

**Regulations For Public Law 13-71 (as amended),
The Corporate Income Tax Act of 2004**

Part 1. General

1.1 Scope of Regulations

These regulations prescribe the scope of taxable income, method of computing tax amounts, tax returns, procedures of payment and, and other necessary matters to ensure proper enforcement of tax liability imposed on a Major Corporation.

1.2 Effective Date

These regulations shall take effect upon compliance with Title 17 of the Code of the Federated States of Micronesia. These regulations shall apply to all corporate income tax returns filed and corporate income tax due after the effective date of the regulations.

1.3 Definitions

As used in these regulations –

(1) The term “Act” means Public Law 13-71 (as amended), the Corporate Income Tax Act of 2004.

(2) The term “Tax” means the corporate income tax imposed by § 321 of the Act.

(3) The term “Gross Profit Ratio” means the amount calculated by subtracting the sum of the (i) book value of the relinquished vessel and the (ii) expenses associated with the transfer of the relinquished vessel from the (iii) proceeds received from the transfer of the relinquished vessel divided by the proceeds received from the transfer of the relinquished vessel.

$$\text{E.g., } \frac{\text{proceeds received} - (\text{book value} + \text{expenses})}{\text{proceeds received}}$$

(4) The term “Net Operating Loss” is the amount by which the total deductions exceed the gross income for the Taxable Year.

(5) The term “Functional Currency” means the currency of the primary economic environment in which the Major Corporation operates.

(6) The terms used in these regulations have the same definitions as in Title 54 of the Code of the Federated States of Micronesia entitled “Taxation and Customs.”, except as otherwise defined in the Act or these regulations or where the definition in Title 54 contradicts the usage of the term in the Act or these regulations.

1.4 Taxable Year

The Taxable Year as defined in § 312(4) of the Act shall not exceed 12 months.

1.5 Notification of Change in Fiscal Year

Where a Major Corporation changes its fiscal year according to § 341 of the Act, it shall notify the Secretary of the change by no later than thirty (30) days thereafter.

1.6 Annual Income Tax Return

(1) The annual income tax return prescribed in § 351 of the Act shall contain the following information:

- (a) The income or loss which is the tax base for the Taxable Year,
- (b) The amount of tax due computed pursuant to § 321 of the Act, and
- (c) Any and all other information required to be provided pursuant to the form approved by the Secretary.

(2) In accordance with § 351 of the Act, the annual income tax return shall be filed together with a Major Corporation’s financial statements. These financial statements shall include the balance sheet, income statement, and any and all other documents as prescribed by the Secretary, in a form acceptable to the Secretary.

(3) In accordance with § 351 of the Act, the annual income tax return shall be filed together

with the audited financial statements of any corporation that owns more than 50% of that Major Corporation. These audited financial statements shall include the balance sheet, income statement, statement of cash flow, and the auditor's opinion; these documents shall be provided in English. Furthermore, the Major Corporation shall provide any and all other documents as prescribed by the Secretary, in a form acceptable to the Secretary.

(4) Annual income tax returns, income tax computation and accompanying financial statements submitted to the FSM Finance may be prepared in the functional currency of the Major Corporation. If the Major Corporation uses its functional currency to prepare these documents, it shall clearly state in the documents the functional currency used.

1.7 Payment of Tax

(1) A Major Corporation shall pay its tax due to the Treasurer of the Federated States of Micronesia.

(2) Where a Major Corporation chooses to pay its tax due in a functional currency other than the U.S. Dollar, and where the FSM Government has a bank account in that particular functional currency, as may be indicated on the tax forms as prescribed by the Secretary, the Major Corporation may deposit the tax due into that account, accompanied by a transmittal receipt from the transmitting institution which shows the amount of tax due in the functional currency.

(3) Where a Major Corporation chooses to pay its tax due in a functional currency other than U.S. Dollar, and where the FSM Government does not have a bank account in that particular functional currency, the Major Corporation shall deposit the tax due into the account indicated on the tax forms as prescribed by the Secretary, and it shall attach a transmittal receipt showing the following:

- (a) Amount of tax due in the functional currency;
- (b) exchange rate used by the transferring institution to convert the functional currency to USD; and,
- (c) the amount transmitted in U.S. Dollar to the Treasurer of the Federated States of Micronesia.

