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F I S C A L   A F F A I R S   D E P A R T M E N T

Maldives
Reform Options to Strengthen Tax Policy

Shafik Hebous, Lee Burns, and John Norregaard

Technical Assistance Report

March 2019

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PREFACE

At the request from the Ministry of Finance (MOF), an IMF technical assistance mission visited Malé, the Maldives from February 4-15, 2019 to review tax policy and identify potential reform options. The mission comprised Shafik Hebous (head), Lee Burns, and John Norregaard (both FAD experts). The mission held discussions with the MOF led by Mr. Ibrahim Ameer (Minister of Finance) and met with Mr. Ismail Ali Manik (Minister of State for Finance), Mr. Ahmed Saruvash Adam (Chief Financial Budget Executive), Mrs. Aishath Hasna Ahmed (Assistant Fiscal Executive), and Mr. Arshad Jameel (Fiscal Affairs Department of the MOF).

The mission held discussions with the Ministry of Economic Development led by Mr. Fayyaz Ismail (Minister of Economic Development) and met Mr. Abdulla Husaam (Under Secretary, President Office).

At the Maldivian Inland Revenue Authority (MIRA), the mission held discussions with Mr. Yazeed Mohamed (Commissioner General of Taxation), Mrs. Asma Shafeeu (Director General for Planning and Development), Mr. Hassan Zareer (Deputy Commissioner General of taxation), Mr. Mohamed Ali Waheed (Deputy Director General), Mrs. Aminath Zumra (Deputy Director), and Mrs. Fathimath Amaanee Khalid (Deputy Manager).

The mission also held discussions with representatives of the private sector, including Maldives National Chamber of Commerce and Industries, representatives of the accounting firms in the Maldives, the Maldives Association of Tourism Industry and the Guesthouse Association of Maldives. The mission thanks the National Bureau Statistics for accessing the latest household survey data.

The mission offered a workshop in Malé that covered topics including establishing a tax policy unit, tax design issues, and international tax matters such as tax treaty policy.

Finally, the team of the mission would like to express its sincere thanks to Mr. Ahmad Naeem (Fiscal Affairs Department of the MOF) for the enormous support for the mission work and meeting scheduling, and the Maldivian authorities for the constructive discussions and kind hospitality.

