A Proposal for Domestic Tax Reform

Note for Public Consultations on Tax Reform
Tax Policy Committee, September, 2007

I. OVERVIEW

Background: Plans to simplify the non-oil tax system and lower the tax burden on the private sector have wide support and date back some time. When he was Prime Minister, President Ramos-Horta put forward a concrete proposal. At the government's request and following a mission in January 2007, the IMF has also provided specific reform recommendations. More recently, the Forth Constitutional Government has included tax reform in its program. To this end, the Minister of Finance has appointed Mr. Rui Gomes to head a tax policy committee to use the President's proposal and the IMF's recommendations as a base for proposing the final shape of reforms to be implemented on January 1, 2008.

Basic motivation: The recent surge in petroleum revenue has reduced the need for non-oil taxation. A well-functioning tax system is central to an effective public administration and a good business environment. As such, the regulatory framework needs to be in line with economic conditions. The newfound petroleum wealth has reduced the reliance on other sources of income and offers the opportunity to implement bold policy changes to help stimulate private sector development. There is therefore scope to implement far-reaching tax reform even if this entails loss of government revenue. This would also be an opportunity to address specific shortcomings in the current system, in particular the reliance on disparate pieces of legislation and provisions that have proven difficult to enforce. In addition to lowering rates and mindful of the administrative capacity constraints, the reform should simplify processes and streamline regulation within one consolidated law.

Important considerations: By international standards the current tax system is relatively straightforward and, aside from problems in certain areas, has served the country well. Moreover, while surging petroleum revenue has reduced the reliance on domestic taxes, oil markets are volatile and income from petroleum is highly uncertain. This suggests that reform should not entirely transform the structure or abolish the current system but instead focus on addressing weaknesses and lowering rates.

Key objectives: The set of options presented here takes into consideration the principles of good tax policy. As a general rule, tax systems should be (i) simple, so that taxpayers understand the rules and can implement them in a cost efficient manner; (ii) neutral, so that economic activities are driven by market forces rather than being dictated by features of the tax system; (iii) stable, so that investors are not subjected to unnecessary uncertainty; and (iv) equitable, so that the tax system is accepted as fair. Faithful to these principles, the proposed reform of non-oil taxation aims to:

1. Facilitate investment and job creation;
2. Reduce the tax burden on wage earners and consumers, especially the poorest;
3. Lower compliance costs and minimize evasion; and
4. Maintain systems so that additional revenue can be raised if required in the future.

II. PROPOSED REFORM

The proposed reform package is an amalgamation of the President's and the IMF's proposals. The IMF report focused on the potential for structural improvements to make the tax system more efficient and easier to administer. The IMF's main proposal was to unify income taxes at a flat low rate in the range of 15–20 percent, with an increased tax-free threshold for individuals and allowing businesses to immediately deduct the full cost of all inputs. The President's proposal also adopts the flat tax model but goes much further in terms of advocating tax reductions, with his proposal essentially eliminating all indirect taxes. The present proposal adopts the IMF recommendations for structural improvements and reduces rates as advocated by the President, although generally not going all the way to zero.

The reform would entail one of the lowest tax regimes in the world. A flat 10 percent income tax with full expensing would render the tax system neutral with respect to different sources of income and would be a powerful incentive for investment. Cutting indirect taxes to 5 percent would reduce the cost of goods and services and provide significant advantages to consumers and businesses alike. With these changes there would be no need for the tax incentives granted by the foreign and domestic investment laws and it is recommended that they be abolished. Also in tune with the objectives of simplification and taxing income equally, it is recommended that the current minimum tax on business turnover be repealed.

A. Specific measures for implementation on January 1, 2008

Direct taxes: ***a simple flat tax system with a low rate***

- Unify the wage income tax and the income tax on non-wage income of both natural and legal persons at a flat rate of 10 percent.
- For natural persons, raise effective monthly exemption threshold to $500.
- For business income tax, replace normal depreciation with full expensing of all fixed assets (new and existing).
- Repeal the minimum tax on business turnover.
- Repeal the tax incentives under the foreign and domestic investment laws.
- Remove all withholding on interest and dividends and reduce the rate for non-resident income to 10 percent.

Indirect taxes: ***maintain simplicity and reduce rates***

- Preserving the current structure, lower the import duty and sales tax rates to 2½ percent each and the service tax to 5 percent.
- Retain excise taxes only for goods with clear adverse implications for health or environment (beer, wine, alcoholic beverages, tobacco, gasoline and diesel fuel).

