

OFFICE OF THE NATIONAL PUBLIC AUDITOR
FEDERATED STATES OF MICRONESIA

**Division of Customs & Tax Administration: Improvement is Needed in
Assessing and Collecting the Taxes Due From Some Independent
Contractors
Fiscal Years 2013 - 2015
REPORT NO. 2017-01**



Haser H. Hainrick
National Public Auditor



FEDERATED STATES OF MICRONESIA

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December 28, 2016

His Excellency Peter M. Christian, President
Honorable Members of the FSM Congress
Federated States of Micronesia

RE: The Audit on the Independent Contracts

We have completed a performance audit on the Independent Contractors at the National Government for fiscal years 2013 - 2015. The audit on Independent Contracts was conducted due to concerns we received regarding unpaid taxes from independent contractors in accordance with applicable tax laws and regulations.

The objective of the audit was to determine whether the Division of Customs and Tax Administration collected the taxes due from independent contractors in accordance with applicable tax laws and regulations

Subpart 2.1 of the *FSM Financial Management Regulations* states that, with respect to employment service contracts entered into by any FSM government agency, the Secretary of the Department of Finance & Administration or his designee must sign the employment service contracts to indicate either concurrence with employment covered by the FSM Public Service System Act, or certification that such employment is exempt from the Public Service System Act.

There are three types of contract forms commonly used by the National Government: Prime Contract, Special Service Contract, and Independent Contract.

- *Prime Contract* means an appointment to a full-time permanent position that requires the services of a noncitizen of the Federated States of Micronesia, under an initial contract of not more than two years' duration.
- *Special Contract* means employees are exempt from the *Public Service System Regulation Act*, salaries negotiable; no right to any leaves except at the discretion of the President or his designee, Speaker or Chief Justice if employed by their jurisdiction, wage and salary tax and social security tax must be withheld.
- *Independent Contract* means that employment under this contract has no employer/employee relationships. An independent contractor is an independent business who/which must be properly permitted, usually including a foreign investment permit if the contractor is not an FSM citizen, and payments to the Independent Contractors for the government comes out of the contracts and services line in the approved budget.

Based on our audit, we conclude that the Division of Customs and Tax Administration did not collect taxes due from some independent contractors as required by law. Various factors contributed to the failure to collect taxes from contractor's revenue such as:

- Lack of internal policies and guidelines to manage independent contractors
- Majority of the independent contracts were not routed to the Division of Customs and Tax Administration for proper tax assessment
- Inconsistent use of contract forms

Consequently, at least \$22,062.23 of uncollected taxes from independent contractors was not collected, hence a loss to the FSM General Fund.

We found the following weaknesses during our audit:

- Not all independent contractors paid the taxes due on their revenues
- Payments to Independent Contractors with employee status were not subjected to tax on salaries and wages and salary withholding.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read 'H. Hainrick', with a stylized flourish at the end.

Haser Hainrick
National Public Auditor

XC: Vice President
Secretary, Department of Finance and Administration
Assistant Secretary, Division of Customs and Tax Administration

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INTRODUCTION

We performed this audit due to concerns we received regarding unpaid taxes from independent contractors in accordance with applicable tax laws and regulations.

Background

Subpart 2.1 of the *FSM Financial Management Regulations* states that, with respect to employment service contracts entered into by any FSM government agency, the Secretary of the Department of Finance & Administration or his designee must sign the employment service contracts to indicate either concurrence with employment covered by the FSM Public Service System Act, or certification that such employment is exempt from the Public Service System Act.

There are three types of contract forms commonly used by the National Government: Prime Contract, Special Service Contract, and Independent Contract.

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- *Independent Contract* means that employment under this contract has no employer/employee relationships. An independent contractor is an independent business who/which must be properly permitted, usually including a foreign investment permit if the contractor is not an FSM citizen, and payments to the Independent Contractors for the government comes out of the contracts and services line in the approved budget.

Chapter 2 Section 121 of Title 54 of FSMC states that an income tax typically applies to practically all income, with rates payable based on the total income of the taxpayer, after giving allowance to certain exemptions, and normally extends to all forms of income, including wages and salaries, interest, royalties, fees, and returns on capital, as well as income realized through the sales of good.