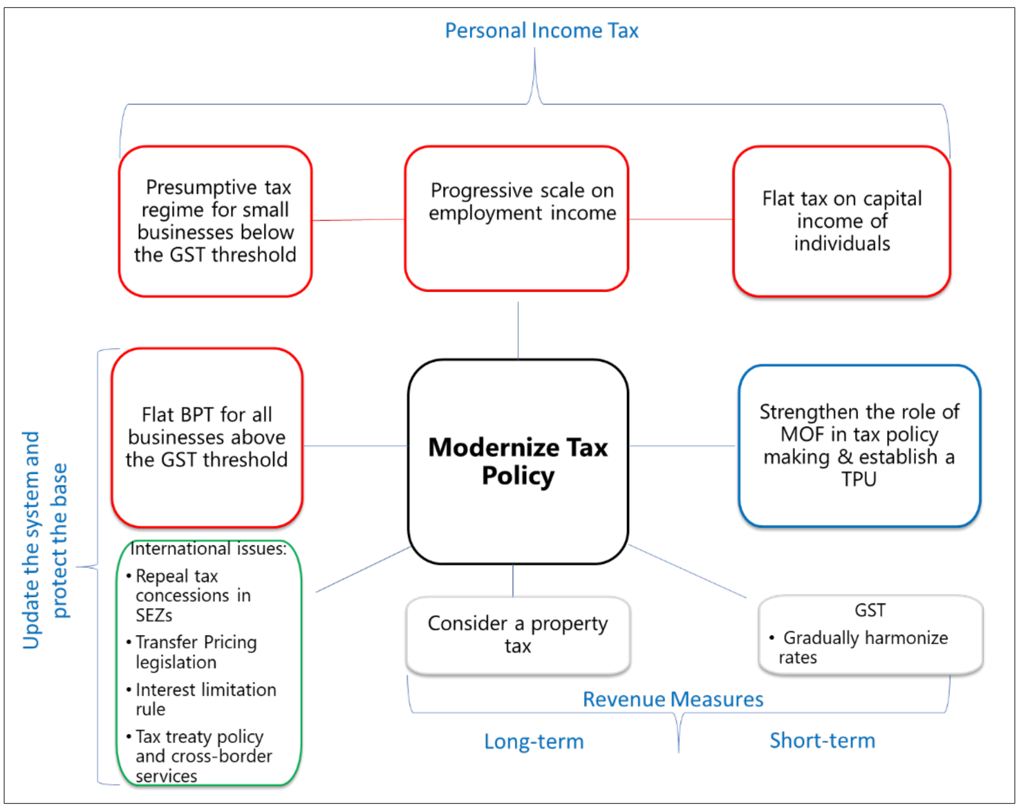
ABBREVIATIONS AND ACRONYMS

BEPS	Base Erosion and Profit Shifting
BPT	Business Profit Tax
BPTA	Business Profit Tax Act
CG	Commissioner General
CGT	Capital Gains Tax
CIT	Corporate Income Tax
DIT	Dual Income Tax
DTA	Double Tax Agreement
EBITDA	Earnings before Interest, Tax, Depreciation and Amortization
FAD	Fiscal Affairs Department (of the IMF)
FDI	Foreign Direct Investment
FIA	Foreign Investment Agreement
GDP	Gross Domestic Product
GNI	Gross National Income
GST	Goods and Services Tax
GSTA	Goods and Services Tax Act
HIES	Household Income and Expenditure Dataset
IMF	International Monetary Fund
MIRA	Maldives Inland Revenue Authority
MNEs	Multinational Enterprises
MOF	Ministry of Finance
OECD	Organisation for Economic Cooperation and Development
PIT	Personal Income Tax
SEZ	Special Economic Zone
SEZA	Special Economic Zone Act
TAA	Tax Administration Act
TPU	Tax Policy Unit
VAT	Value-Added Tax
WEO	World Economic Outlook
WHT	Withholding Tax

EXECUTIVE SUMMARY

This report reviews tax policy in the Maldives and identifies reform options to support efficiency, equity, and revenue. The absence of a broad-based personal income tax (PIT) generates revenue leakages and significantly diminishes the role of tax policy in income redistribution. A modern tax design requires a holistic view of the taxation of different sources of income and different legal forms of taxpayers to maintain tax neutrality, to the extent possible, while preserving some degrees of progressivity, simplicity, and administrability. Moreover, updating the tax system to cope with recent international developments is vital to safeguard revenues. While strengthening the goods and services tax (GST) can raise revenues in the short- to medium-term, a property tax is an important option for the long-term. The diagram below demonstrates reform priorities, as identified in this report, to modernize tax policy in the Maldives.

Diagram: Modernizing Tax Policy in the Maldives



The Big Picture

Strengthen the Role of the MOF in Tax Policy Making and Tax Analytics

The MOF should play a central role in exercising its mandate over tax policy formulation. Tax policy should be formulated at the MOF with a broader view of the tax system as a whole and should be guided by the policy objectives and economic analysis. Amending tax laws and establishing a tax policy unit (TPU) are important steps in this process.

Implement a Modern Income Tax Architecture

A recommended option for an income tax architecture in the Maldives entails elements of a dual income tax comprising the following reform *package*:

- Employment income should be subject to a moderately progressive tax scale (ideally with two non-zero rates: 10 percent and a top rate of 15 percent that is equal to the Business Profit Tax "BPT" rate), with carefully chosen income brackets as discussed in this report.

- Capital income of individuals should be subject a uniform tax rate of 10 percent, which is equal to the first non-zero tax rate in the employment income tax scale. Furthermore, it is equal to the cross-border withholding rate on *all* capital income.

- A simplified presumptive tax regime with a uniform rate on turnover for businesses, e.g., 3 or 4 percent should be introduced for small businesses below the GST threshold. The presumptive regime lowers administrative and compliance costs.

- The rates of BPT should be unified at 15 percent, including for banks and foreign income.

Based on a preliminary analysis, this report estimates that the recommended PIT reform can raise total tax revenues in the Maldives by about 4 percent and lowers the Gini coefficient from 0.59 to 0.58. Further, it is estimated that the progressivity of the system implies that about 60 percent of the PIT (including the presumptive tax) will be paid by the high-income group (top decile). A detailed follow-up study of the impact of a proposed PIT reform should be conducted (e.g., by the TPU) to guide the reform.

Protect the Tax Base from Erosion and Boost Revenues

- Adopt up-to-date anti-tax avoidance measures and repeal tax concessions.
- Gradually harmonize the GST rates and consider the potential for a recurrent property tax.