Part 2. Tax Computation

2.1 Tax Base

The Major Corporation's tax base for the Taxable Year shall be its taxable income of the Taxable Year.

2.2 Computation of Taxable Income

(1) Taxable income of a Major Corporation shall be the amount obtained by deducting the gross expense from the gross income of the Taxable Year.

(2) In computing taxable income, the amount to be included in gross income shall be, unless otherwise provided in these regulations, the amount of income in the stated Taxable Year from:

- (a) sales of assets;
- (b) gratuitous transfers of assets;
- (c) rendering of services;
- (d) gratuitous acquisitions of assets; or
- (e) any transactions other than capital transactions.

(3) In computing taxable income, the amount to be included in gross expense shall be, unless otherwise provided in these regulations:

- (a) The cost of sales, cost of completed construction work, and other similar costs related to income during the Taxable Year;
- (b) The amount of selling expenses, general administrative expenses, depreciation expenses, and other expenses during the Taxable Year (except expenses that are speculative as of the last day of the Taxable Year);
- (c) The amount of loss from transactions other than capital transactions during the Taxable Year.

(4) The amount of income in the Taxable Year prescribed in subparts 2.2 (2) and (3)

hereinabove shall be computed in accordance with GAAP as prescribed in § 322 of the Act.

(5) Capital transactions as described in subpart 2.2 (2) or (3) hereinabove mean transactions which cause an increase or decrease in the paid in capital or other capital accounts, and the distribution of profit or retained earnings, and any other reserve accounts of the Major Corporation.

Part 3. Income

3.1 Exclusion from Gross Income of a Revaluation Gain of Assets

Where the book value of the assets of the Major Corporation increases due to a revaluation, such increase in the amount shall not be included in the Major Corporation's gross income in computing the amount of income for the Taxable Year.

3.2 Inclusion in Gross Income of Amount of Foreign Income Tax of Foreign Subsidiary Corporation

Where a Major Corporation utilizes the foreign tax credit as applied under subpart 6.1(4) for the Taxable Year, the amount of the tax to be levied on income of the foreign subsidiary corporation computed under subpart 6.1(4) shall be included in gross income in computing the taxable income for the Taxable Year of the Major Corporation.

3.3 Exclusion from Gross Income of Dividend Income from other Major Corporations

Any dividend received from another Major Corporation, such amount shall be excluded from the Major Corporation's gross income in computing the amount of income for the Taxable Year.

Part 4. Expenses

4.1 Deductible Expenses

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's industry. A necessary expense is one that is helpful and appropriate for the taxpayer's business.

4.2 Exclusion from Gross Expense of Revaluation Loss of Assets

Where the book value of the assets of the Major Corporation decreases due to a revaluation, such decrease in the amount shall not be included in the Major Corporation's gross expense in computing the amount of income for the Taxable Year.

4.3 Salary of Directors and Officers Excluded from Gross Expense

(1) Of the compensation paid to directors and officers of a Major Corporation, the following shall not be included in the Major Corporation's gross expense in computing the amount of income for the Taxable Year:

- (a) Fixed compensation paid periodically, which periodic frequency does not exceed one month during the Taxable Year, or other similar compensation;
- (b) Fixed compensation to be paid at a predetermined time, in accordance with Major Corporation policy, for duties of directors and officers;
- (c) any portion of the compensation that is unreasonably high.

(2) Compensation paid to the Major Corporation's directors and officers by means of concealing facts or manipulating accounting records by a Major Corporation shall not be included in gross expense in computing taxable income for the Taxable Year of the Major Corporation. Such compensation shall include, but not be limited to, benefits obtained due to waiver of debts or any other economic benefits obtained.

4.4 Exclusion from Gross Expense of Donations

(1) Donations paid to charities within the Federated States of Micronesia exceeding five percent (5%) of taxable income shall not be included in the Major Corporation's gross expense in computing the amount of income for the Taxable Year.

(2) Contributions or donations paid to a foreign-related person of the Major Corporation shall not be included in the Major Corporation's gross expense in computing the amount of income for the Taxable Year.

4.5 Exclusion of Entertainment Expense from Deductible Expenses

(1) Entertainment expenses shall not be included in the Major Corporation's gross expense

in computing the amount of income for the Taxable Year.