Functions of the Division of Customs and Tax Administration

- (a) Revenue Unit
 - Assess, levy, collect and administer taxes on incomes and local revenues; and
 - Deposit the proceeds from such collections to the funds of the National Government.
- (b) Customs Unit
 - Administer and enforce the FSM customs laws and regulations;

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- Collect import duties on goods entering the FSM;
- Control prohibited substances from entering the FSM;
- Utilize modern taxpayer education, audit, and enforcement methods to assure high levels of compliance with tax laws and regulations.

Independent Contractor

Prudent practices define independent contractor as follows:

People such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors and others who are in an independent trade, business, or profession in which they offer their services to the general public are generally independent contractors. However, whether these people are independent contractors or employees depends on the facts of its case. The general rule is that an individual is an independent contractor if the employer has the right to control or direct only the result of the work and not what will be done and how it will be done.

An independent contractor is simply someone who works for someone else, but not as an employee. For income tax purposes, the independent contractor is considered a sole proprietor. The designation of sole proprietor is simply the default form of small business, which means one needs to pay to register his business or to incorporate.

Objective, Scope and Methodology

Objective

To determine whether the Division of Customs and Tax Administration collected the taxes due from independent contractors in accordance with applicable tax laws and regulations

Scope

The scope of this audit covered the payments made to independent contractors by, and the taxes they paid to, the national government for calendar years 2013, 2014 and 2015.

This audit is limited to the review of payments made to individual persons who have had independent contracts with the National Government. This did not cover established construction companies and business entities.

We conducted this audit pursuant to the authority vested in the Public Auditor as codified under Chapter 5, Title 55 of the FSM Code, 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

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other public legal entities, including, but not limited to, States, subdivisions thereof, and nonprofit organizations receiving public funds from the National Government.”

Methodology

To satisfy our objective, we performed the following:

We conducted this performance audit in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

We obtained and reviewed the expenditure reports representing payments made to independent contractors by the national government and the tax rolls for fiscal years 2013, 2014 and 2015. We judgmentally selected a sample of payments to independent contractors and traced whether the Division of CTA had assessed and collected the corresponding taxes from those payments.

Lastly, we interviewed key officials and staff from the Department of Finance and Administration specifically the Secretary, the Assistant Secretaries of both the Divisions of Personnel and the CTA to confirm our understanding of the issues involving the independent contractors and their tax obligations

Prior Audit Coverage

The prior audit related to this audit is the audit on “Fisheries Observer and Port Sampler Revolving Fund: Improvement in Internal Controls is Needed To Ensure Compliance of Financial Activities with the Law,” which is our Audit Report No. 2015-05. A similar finding was that the amounts paid for the services of the Observers and Port Samplers were not subjected to income tax withholding and social security taxes.

Conclusion

Based on the results of our audit, we conclude that the Division of Customs and Tax Administration did not collect all the taxes due from independent contractors. Improvement is needed in the way the taxes are assessed and collected. Furthermore, the audit disclosed that some independent contractors have employer-employee relationship with the National Government and, therefore, have status of employees, who are subject to income withholding tax requirements. However, the deduction of income withholding taxes was not implemented as required by law.

The findings and recommendations are discussed in detail in the following pages.

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FINDINGS AND RECOMMENDATIONS

Finding No. 1: Not All Independent Contractors Paid the Taxes Due on Their Revenues

Independent Contractors are considered businesses for tax purposes, and there is no employer-employee relationship under an independent contract arrangement.

Section 141 Title 54 FSM Code requires that businesses, which are earning revenues should be assessed, levied, and paid gross receipt taxes in the following manner:

- \$80 on the first \$10,000 of their gross revenues,
- 3% additional tax on gross revenue exceeding \$10,000
- Gross revenues of not more than \$2,000 per year are exempt from taxation. Taxes paid should be claimed by filing for a refund.