Recommendations

Major recommendations of this report are summarized in the Table below:

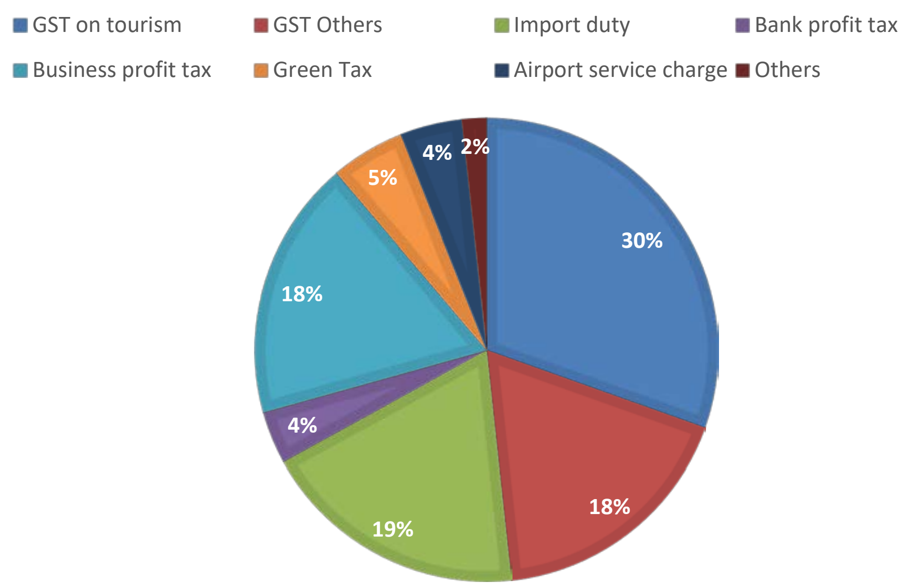
Recommendation	S: Short-term S-M: Short to medium L: Long-term
Strengthening Tax Policy Process	
Amend the tax laws to provide that regulations on tax policy matters are made by the MOF	S
Regulations should be amended by making a subsequent amending regulation rather than by a tax ruling	S
Amend the TAA to provide that tax rulings are binding on MIRA but not on taxpayers	S

Strengthening Tax Policy Process (cont.)	
Tax rulings on tax policy matters should be made by the MOF with input from MIRA. However, such rulings could be formally issued by MIRA	S
Establish a TPU in the MOF and ensure institutional arrangements that enable the TPU to regularly access the relevant data	S
Require in the law the annual publication of a tax expenditure report to inform the tax policy debate and enhance transparency	S
Personal Income Tax	
Introduce a moderately progressive tax scale on employment income (salaries and benefits), e.g., as follows: ▪ zero-tax bracket; (e.g., for the first tercile of income distribution) ▪ 10 percent; ▪ 15 percent (e.g., for the top 10th decile of income distribution)	S-M; Element of a tax reform package
Introduce a uniform tax of 10 percent on all individual capital income	S-M; Element of a tax reform package
Maximize the use of withholding mechanisms and avoid providing deductions	S-M; Element of a tax reform package
Presumptive Tax	
Introduce a presumptive tax regime with a uniform turnover tax, e.g., with a rate of 3 or 4 percent, for businesses below the GST threshold	S-M; Element of a tax reform package
Business and Profit Tax	
Repeal the basic allowance of MV 500,000	S-M; Element of a tax reform package
Apply the standard BPT rate (of 15 percent) on banks and foreign income	S-M; Element of a tax reform package
International Tax Aspects	
Adopt a transfer pricing legislation based on OECD guidelines	S
Include the limitation on interest deductions in the law	S
Impose a uniform cross-border withholding tax of 10 percent on dividends, interest, royalties, and management and technical fees	S
Provide for the taxation of gains derived on a direct or indirect transfer of immovable property located in the Maldives	S
Align the PE definition in the BPTA with the definition in the Maldives Model Tax Treaty, including updating for BEPS changes	S
Repeal all tax concessions from the SEZ Act	S
Remove the option of including a tax exemption in an FIA	
Review and improve the policy of negotiating tax treaties	S
GST	
Gradually harmonize the GST rates by removing the zero-rating (except for exports) and increasing the 6 percent rate	S
Preserve the existing GST threshold	S
Property Tax	
Consider introducing a recurrent property tax	L

