** *Any person, company or corporation who knowingly, willfully or unlawfully refuses to comply with the final notice of demand to pay any and all taxes due including interests, or failed or refused to file tax returns, its business establishment shall be closed and opened only until the execution of a closing agreement or installment agreement as approved by the Attorney General. (CSTA Section 18.8)*

5. **Liens and Levy** - *Taxes levied, which are due and unpaid, including penalties charged are debts to the State and shall constitute liens in favor of the State upon all property and rights to property, whether real or personal belonging to any person, business, association or corporation liable for the tax, and such taxes and penalties may be collected by levy upon such property and rights to property in the same manner as the levy of an execution. (CSTA Section 22)*

Appendix C- Schedule of Outstanding Tax Assessment

Name	Date	Type of Tax	Assessed Tax	Penalty	Total Assessment	Total Collection	Outstanding	Without Collection
1. Taxpayer A	01/03/10	Gen Mdse	\$ 84,790	\$ 264,946	\$ 349,736	0	\$349,736	\$349,736
2. Taxpayer B	05/05/10	Poker Machine	32,500	65,000	97,500	0	97,500	97,500
3. Taxpayer C	10/22/10	Cigarette	83,500	7,475	90,975	0	90,975	90,975
4. Taxpayer D	09/21/10	Alcohol	61,640	Waived	61,640	34,244	27,396	
5. Taxpayer E	10/28/10	Cigarette	17,462	1,559	19,021	6,832	12,189	
6. Taxpayer F	04/30/12	Alcohol	6,000	Waived	6,000	2,000	4,000	
7. Taxpayer G	12/28/11	GM, Luxury	6,089	Waived	6,089	4,749	1,340	
8. Taxpayer H	03/21/12	Service Tax	2,261	767	3,028	1,767	1,261	
9. Taxpayer I	08/9/11	GM/Alcohol	3,337	584	3,921	3,666	255	
Sub-total:			\$ 297,579	340,331	637,910	53,328	584,652	538,211
Cases Referred to the Office of Attorney General								
10. Taxpayer J	1/3/10	Cigarette Tax	332,016	51,014	383,030	0	383,030	383,030
11. Taxpayer K	2//18/10	Poker Machine	69,500	208,500	278,000	0	278,000	278,000
Sub-Total			\$ 401,516	\$259,514	661,030		\$ 661,030	661,030
Grand Total			\$ 699,095	\$ 599,845	\$ 1,298,940	\$ 53,328	\$ 1,245,862	\$ 1,199,241

Source – Chuuk State Tax and Revenue Office, unaudited

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Appendix D- Tax Reforms for Implementation

In 2005, the FSM, thru the Tax Reform Task Force (TRTF), started to undertake appropriate steps in paving the way for the new tax reforms for implementation. The key reasons for the new tax reform are:

- To address the budgetary pressures and, in some cases, imbalances resulting from decrease in compact funds;⁶
- To cushion the adverse impact on the economy resulting from the decrease in compact funding as well as the global financial crisis;
- To address the inherent weaknesses in current tax administration;
- To improve the current tax regime which does not encourage economic growth; and
- To position the tax system to comply with Trade Liberalization Agreements, which the FSM is a party.

The following summarizes the new tax reform:

- **Value Added Tax (VAT)** – This will replace the existing national import duties/tariffs and sales taxes at the four states. The proposed VAT rate is 10%, which is applicable to imports and sales of goods and services within the FSM. All exports will be free of VAT. The VAT is called a consumption tax because it is ultimately borne by the consumer. It is broad-based, making VAT a more secure source of government revenue and with greater fairness and equity. The VAT will abolish the States’ sales taxes and import duties and tariff.
- **Income Tax** – This will modernize income tax through the elimination of the current Gross Receipt Tax (GRT).
- **Net Profit Tax (NPT)** - Business with annual revenues under \$2,000 will not pay NPT. The revenues from \$2,000-\$10,000 will pay a presumptive tax (flat) of \$80 per year and those with revenues exceeding \$10,000 will pay at the rate of 25% on their net profits.
- **Excise Tax** – In addition to the VAT, the tax reforms also propose the introduction of a State excise tax on “sin” goods such as alcohol and tobacco. This will ensure that the revenues currently collected on “sin” goods are continued under the new tax regime.
- **Taxpayer Identification Number (TIN)** – To make the tax administration more efficient and to ensure proper crediting of taxes, the **Unified Revenue Authority (URA)** will introduce a unique numbering system, which will cover all taxpayers to the FSM. The TIN