(2) Entertainment expenses as prescribed in subpart 4.4 (1) hereinabove includes social, entertainment, discretionary, and other expenses of a Major Corporation for the purpose of entertainment, hosting meals, recreation, gift-giving, or any similar act for its customers, suppliers, or other business related parties except for the following:

- (a) Ordinary expenses exclusively relating to activities, such as athletic games, amusement, or recreational travel involving the Major Corporation's employees;
- (b) Ordinary expenses (excluding expenses that are exclusively for the entertainment of the Major Corporation's directors, officers, employees, or their families) for eating and drinking and other similar conduct during which the business of the Major Corporation is discussed.

4.6 Exclusion from Gross Expense of Amount of Income Tax

Income tax paid by a Major Corporation shall not be included in the Major Corporation's gross expense in computing the amount of income for the Taxable Year.

4.7 Exclusion from Gross Expense of Foreign Tax Credit

When the Major Corporation utilizes the foreign tax credit as prescribed in § 331 of the Act pursuant to subpart 6.1 (Credit for Foreign Taxes), such amount of the foreign income tax credit shall not be included in the Major Corporation's gross expense in computing the amount of income for the Taxable Year.

4.8 Inclusion in Gross Expense of Gains from the Exchange of Vessels

- (1) (a) Subpart 4.8 shall apply if, during a Taxable Year, a Major Corporation:
- (i) transfers a vessel it owns;
 - (ii) acquires a replacement vessel; and,
 - (iii) uses or has a prospect to use the replacement vessel for the business of the Major Corporation within 1 year from the acquisition of the replacement vessel in subpart 4.8 (1)(a)(ii).

(b) Concerning replacement vessels, Major Corporations shall include the amount calculated in either (i) or (ii) below in the Major Corporation's gross expense in computing

the amount of income for the Taxable Year:

- (i) where the amount, which is the lesser of the proceeds received from the transfer of the relinquished vessel or the acquisition price of the replacement vessel, is accounted to reduce the book value of the replacement vessel, or
- (ii) where the amount, which is the amount computed in (i) above multiplied by the Gross Profit Ratio multiplied by 80%, is accounted as a reserve for the fiscal year,

(2) Subject to subpart 4.8 (1)(a), the Major Corporation can consider a vessel a replacement vessel, and may choose to have the provisions of subpart 4.8 (1)(b) apply to the Major Corporation, if the vessel meets the following conditions:

- (a) The Major Corporation has acquired the replacement vessel within three years prior to the first day of the Taxable Year in which the vessel that the Major Corporation owned was relinquished, and
- (b) The Major Corporation has, within one year from the date of acquisition, used or planned to use the replacement vessel for the business of the Major Corporation (however, if the replacement vessel has ceased to be used for the business of the Major Corporation by the last day of the Taxable Year or within one year from the date of the acquisition, whichever date is earlier, then it shall no longer meet the requirement of subpart 4.8 (2)(b))

(3) Provided that a Major Corporation has relinquished the vessel that it owns within the Taxable Year, and plans to acquire a replacement vessel within three years from the day after the last day of the Taxable Year, and plans to use such replacement vessel within one year from the date of such acquisition for the business of the Major Corporation:

- (a) Any portion of the proceeds received from the transfer of the relinquished vessel that is used to acquire the replacement vessel shall be multiplied by the Gross Profit Ratio.
- (b) The amount calculated in subpart 4.8 (3)(a) shall be included in gross expenses in calculating the income of the Taxable Year provided that the Major Corporation has set up a special allowance account for the fiscal year (this includes accounting as a

reserve for the fiscal year).

4.9 Exclusion from Gross Expense of Expenses Relating to Illegal Acts

(1) Where a Major Corporation manipulates, conceals, or disguises any facts that are the bases in computing the Major Corporation's taxable income, loss, or tax due (collectively, the "Concealment"), any expenses or losses associated with the Concealment shall not be included in gross expense in computing taxable income for the Taxable Year of the Major Corporation.

(2) Any criminal penalty, administrative penalty, fine, or any equivalent penalty or fine, imposed by law, either domestically or in a foreign country, which a Major Corporation pays, shall not be included in gross expense in computing taxable income for each Taxable Year of the Major Corporation.