I. INTRODUCTION

1. **The Maldives is highly dependent on revenue from the tourism sector.** The tax-GDP ratio was about 19.3 percent in 2018, but the country ran a budget deficit of 4.8 percent (and larger deficits in previous years). The public debt carrying capacity of the Maldives remains weak (IMF, 2019) and the external financing of public investment is gradually declining, raising the need for tax measures and strengthening tax policy. Broadening the tax base remains challenging as the Maldivian economy is highly dependent on tourism (a sector that is geographically scattered over hundreds of islands). The goods and services tax (GST) raises more than 48 percent of total tax revenues, most of which is from the tourism sector alone (30.5 percent of total tax revenues). Other important sources of revenue are the business profit tax "BPT" (18 percent of total tax revenues) and import duty (19 percent). The 'green tax', a tax on tourists of 6 US dollar per night, generates 5 percent of total tax revenues (Figure 1).

Figure 1. Tax Structure in the Maldives



Source: IMF staff calculation. Data are obtained from the Maldives Monetary Authority (Table 6.2).

2. **While important measures have been taken since 2011, there is significant scope for further improving the tax design and the tax policy making process to mobilize revenues and improve the equity and efficiency features of the system.** In 2010, the Maldives Inland Revenue Authority (MIRA) was established. In 2011, two new taxes were introduced: the BPT (top rate of 15 percent) and the GST, whereby the latter in lieu of a sales tax. The main revenue raising strategy since 2011 has been gradually increasing the top GST rate from initially 3.5 percent to currently 12 percent. There is no tax on employment income in the Maldives.

3. **This report reviews the overall design of the tax system and explores tax policy reform options for the Maldives.** A key issue for the Maldives is to strengthen the role of the Ministry of Finance (MOF) in tax policy formulation (Section II). The report reviews income taxes including the potential for introducing a PIT and improving the existing BPT (Section III). Moreover, it assesses the robustness of the system to international tax base erosion (Section IV), and tax treaty policy (Section V), to identify options for updating the Maldivian tax policy. Finally, the report reviews the GST (Section VI) and gives a primer on property taxes in the Maldivian context (Section VII).

II. STRENGTHENING TAX POLICY MAKING

A. Preparation of Regulations and Tax Rulings

4. **The sources of tax law will depend on the legal system of the country.** In the context of the Maldives, there are three legal sources specified under the tax laws: (i) the primary tax law particularly, the Business Profit Tax Act (BPTA) and GST Act (GSTA); (ii) regulations made under the primary tax law; and (iii) tax rulings made under the Tax Administration Act (TAA). The treatment of tax rulings as, in effect, subsidiary legislation is because the TAA prescribes that tax rulings are binding on taxpayers. This is a departure from international best practices where a tax ruling is a purely administrative matter prepared by the tax administration, to give taxpayers guidance on the way that the tax administration interprets and applies the tax law.

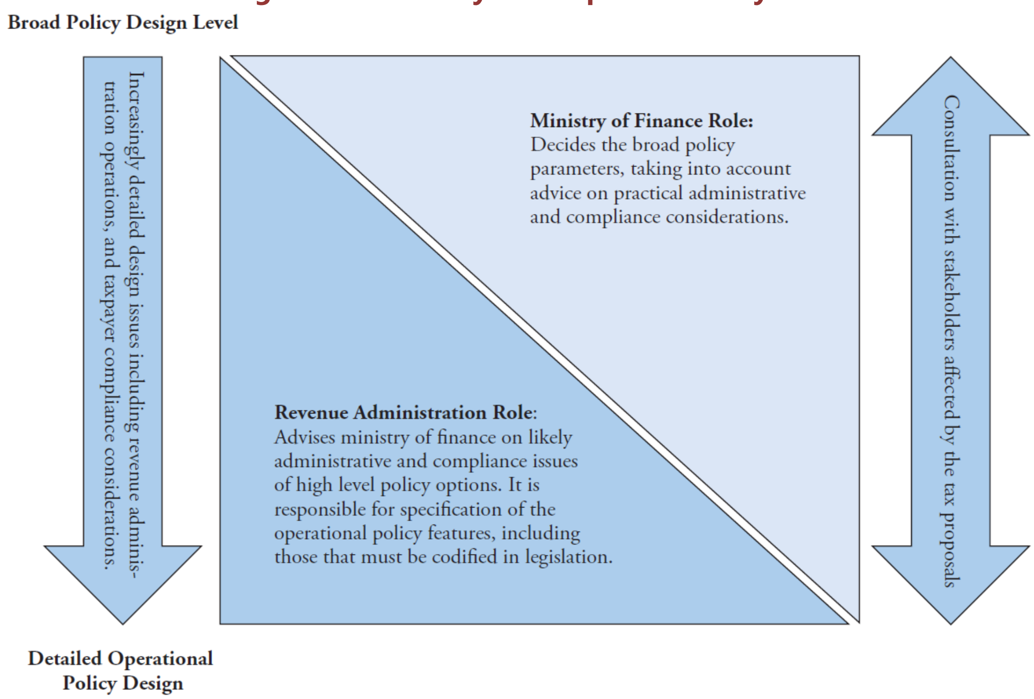
5. **While the relevant Tax Acts are passed by the People's Majlis (Parliament), the executive arm of the government prepares and implements regulations and tax rulings.** Presently, this is done by MIRA, which is established as an independent body that reports directly to the People's Majlis.[1] This is appropriate for regulations and tax rulings of a purely procedural or administrative nature. However, some existing regulations and tax rulings deal with tax policy matters; but, under the TAA, MIRA has only limited powers in relation to tax policy.