⁶ Under the terms on the Amended Compact, the funding received by FSM will decrease by \$800,000 per year from 2007 until the conclusion of the agreement in 2023

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will be used to track tax payments, overdue amounts, filed tax returns, overdue tax returns, importers and exporter transactions, employer salaries and wages withholding returns and payments, tax assessments, and automated notices to taxpayers. The taxes to be tracked by the taxpayer's TIN would include VAT on imports and sales of goods and services within FSM, excise taxes, NPT, and wages/salaries withholding tax.

To support the above changes, the **Revenue Administration Act (RAA)** enacted by the FSM National Congress needs to be endorsed by each of the states through legislation as a uniform/single set of rules in administering all the taxes nationwide, including the excise tax which will be imposed by the states. Then, in addition, an independent office called **Unified Revenue Authority (URA)** would be established to consolidate all tax administration functions that are currently performed at the national and state levels by the five separate authorities – four tax administrations and the national tax administration. The passing of the related new enacting laws among the five governments (including the national) are enacted as law or in various stages of review.

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MANAGEMENT RESPONSE



**TAX AND REVENUE DIVISION
Department of Administrative Services
CHUUK STATE
FEDERATED STATES OF MICRONESIA**

Mr. Haser Hainrick
National Public Auditor
Office of the Public Auditor
PO Box PS-05, Palikir
Pohnpei, FSM 96941

December 2, 2013

Department comments on Draft Report No. 2014-04

Dear Mr. Hainrick

Thank you for your letter dated November 19, 2013 and providing me with an opportunity to comment on the draft report No. 2013-07 "Inspection of Chuuk State Tax and Revenue Section Fiscal Years 2012-2012".

I would like to thank you and your staff for the professional and courteous manner in which the inspection was undertaken. I commend your office for the professional manner in which this inspection was undertaken.

Thank you for the opportunity to provide comments on the report.

I largely agree with your findings and recommendations. The report highlights a number of areas of administration over the period 2010 to 2012 that need improvement. The recommendations contained in the report provide valuable suggestions on the way forward.

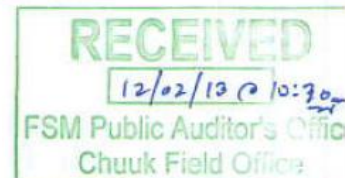
Your recommendation that there should be an improved strategic planning process is, I believe, critical to our work and will be followed up over the coming months.

I am also pleased to advise that the Department of Administrative Services (DAS) has been taking active steps to improve the performance of the Tax and Revenue section. With the support of our Tax Advisor, the department is re-designing its debt management practices and has improved our data management procedures. We have also started the work in upgrading our audit training guidelines into a more comprehensive Compliance Procedures Manual.

In addition, the Attorney General and I have taken steps to ensure that all issues referred to the Attorney General's office are properly managed by my department and that formal procedures are in place to ensure matters referred to the Attorney General are well managed into the future.

A number of my staff are being given training by the Attorney General's Office on law and procedures related to law enforcement. This will improve the quality of evidence and files referred to the Attorney General's office.

PO Box 189, Weno Chuuk State, Federated States of Micronesia, 96942



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With respect to recommendations to amend the tax laws I agree that the laws should be clear and administrable. I will examine the tax laws over the coming months with a view to recommending necessary changes that will enhance the ability for taxpayers to voluntarily comply with the tax laws as well as supporting the State's enforcement of those who do not comply. This will need to be done in a way that meets the long term economic objectives of Chuuk State – particularly given the current uncertainty about the future of FSM's Tax Reform plans.

Again, I thank you for the report and will ensure that the Tax and Revenue Section implement all agreed recommendations effectively and in a timely way.