(3) Any expenses or losses incurred by a Major Corporation for bribes or improper benefits to domestic or foreign public servants shall not be included in gross expense in computing taxable income for each Taxable Year of the Major Corporation.

Part 5. Net Operating Loss

5.1 Net Operating Loss Carry Forward

Where there is a net operating loss that arose in the Taxable Years beginning within 7 years before the first day of each Taxable Year in which a Major Corporation filed a annual income tax return (excluding any net operating loss that was included as gross expense in computing taxable income for any Taxable Year during that period), the net operating loss shall be included in gross expense in computing taxable income for each Taxable Year.

Part 6. Foreign Taxes

6.1 Credit for Foreign Income Taxes

(1) The foreign income tax for which a credit shall be allowed as prescribed in § 331 of the Act (hereinafter "Creditable Foreign Tax") shall be limited to the foreign income tax paid

from foreign source income for the Taxable Year.

(2) Where (i) the foreign income tax to be paid by the Major Corporation during the Taxable Year exceeds the Creditable Foreign Tax for the Taxable Year, and (ii) there is a Creditable Foreign Tax that may be carried forward to the Taxable Year from a Taxable Year that started within the immediately preceding 7 years, then the Creditable Foreign Tax carried forward shall be credited against the income tax due for the Taxable Year.

(3) Where (i) the amount of foreign income tax to be paid by a Major Corporation during the Taxable Year is less than the amount of the Creditable Foreign Tax for the Taxable Year, and (ii) there is any amount of foreign income tax carried forward as prescribed in § 331 of the Act from the preceding 7 years, then, after applying the amount of foreign income tax to be paid for the Taxable Year, the amount carried forward shall be credited against the income tax due of the Taxable Year up to the amount of Creditable Foreign Tax.

(4) Where a Major Corporation receives dividends from retained earnings (limited to the amount connected to stocks and investments), dividends from profits, or distributions from retained earnings (limited to the amount connected to investments) of its foreign subsidiary, the amount of foreign income tax on the income of that foreign subsidiary corresponding to such dividend shall be deemed a foreign income tax of the Major Corporation for which the Creditable Foreign Tax applies, and the provisions of subparts 6.1 (1), (2), and (3) shall apply. A foreign subsidiary is a Foreign Corporation for which the Major Corporation holds 25% or more of its issued stock or investment.

(5) Where (i) a Major Corporation receives dividends or distributions as prescribed in subpart 6.1 (4), and (ii) the Major Corporation's foreign subsidiary (hereinafter the "Foreign Subsidiary") receives dividends from retained earnings (limited to the amount connected to stocks and investments,) dividends from profits, or distributions from retained earnings (limited to the amount connected to investments) from its foreign subsidiary (hereinafter "Foreign Second Tier Subsidiary "), the amount of foreign income tax on the income of that Foreign Second Tier Subsidiary corresponding to such dividend shall be deemed a foreign income tax of the Foreign Subsidiary for which the Creditable Foreign Tax applies, and the

provisions of subpart 6.1 (4) shall apply. A Foreign Second Tier Subsidiary is a Foreign Corporation for which the Major Corporation indirectly holds 25% or more of its issued stock or investment through the Foreign Subsidiary.

Part 7. Rulings

7.1 Binding Public Rulings

(1) The Secretary may make a public ruling in accordance with subpart 7.1 setting out the Secretary's interpretation on the application of a revenue law.

(2) A public ruling made in accordance with subpart 7.1 is binding on the Secretary until withdrawn.

7.2 Making a Public Ruling

(1) The Secretary shall print and maintain a gazette or other publication to be made available free of charge to the public. The Secretary shall make a public ruling by publishing a notice of the ruling in such gazette.

(2) A public ruling must state that it is a public ruling and have a number and subject heading by which it can be identified.

(3) A public ruling applies from the date specified in the ruling and if no date is specified, from the date of publication in the gazette identified in subpart 7.2 (1).

7.3 Withdrawal of a Public Ruling

(1) The Secretary may withdraw a public ruling, in whole or part, by publishing notice of the withdrawal in the gazette identified in subpart 7.2.

(2) If legislation is passed or regulations promulgated, or the Secretary makes another public ruling, that is inconsistent with an existing public ruling, the existing ruling is treated as withdrawn to the extent of the inconsistency.