6. **MIRA's powers and responsibilities are set out in section 3 of the TAA and relate to administrative and procedural matters concerning the collection and enforcement of tax liabilities.** Under the TAA, MIRA's powers in relation to tax policy are limited to: (i) providing technical input into the making of tax policies as required by the Government; and (ii) implementing tax policies developed by the Government.[2] Further, the Board of MIRA is responsible for implementing tax policies determined by the Minister of Finance.[3] Consequently, the TAA provides for a clear separation of powers in relation to tax policy. It is the role of the MOF to develop tax policies and the role of MIRA to implement these tax policies. This separation is consistent with international norms.

[1] Section 11(b) of the TAA. It is noted that MIRA submits its budget to the Ministry (section 11(a) of the TAA).
[2] Section 3(a) and (i) of the TAA.
[3] Section 4(b)(3) of the TAA.

7. Despite this clear separation of powers under the TAA, the practice in the Maldives has been that MIRA prepares and implements regulations and tax rulings on tax policy matters. It is understood that there may not always have been input from the MOF in the preparation of regulations and rulings. This situation has arisen partly because of the way that the regulation-making power is framed in the tax laws and partly because of the absence of a tax policy unit, or similar unit, in the MOF. It is vital to reorganize responsibilities for formulating regulations and tax rulings on tax policy matters between the MOF and MIRA. This reorganization should make clear that the development of tax policies is the responsibility of the MOF with technical input from MIRA. It is then the responsibility of MIRA to implement these tax policies. This is illustrated by Figure 2 and accords with the legal position under the TAA.

Figure 2. Tax Policy Development Life Cycle



Source: Grote (2017)

8. The reorganization of responsibilities for tax policy formulation will require some clarification of the regulation-making power in the tax laws and of the scope of coverage of tax rulings. This is discussed further below. Another important issue is rethinking the composition of the MIRA Board.

9. The TAA does not provide for a representative of the MOF to be a member of the Board of MIRA. The primary role of the Board of Directors of a Revenue Authority is to provide broad administrative and financial oversight of its operations. Typically, the MOF is represented on the Board to facilitate the Board's role in implementing tax policies developed by the Ministry—as for example, in Mauritius, Uganda, Kenya, Tanzania, and Fiji. The Board can play an important role in enhancing the work of both the revenue authority and the MOF through better co-ordination of policy and administration matters. It is absolutely critical, however, not to limit the independence of the Board. Furthermore, the Chairperson usually has a significant experience in public administration but is independent from the MOF and the Tax Authority. Establishing a Tax Policy Unit, as recommended below, is an opportunity to consider amending the TAA to provide that a representative of the MOF is a member of the Board of MIRA.