I have provided you with specific comments on each recommendation in your report in the attached table.

Regards,


Mr. Jesse Mori
Director



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COMMENTS ON FINDINGS AND RECOMMENDATIONS

FINDING 1

RECOMMENDATION 1

The Department of Administrative Services (DAS) agrees with this recommendation.

RECOMMENDATION 2

DAS agrees with this recommendation.

DAS has commenced using statutory levy powers on bank accounts and is currently developing formal procedures for levy of bank accounts, salary and wages and other assets. These powers are currently the subject of litigation.

DAS will review the current laws and will consider implementation of effective tax collection strategies.

RECOMMENDATION 3

DAS will, in consultation with the Attorney General's office and other stakeholders look to strengthen the current taxation laws to help ensure voluntary compliance is enhanced as well as the State's ability to enforce the law against those who do not comply.

The suggested strategies are noted and will be considered as part of the review.

I would expect that this review would be completed before the end of June 2014.

RECOMMENDATION 4

Agreed. DAS and the Attorney General's office will develop effective procedures to manage all issues that are referred to the Attorney General by DAS. The Supervisor of the Tax and Revenue section will remain responsible for ongoing management of all issues referred to the Attorney General and will provide me with regular reports.

FINDING 2

RECOMMENDATION THAT THE DIRECTOR AND ATTORNEY GENERAL SHOULD CONSIDER COLLABORATING TO DEVELOP AND IMPLEMENT CONTROL PROCEDURES TO ENSURE THAT DECISIONS ON TAX CASES REFERRED FOR LEGAL RESOLUTION ARE DECISIVE AND WITHOUT UNNECESSARY DELAY.

Agreed.

FINDING 3

RECOMMENDATION A TO D

Agreed. DAS will introduce strategic and operational plans for Tax and Revenue as soon as possible (but before the start of fiscal year 2014-15). These plans will include performance measures and monitoring.

Appropriate risk based case selection and revenue gap analysis will progressively be implemented over the next 12 months for audit case selection, debt management and reporting purposes.

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If necessary, and subject to funding, training will be sought and provided to Tax and Revenue section staff to implement these recommendations.

FINDING 4

RECOMMENDATION 1

Agreed. The current Audit training guidelines will be updated and expanded into a robust procedures manual that will guide and support Tax and Revenue staff to perform their work.

RECOMMENDATION 2

Agreed. Ongoing training will be provided to staff to assist them improve their skills where appropriate.

RECOMMENDATION 3

Agreed. Formal tax audit reports will be prepared at the completion of each audit to assist in monitoring and evaluation of the audit functions. The supervisor of Tax and Revenue section will incorporate the reports into the regular reporting processes.

FINDING 5

RECOMMENDATION THAT THE DAS DIRECTOR SHOULD CONSIDER DEVELOPING AND PROMULGATING TAX REGULATIONS IN ORDER TO IMPLEMENT EFFECTIVELY THE CHUUK STATE TAX ACT.

Agreed. As part of the review referred to in the response to recommendations 2 and 3 of Finding 1 DAS will review current laws and regulations and recommend changes necessary to improve voluntary compliance and enforcement of the tax laws.

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NATIONAL PUBLIC AUDITOR'S COMMENTS

We would like to thank the management and staff of Department of Administrative Services, Chuuk State Tax and Revenue Section and the Office of the Attorney General for their assistance and cooperation during the course of the audit.

In addition to providing copies of the final report to the President and Members of the Congress, we will also sent copies to the audited departments. Furthermore, we will make copies available to other interested parties upon request.

If there are any questions or concerns regarding this report, please do not hesitate in contacting our Office. Contact information for the Office can be found on the last page of this report, along with the National Public Auditor and staff who made major contributions to this report.

Haser Hainrick
National Public Auditor



December 10, 2013

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ONPA CONTACT AND STAFF ACKNOWLEDGEMENT

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ACKNOWLEDGEMENTS In addition to the contact named above, the following staff made key contributions to this report:

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Evelyn Paul, Auditor-in-Charge
Evangeline Eko, Staff Auditor

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