We judgmentally selected 84 (out of 104) independent contracts for 2013 to 2015 to test their assessment and collection of the corresponding gross receipt taxes. Based on our test, we found that 73 (70%) of the independent contractors during the years 2013 to 2015 did not pay taxes on their gross revenues, and the Division of Customs & Tax Administration was not aware of the non-payments. Refer to Table 1 below.

| Table No. 1 | | | | | | | | |
|--|--------|--------------|---------|--------------|--------|--------------|-------------|----------------|
| Test Computation of Taxes on Revenues Earned by Independent Contractors | | | | | | | | |
| Description | FY2013 | | FY 2014 | | FY2105 | | Grand Total | |
| | # | Amount | # | Amount | # | Amount | # | Amount |
| Total Payments to Independent Contractors | 36 | \$457,892.29 | 34 | \$491,102.55 | 34 | \$461,914.37 | 104 | \$1,410,909.21 |
| Sample selected to check the collection of taxes | 28 | \$448,820.91 | 26 | \$481,222.02 | 30 | \$457,894.77 | 84 | \$1,387,937.70 |
| Total Taxes Due on Revenue | | \$8,961.23 | | \$9,702.85 | | \$9,026.29 | | \$27,690.37 |
| Less Taxes Collected | 0 | \$0.00 | 5 | \$585.14 | 6 | \$5,043.00 | 11 | \$5,628.14 |
| Uncollected Taxes | 28 | \$8,961.23 | 21 | \$9,117.71 | 24 | \$3,983.29 | 73 | \$22,062.23 |
| Note: About 87% did not pay their tax obligations; only 13% out of the total made tax payments | | | | | | | | |

Furthermore, our examination of the samples tested disclosed that some independent contractors had employer-employee relationship with the National Government. Therefore, they had the

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status as employees subject to taxes on their salaries and wages. This is discussed further in Finding No. 2 below.

As a result, a total of \$22,062.23 taxes on gross revenues on the sampled independent contractors were not collected and remitted to the FSM Treasury for the period covered by audit.

Cause and Recommendation

The Division of Customs & Tax Administration failed to collect the taxes due from the independent contractors due to the following:

- Lack of internal policies and guidelines to manage and monitor independent contractors
Currently there are no internal policies and guidelines in place to monitor independent contracts to ensure that contractors are voluntarily filing and paying the income taxes due from them.
- Not all the Independent Contracts were routed to the Division of Customs & Tax for tax assessment
The current practice now has been to route all contracts to Division of Personnel, to Finance for fund certification, and then to Department of Justice for legal sufficiency. The Division of CTA that shall establish the proper tax determination or assessment was not involved in the routing process.
- Inconsistent use of contract forms
The Division of Personnel has the Independent Contract form specimens; however, each department prepares its own independent contract agreement forms, which sometimes lacks the provision on tax obligations and responsibilities of the independent contractors.

We recommend that the Secretary, Department of Finance & Administration should:

- Implement clear internal policies and guidelines to properly manage all government independent contractors for tax purposes.
- Require that all employment contracts should be routed to the Division of Customs and Tax Administration for proper tax considerations and to ensure that the correct amounts of tax payments are made accordingly.
- Require the use of a uniform Independent Contract Agreement form by all departments/agencies for consistency and to ensure that the tax obligations are clearly included in the Independent Contract Agreements and paid for by the independent contractors as required by law.

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Finding No. 2: Payments to Independent Contractors With Employee Status Not Subjected to Salary Tax Withholding

According to Section 112.3 Title 54 FSMC, “*Employee*” means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

The common law for the FSM is based upon the law of the United States, the Trust Territory and other nations in the common law tradition up to initiation of the constitutional government for FSM in 1979. *Rauzi v. FSM, 2 FSM Intrm.8, 17 (Pon 1985)*.

Under common-law rules, anyone who performs services is your employee ***if you can control what will be done and how it will be done***. This is so even if the employer gave the employee freedom of action. What matters is that, you have the right to control the details of how the services are performed (reference IFRS¹). Furthermore, the FSM Income Tax Law’s distinction between employees and businesses reflects the congressional expectation that businesses and employees are generally distinguishable on the basis of whether the generation of their income would require substantial expenditures by them. *Rauzi v. FSM, 2 FSM Intrm.8, (Pon 1985)*.

The computation of tax as well as the manner of collecting tax for employees is different from the computation of tax for independent contractors that are considered as businesses. According to Section 121 Title 54 FSMC on taxes on wages and salaries, “*There shall be assessed, levied, collected/paid a tax of 6 % on the first \$11,000 and 10% on the amount over the first \$11,000 of all wages and salaries received by every employee, as defined, except as provided in section of this chapter.*”²

Furthermore, for the manner of collecting tax from employees, “*The tax imposed by Section 121 of this Chapter shall be collected by the employer by deducting and withholding the tax imposed on any wages and salaries as and when paid or credited to employee.*” Section 131 Title 54 FSMC.