Regulations

10. The Constitution provides that the People's Majlis can, in a law, delegate the power to a body to make regulations for the purposes of that law.[4] Any regulation requiring compliance by citizens (such as taxpayers) can be made only under an express power provided for in the primary law.[5] Both the BPTA and GSTA delegate the regulation-making power to MIRA.[6] While most regulations contemplated by the tax laws are of an administrative or procedural nature, some provisions in the tax laws require regulations that involve policy matters. For example, the GSTA provides for the making of regulations in relation to exempt supplies[7] and the BPTA provides for the making of regulations in relation to deductions.[8] The TAA provides that the regulations to be made by MIRA are to be made by the Board of Directors of MIRA.[9]

11. There is a potential conflict under the tax laws between those provisions requiring regulations on tax policy matters and MIRA's powers in relation to tax policy. The regulation-making power in the tax laws, therefore, needs to be amended so as to align with the legal authority of MIRA under the TAA. Ideally, it should be provided that the making of all regulations are centralized in the MOF with input from MIRA as appropriate. However, given that MIRA is an independent body reporting to Parliament and not the MOF, it could be provided that regulations relating to tax policy matters are to be made by the MOF and regulations relating to administrative and procedural matters are to be made by MIRA.

Tax Rulings

12. The TAA also empowers the Commissioner General (CG) to issue tax rulings.[10] It is provided that tax rulings may be made for two purposes: (i) to amend the regulations; and (ii) to establish principles required for the implementation of the tax laws and regulations. Where a tax ruling amends a regulation, the ruling forms part of the regulation. It is provided that both types of rulings are binding on taxpayers.

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[4] Section 94(a) of the Constitution.
[5] Section 271 of the Constitution.
[6] Section 49 of the BPTA and section 67 of the GSTA. Both sections provide that this is subject to the relevant Act providing otherwise. However, it appears that all regulations required to be made under both Acts are to be made by MIRA.
[7] Section 20 of the GSTA.
[8] Sections 10 and 11 of the BPTA.
[9] Section 4.
[10] Section 84 of the TAA.

13. The use of tax rulings to amend the regulations is uncommon by international standards. As noted above, the norm is for issuing of tax rulings to be a purely administrative process providing guidance to taxpayers. The problem with tax rulings amending the regulations is that there is not the same oversight for the making of tax rulings as there is for the making of regulations. In particular, while regulations are made in consultation with the Attorney General's Department, tax rulings are simply made by MIRA without any requirement for consultation with the Attorney General's Department or the MOF.

14. While many of the rulings issued by MIRA relate to administrative and procedural matters, there are a number of rulings that have been made on tax policy matters. A recent example is TR-2018/B64 (as revised by TR-2018/B68) on Thin Capitalization, which purports to limit the deduction for interest expense. Interest is fully deductible under the BPTA provided that: (i) it is incurred wholly and exclusively for the purpose of producing income; and (ii) the rate of interest does not exceed 6 percent.[11] TR-2018/B64 limits the amount of the interest deduction to 25 percent of the taxable income of the taxpayer before interest, tax, and capital allowances. This was recently increased to 30 percent under TR-2018/B68.

15. There are two issues with tax policy rulings like TR-2018/B64 being made by MIRA: (i) the legality of the ruling; and (ii) the appropriate body to make the ruling. On the first issue, in the case of TR-2018/B64, it is noted that there does not appear to be any specific power in the BPTA for the making of a binding ruling to limit the deductibility of interest. While the BPTA permits the making of regulations about deductions, TR-2018/B64 is a ruling not a regulation and, while rulings can amend the regulations, this is not expressly provided for in TR 2018/B64. It is acknowledged, though, that the ruling may be supported by the general anti-avoidance provision in the BPTA.[12] Importantly, though, the subject matter of the ruling is clearly tax policy and, as noted above, under the TAA, tax policy is the responsibility of the MOF not MIRA.

16. The making of rulings by MIRA should be limited to procedural and administrative matters. For example, the TAA provides the CG with discretion to grant a taxpayer an extension of time to comply with obligations under the tax laws, such as the filing of tax returns and the payment of tax.[13] The CG could issue a ruling providing taxpayers with guidance as to how the CG may exercise this discretion. This would be a matter clearly within the power of MIRA.

17. It is common also for rulings to be made on interpretative matters under the tax laws. This is an important component of self-assessment to assist taxpayers in the preparation of their tax returns (i.e. self-assessments). It is important that interpretive tax rulings are binding on MIRA so that taxpayers can self-assess their tax liabilities based on the ruling without the possibility that MIRA can later change their interpretation to the detriment of the taxpayer.

[11] Sections 10(a) and 1(a)(5) of the BPTA.
[12] Section 30 of the BPTA.
[13] Section 81 of the TAA.

However, as a purely administrative matter, rulings are not normally binding on taxpayers and, therefore, taxpayers should be free to self-assess their tax liabilities based on their interpretation of the tax law and then proceed to dispute resolution as appropriate.