(3) The withdrawal of a public ruling, in whole or part, has effect –
(a) if subpart 7.3 (1) applies, from the date specified in the notice of withdrawal

and if no date is specified, from the date notice of the withdrawal is published in the gazette; or

(b) if subpart 7.3 (2) applies, from the date of application of the inconsistent legislation or public ruling.

(4) A public ruling that has been withdrawn in whole or in part –

(a) continues to apply to a transaction commenced before the public ruling was withdrawn; and

(b) does not apply to a transaction commenced after the ruling was withdrawn to the extent that the ruling is withdrawn.

7.4 Binding Private Rulings

(1) The Secretary may, upon application in writing by a taxpayer, issue to the taxpayer a private ruling setting out the Secretary's position regarding the application of a revenue law to a transaction entered into, or proposed to be entered into, by the taxpayer.

(2) If the taxpayer has made a full and true disclosure of all aspects of the transaction relevant to the making of a private ruling and the transaction has proceeded in all material respects as described in the taxpayer's application for the ruling, the ruling is binding on the Secretary in relation to the taxpayer.

(3) If a private ruling is inconsistent with an existing public ruling, the private ruling has priority to the extent of the inconsistency.

7.5 Refusing an Application for a Private Ruling

(1) The Secretary may refuse an application for a private ruling if –

(a) the Secretary has already decided the matter that is the subject of the application in a tax assessment;

(b) The Secretary is of the opinion that an existing public ruling adequately covers the matter that is the subject of the application;

(c) the application relates to a matter that is the subject of a tax audit or an objection;

(d) the application is frivolous or vexatious;

(e) the arrangement to which the application relates has not been carried out and

there are reasonable grounds to believe that it will not be carried out;

(f) the applicant has not provided the Secretary with sufficient information to make a private ruling; or

(g) in the opinion of the Secretary, it would be unreasonable to comply with the application having regard to the resources needed to comply and any other matters the Secretary considers relevant, such as disadvantage to other taxpayers.

(2) The Secretary shall serve the applicant with a written notice of the refusal to make a private ruling.

7.6 Making a Private Ruling

(1) The Secretary must make a private ruling unless subpart 7.5 applies.

(2) The Secretary makes a private ruling by serving written notice of the ruling on the applicant.

(3) The Secretary may make a private ruling on the basis of assumptions about a future event or other matter as considered appropriate.

(4) A private ruling must set out the matter ruled on, identifying –

(a) the taxpayer;

(b) the revenue law relevant to the ruling;

(c) the tax period to which the ruling applies;

(d) the arrangement to which the ruling relates; and

(e) any assumptions on which the ruling is based.

(5) A private ruling is made at the time the applicant is served with notice of the ruling and remains in force for the period specified in the ruling.

7.7 Withdrawal of a Private Ruling

(1) The Secretary may, for reasonable cause, withdraw a private ruling, in whole or part, by written notice served on the applicant.

(2) If legislation is passed or regulations promulgated, or the Secretary publishes a public ruling, that is inconsistent with a private ruling, the private ruling is treated as withdrawn to the extent of the inconsistency.

(3) The withdrawal of a private ruling, in whole or part, has effect –
(a) if subpart 7.7 (1) applies, from the date specified in the notice of withdrawal; or
(b) if subpart 7.7 (2) applies, from the date of application of the inconsistent legislation or regulation or public ruling.

(4) A private ruling that has been withdrawn –
(a) continues to apply to a transaction commenced before the ruling was withdrawn; and
(b) does not apply to a transaction commenced after the ruling was withdrawn to the extent that the ruling is withdrawn.

Part 8. Records; Inspection and Audit

8.1 Requirements for Records; Inspection and Audits

(1) Pursuant to the provisions of Title 54 of the Code of the Federated States of Micronesia § 151, as incorporated by § 370 of the Act:

- (a) All Major Corporations shall keep and maintain accurate records.
- (b) The Secretary may inspect and audit records at any reasonable time for the purpose of administering the provisions of the Act. For purposes of this Act, the reasonable time the Secretary may commence inspection or audit of records shall be:
 - (a) within three (3) years after the original return is filed; or,
 - (b) within seven (7) years after the original return is filed if the inspection or audit reveals fraud, a willful attempt to evade tax, or no return is filed.