III. Implications

Economic development: The Tax Policy Committee believes that the proposed reform would remove essentially all impediments to doing business imposed by the current tax system. Imports would only be taxed at a rate that roughly reflects the cost of maintaining border controls, and businesses would pay income tax only to the extent they have profits in excess of the normal return to capital. Wages would be tax free for all but the highest income earners, benefiting employees and business owners alike. Lower taxes would strongly complement other efforts to improve the business environment. The full results would not be immediate, but over time these measures would significantly boost investment and job creation.

Consumers: With lower taxes, it is expected that market forces will quickly cause a reduction in consumer prices. The near-term gain to consumers can be evaluated by considering the magnitude of this impact. If the reduction in indirect taxes is fully passed on to consumers but without further indirect effects (e.g. from businesses lowering their prices due to the reduction in income tax), the proposed reform is estimated to cause an almost 5 percent reduction in the price level faced by the average consumer. The impact on different consumers will vary according to consumption patterns but the Tax Policy Committee believes that all consumers would eventually benefit from job creation and higher wages.

Tax administration: The proposed simplifications will lower the burden associated with filing and collecting taxes. This will benefit businesses and reduce the cost of public administration.

Macroeconomic framework: Revenue from domestic taxation represents only about one tenth of the currently estimated sustainable income from Timor-Leste's petroleum wealth. With careful planning and prioritization, there is substantial room to simultaneously increase government spending and reduce taxes on the non-oil economy. Nevertheless, over the longer term there is much uncertainly regarding petroleum revenue and hence the importance of maintaining domestic tax systems so that additional revenue can be raised if needed.

IV. QUESTIONS AND NEXT STEPS

- Does the proposed reform address the shortcomings in the current system?
- Does it maximize the benefits to businesses and consumers?
- Is it fair?
- Following consultations, the Government will determine shape of reform and present draft law to Parliament for enactment on 1 January 2008.

TAX POLICY COMMITTEE: PROPOSAL FOR TAX REFORM

1. DIRECT TAXES

1.1 Income Tax

Timor-Leste has inherited the Indonesian income tax system with some modifications. The income tax applies to all taxable income other than that subject to withholding taxes (1.3) or wage income tax (1.4), and is supplemented by the minimum income tax (1.2). In the case of a legal person, income from dividends, interest, royalties and rent is included in the taxable income, with a credit for withholding tax. Progressive rates with three Brackets are applicable in the case of a natural person, and a flat rate is applicable in the case of a legal person.

Exemptions and Deductions	**Rates**
Depreciation: Business building - Straight line depreciation: 20 years useful life at 5%; -10 years useful life at 10% Depreciable assets Individual depreciation: 1-4 years useful life at 25%; 5-8 years useful life at 12.5%; 9+ years useful life at 6.25% Pooling depreciation: 1-4 years useful life at 50%; 5-8 years useful life at 25%; 9+ years useful life at 12.5% Amortisation of intangibles: 1-4 years useful life at 25%; 5-8 years useful life at 12.5%; 9+ years useful life at 6.25% Deductible expenses include: bad debt, interest, foreign exchange losses, salary and wages, contractor expenses, R&D expenses, and losses from sale/ transfer of property.	Natural person Income brackets and tax rates: 0 - $3,368 10 % $3,368 - $6,737 15 % $6,737 – 30 % Legal person Income tax rate: 30 %
Reform Recommendation	
Unify the wage income tax and the income tax on non-wage income of both natural and legal persons at a flat rate of 10 percent. For natural persons, raise effective monthly exemption threshold to $500. Replace normal depreciation with expensing of fixed assets (new and existing), and replace inventory valuation methods with immediate deduction of all business inputs. Allow indefinite carry-forward of losses. Disallow interest as a deductible business expense (except for financial institutions). Repeal the tax incentives under the foreign and domestic investment laws.	

1.2 Minimum Income Tax

Minimum income tax is levied on the taxpayer's total turnover for the year. The ordinary income tax payable is credited against the minimum tax payable for the year.

Exemptions and Deductions	**Rates**
The taxpayer's total turnover does not include any amount derived by the taxpayer that is subject to the withholding taxes.	1 % of total turnover
Reform Recommendation	
Repeal	

1.3 Withholding Taxes

Income earned from designated sources (including dividend, interest, royalty, and rent) is subject to withholding tax at a variety of rates. The tax is withheld by a person making payments to the recipient of the income. The withholding taxes are final, except for dividends, interest, royalties and rent paid to a legal person.

<table>
<tr><th>Exemptions and Deductions</th><th>Rates</th></tr>
<tr><td></td><td>Tax rates vary according to the source of income: Payable to residents and non-residents with permanent establishment:
Type of income (tax rate)
• dividend/ interest/ royalty (15%)
• rent from land/ building (10%)
• income from:
1. prizes and lotteries (15%)
2. construction activities (2%)
3. construction consulting (4%)
4. provision of transportation (2.64%)
5. petroleum drilling/ mining (4.5%)
6. provision of selected services (0%)
Payable to non-resident without permanent establishment:
all income 20%</td></tr>
<tr><th colspan="2">Reform Recommendation</th></tr>
<tr><td colspan="2">Remove all withholding on interest and dividends.