18. Rulings on interpretive matters inevitably raise tax policy issues and, therefore, should be made by the MOF, albeit with technical input from MIRA, as prescribed by the TAA. Such rulings could continue to be formally issued by MIRA on the basis that the issuance of the ruling is the implementation of tax policy decisions taken by the MOF. However, the formal process for the making of the ruling should shift from MIRA to the TPU.

Recommendations

- Amend the tax laws to provide that regulations on tax policy matters are made by the MOF.
- Regulations on tax policy matters should be prepared by the MOF with input from MIRA and oversight by the Attorney General's Department.
- Regulations should be amended by making a subsequent amending regulation rather than by a tax ruling.
- Amend the TAA to provide that tax rulings are binding on MIRA but not on taxpayers.
- Tax rulings on purely administrative and procedural matters should continue to be made by MIRA.
- Tax rulings on tax policy matters should be made by the MOF with input from MIRA. However, such rulings could be formally issued by MIRA.

B. Establishing a Tax Policy Unit (TPU)

19. A TPU should be established and located in the Maldivian MOF. It is important that the establishment of the TPU is accompanied by the above recommended reorganization of responsibilities between the MOF and MIRA. In the context of the Maldives, the TPU can be integrated into the Fiscal Affairs Department of the MOF, and can initially comprise a small core team (e.g., 4 staff members) with the potential to expand as its technical capacity develops and to the extent financing conditions permit.

20. A TPU generally encompasses various key functions, two of which are critical and should be the priority during the initial stage of a TPU in the case of the Maldives:

I. Guide general tax design and associated public consultations. The TPU should play a critical role in guiding tax policy reform, producing objective analysis of the available tax options in the Maldives, and explaining in a non-politicized way the economic rationale and intent behind tax policy changes and tax legislation.

II. Perform revenue and economic impact analyses, including revenue forecasting, tax expenditure analysis, economic and revenue impact of a proposed tax reform including a distributional analysis.

21. Other functions of a TPU can gradually gain importance as the TPU masters its main functions and acquires more experience. These include: i) initiate, participate, and oversee manifestation of policy content during legal drafting processes. The drafting of tax laws may initially be assigned to the Attorney Generals' Office, with growing involvement of the TPU over time; ii) contribute to international tax commitments and obligations by, among other things, assessing the impact of implementing international minimum standards for corporate income taxation and supporting the country team that is negotiating tax treaties with the relevant economic impact analysis.

22. Accessing the relevant data is vital for the TPU to be able to properly perform its functions. Institutional arrangements should enable the TPU to access meaningful information *on a regular basis* including from MIRA (e.g., anonymized taxpayers data disaggregated at the needed level), National Bureau of Statistics (e.g., household survey and consensuses data), and the Maldives Monetary Authority (e.g., data on international cross-border dividends flows).

23. Close coordination and cooperation between MIRA and the TPU (and more generally the MOF) is key for strengthening tax policy and revenue performance in the Maldives. To ensure continuous communication at the technical level, a Task Force Team, comprising selected staff from the TPU and MIRA, can be established to regularly discuss tax measures (including the income tax reform, international tax issues, the GST, and data exchange).

24. Annual publication of a tax expenditure budget should be required in the law to inform the tax policy debate and enhance transparency. Tax expenditures are measured as deviations from a baseline "benchmark tax" system[14], and are as important for the overall financial position of the government as outlay expenditures. It is important to note that a tax expenditure estimate is not a revenue estimate, but rather it reflects the amount by which tax liability is reduced due to a specific tax provision. The estimate does not include any behavioral response. The production and use of tax expenditure estimates should be legally required and presented to Parliament by the MOF (and conducted by the TPU). Examples of tax expenditures in the Maldives include zero-rated goods for the GST. Tax expenditures should be incorporated into the budget process.

Recommendations

- Establish a TPU in the MOF.

[14] There are alternative ways to define a benchmark tax system, but generally it should be chosen to exclude tax provisions that favor particular groups of taxpayers or goods and services (such as reduced GST rates).

- Ensure institutional arrangements that enable the TPU to regularly access the relevant data.

- Require in the law the annual publication of a tax expenditure budget to inform the tax policy debate and enhance transparency.