Based on our review of the sampled independent contractors by the National Government, we found at least 10 contractors who appeared to have an employer-employee relationship considering both their day-to-day activities and the right of the government to control the details of how their services were to be done. These contractors should have been subjected to salaries withholding tax which provides for higher tax rate (6%) instead of tax on revenues (3%). The computed salary taxes for withholding for these employees are indicated in Table No. 2 below.

¹ International Financial Reporting Standards

² Section 22 refers to the provision for deduction from taxes.

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| Table No. 2 | | | | |
|--|--------------|---------------|---------------|--------------|
| Independent Contractors With the Status of Employees | | | | |
| Description | FY 2013 | FY2014 | FY2015 | Total |
| Number of Employees | 3 | 6 | 7 | 16 |
| Total Salary | \$ 11,700.00 | \$ 114,586.81 | \$ 123,676.72 | \$249,963.53 |
| Computed Tax Withholding | \$ 702.00 | \$ 9,063.09 | \$ 9,512.81 | \$ 19,277.90 |
| Actual Tax Collection | \$0 | \$ 0 | \$ 0 | 0 |
| Estimated Uncollected Tax | \$ 702.00 | \$ 9,063.09 | \$ 9,512.81 | \$ 19,277.90 |

As a result, the Division of CTA did not deduct and withhold income taxes amounting to at least \$19,278 for salaries and wages paid to employees/contractors who were using the Independent Contract Agreement forms.

Cause and Recommendation

The failure to properly assess and collect taxes on salaries and wages was due to the following factors:

- Lack of clear guidelines on how to determine the employer-employee relationship for independent contractors.
- The employment contract agreement forms for some of the employees wrongly specified “no employer-employee relationship.”

We recommend that the Secretary, Department of Finance & Administration in coordination with the Attorney General, should develop and implement guidelines on how to determine the existence of employer-employee relationships for independent contractors.

We also recommend that the Secretary, Department of Finance & Administration should assess and collect income withholding taxes from the independent contractors who have the status of employees.

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MANAGEMENT RESPONSE




Government of the Federated States of Micronesia
Department of Finance & Administration
P.O. Box PS158 Palikir, Pohnpei FM 96941

Office of the Secretary

December 22, 2016

TO: FSM Public Auditor

FROM: Secretary of Finance & Administration 

SUBJECT: Response to the Audit on Independent Contractors

Thank you for the audit on the subject matter and please note that I have read the draft audit and I will do the followings to improve:

Finding # 1:

- a. We are currently enforcing that all independent contract must have a business ID otherwise they must go thru payroll II. This payroll II is the payroll processing that we established to process all contracts under contractual services. With that, all contract thru that process must have automatic tax deductions.
- b. Personnel must revise the forms to accommodate all the information required.

Finding # 2:

- a. As already indicated above, the way to identify the independent contractor is to indicate the business ID # and for employment contract should have a personal social security #.
- b. With the current set up, we are able to collect all taxes. We will continue to make sure that all employment contracts are allowing tax deductible on the employment contracts.

I will try to work with AG for better guidance and to ensure that the deductions are properly made.

Thank you for pointing out our weaknesses and I will get back to you when I need clarifications.

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ONPA EVALUATION OF MANAGEMENT RESPONSE

We requested for a management response from the Secretary of Finance and Administration. The management response generally agreed with our findings and recommendations in the report.

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We would like to thank the management and staff at the Department of Finance & Administration and in particular the staff at the Division of Customs and Tax Administration for their assistance and cooperation during the course of the audit.

We have provided copies of the final report to the President, Vice President and Members of the Congress for their use and information. Additional copies will be available to other interested parties upon request.

If there are any questions or concerns regarding this audit, please do not hesitate in contacting our office. The information to contact the office appears on the last page of this report.



Haser Hainrick
National Public Auditor

December 28, 2016

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ONPA CONTACT AND STAFF ACKNOWLEDGEMENT

ONPA CONTACT Haser H. Hainrick, National Public Auditor
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ACKNOWLEDGEMENTS In addition to the contact named above, the following staff made key
contributions to this report:

Manuel San Jose CPA, CGAP, CIA, CISA, CRMA, Audit Manager
Erick Paul, Auditor-In-Charge

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