Set rate for income of non-residents without permanent establishment at 10 percent.

Include largest service providers in regular income tax.</td></tr>
</table>

1.4 Wages Income Tax

The wage income tax is withheld by the employer.

<table>
<tr><th>Exemptions and Deductions</th><th>Rates</th></tr>
<tr><td>Each employee is allowed a monthly tax credit of $10 against the wage income tax payable for the month.
Excess credit is neither refunded nor carried forward.
Exempt wages include:
(a) wages received for official duties by diplomatic staff of a foreign government’s representative office
(b) wages of a public servant of a foreign government
(c) wages of an employee of the UN or its agencies</td><td>Resident with Tax Identification Number (TIN):
Monthly wage income (tax rate)
• $0 to $550 (10%)
• above $550 (30%)
Non-resident (20%)
Resident without TIN (30%)</td></tr>
<tr><th colspan="2">Reform Recommendation</th></tr>
<tr><td colspan="2">Unify income taxes at low flat rate, see above1.1.</td></tr>
</table>

2. Indirect Taxes

2.1.1 Import Duties

All taxes in this category are levied at the border. Applicable to all imports at an advalorem rate except for selected import items.

Exemptions and Deductions	Rates
Imported goods that are exempt include: (a) when accompanying an arriving person • 200 cigarettes and 2.5 litre s of excisable beverages • non-commercial goods for personal use up to $300 • household effects (returning former residents) (b) imports by diplomats, UN and specialized agencies. (c) re-imported goods (d) goods for which import duty is less than $10	6 percent of the customs value. The customs value is the transaction value of the goods, including cost, insurance and freight (cif)
Reform Recommendation	
Otherwise maintaining the current system, reduce import duty rate to 2½ percent. Repeal all indirect tax incentives under the foreign and domestic investment laws.	

2.1.2 Sales Tax

Sales tax is applicable to imported goods, and goods sold and services provided domestically. For imported goods, the tax base consists of customs value, and the import duty and excise tax payable. Sales tax applicable to goods sold and services provided domestically is not collected currently.

Exemptions and Deductions	Rates
Sales tax does not apply to imported goods exempt from import duty.	6 percent of the sum of: the customs value of the goods; the import duty payable; and the excise tax payable.
Tax Policy Committee	
Otherwise maintaining the current system, reduce sales tax rate to 2½ percent.	

2.1.3 Excise Tax

Excise tax is levied on designated goods at specific or ad-valorem rates. Excise taxes on imported goods are levied on the excise value, or the customs value plus the import duty payable. Excise tax is also applicable to designated goods produced domestically, but is not collected currently because of the absence of domestic production. Some of the excises (e.g., those on private yachts and aircrafts) bear characteristics of a luxury goods tax.

Exemptions and Deductions	**Rates**
Exemption is given to: (a) Goods exported from Timor-Leste within 28 days of importation. (b) Goods that are exempt from import duty.	Rates for major excisable goods: *Specific rates on quantity* • Soft drinks $ 0.65 per litre • Beer $ 1.90 per litre • Wine $ 2.50 per litre • Alcoholic beverages $ 8.90 per litre • Tobacco $ 19.00 per kg • Gasoline, diesel fuel $ 0.06 per litre *Ad-valorem rates of the excise value* • Fruit juices/ ice cream 12 % • cigarette lighter, smoking pipe 12 % • Audio electronic goods 12 % • Mobile phones, TV, videos 12 % • Perfumes 18 % • Fireworks, arms/ ammunition 120% • Motor cars: the greater of 36 % excise value, or $500 + 36% over $20,000 • private yachts / aircrafts 12 %; in excess of US $20,000 36 %
Reform Recommendation	
Eliminate excise taxes except those with clear adverse implications for health or environment (beer, wine, alcoholic beverages, tobacco, gasoline and diesel fuel). Specify the factory gate as the excise point and the value at that point as the excisable value for domestic excisables. Admit under bond excisable imports which are inputs to domestic excisables.	

2.2 Service Tax

The service tax applies to designated services, which comprise:
(a) hotel services
(b) restaurant and bar services
(c) telecommunications services
(d) rental services of: (i) cars, trucks, omnibuses, etc
(ii) helicopters and airplanes
(iii) seagoing vessels

Exemptions and Deductions	Rates
Service tax is payable by providers of services, with monthly turnover of $500 or more	A uniform rate of 12%.
Tax Policy Committee	
Otherwise maintaining the current system, reduce service tax rate to 5 percent. Remove transport rentals from the list of designated services.	