III. INCOME TAX

A. Background

25. **The Maldivian Government has expressed a strong interest in introducing a modern, broad-based PIT, in support of stronger equity and general revenue raising.** The existing tax system does not tax employment income (salaries or benefits), but includes a very narrow element of a PIT on income of the self-employed. Under the BPTA, business income of individuals is subject to a tax of 15 percent, but with a basic allowance of MVR 500,000. A proposed Personal Income Tax Bill (Box 1) was rejected by the parliament in 2011, and a new proposal for an income tax is expected to be made in the short-term, possibly in 2019.

26. **The existing tax system is subject to serious shortcomings raising tax arbitrage opportunities and leading to significant tax enforcement challenges.** First, the lack of a PIT has generated incentives for the self-employed to characterize income as salaries rather than business profits. Introducing a cap on the deduction of salaries of owners of self-employed businesses has not completely resolved this issue. Second, the capability of the system to redistribute income in the society is very limited. The non-taxation of some sources of income and the rather complex taxation of small businesses do not only adversely affect revenues but also limit the tax policy scope for addressing income inequality and other objectives.

Box 1. Summary of the Rejected 2011 Personal Income Tax Bill

The personal Income Tax Bill proposed a progressive tax scale on all sources of individual income (salaries, capital income, and business income) as follows:

Income Bracket	Marginal Tax Rate
0; 360,000 MVR	0
360,000; 720,000 MVR	2.5%
720,000; 1.2 million MVR	6%
1.2 million; 1.8million MVR	9%
>1.8 million MVR	15%

B. Designing a PIT for the Maldives

27. Introducing a PIT is a balancing act between the social choice of the degree of income redistribution (progressivity) of the system, revenue impact, simplicity, and administrability. Hence, policy objectives and tax principles should guide the design of the PIT.

28. Moreover, the PIT should be viewed as an integral component of the entire tax system. The PIT covers i) employment (labor) income, ii) capital income of individuals, and iii) business income of the self-employed. Neutrality between the various sources of income and among the legal forms of taxpayers, to the extent possible, should be maintained. Otherwise, deficiencies arise in the form of arbitrage opportunities that lead to revenue leakages and unequal treatment of taxpayers with potentially adverse perceptions about the fairness of the system. Also, it is important at the outset of reform to make a clear choice of income tax 'architecture' as discussed below.

29. An attractive option for the Maldives is to adopt a PIT with elements of a dual income tax (DIT). There are various ways to design a PIT (Box 2), but the DIT has attractive features and would be highly recommended for the Maldives. The DIT design is different from the 2011 Personal Income Tax Bill. A DIT would impose a uniform and relatively low rate of tax on all capital income of individuals in addition to a (modestly) progressive tax applied to labor income with a carefully chosen initially relatively high threshold. Furthermore, to secure maximum simplicity (at least in the initial reform stages), it is strongly recommended to allow for *maximum utilization of withholding mechanisms* for basically all taxed income types. Thus, it is crucial to avoid the use of individual tax allowances and other tax reliefs that are dependent on individual taxpayer circumstances.

30. The rest of this sections presents a preliminary analysis using the Household Income and Expenditure (HIES) dataset—provided by the National Bureau of Statistics (NBS)—and other data sources, to:

- Explore options for a tax scale to be applied to employment income.
- Recommend options to tax individual capital income and income of the self-employed.
- Illustrate how to analyze the redistribution effects of a proposed PIT design (on labor and capital income of individuals including business income of the self-employed), and how to estimate the overall revenue impacts of a PIT reform.

31. A tax reform of this significant magnitude crucially requires an in-depth preparatory study of all key aspects of reform. The estimates presented in this report, while informative for a PIT reform, are of a preliminary nature. The accuracy of the figures crucially depends on the quality of the data. A detailed follow-up study, by the Maldivian authorities (e.g., the TPU or a Working Group comprising the MOF and MIRA) would be important to provide final estimates and analysis. Beyond the tax policy design, preparations in terms of legal drafting and development of the required administrative capabilities are vital for the success of the reform. Further Technical Assistance (TA) in these areas is warranted.

Box 2. PIT Design Alternatives

The dual income tax (DIT). As first introduced by the Nordic countries in the early 1990s, the DIT combines a relatively low flat tax on capital income with progressive taxation of labor and (possibly) other non-capital income. Ideally, the flat capital tax should be as broad-based as possible, with no exemptions or allowances, to achieve the greatest possible neutrality in the taxation of capital income. Its introduction was in part driven by the need to address both the high mobility of capital income and tax arbitrage due to differential taxation across capital income sources (rooted in the ease with which one capital income source can be converted to another, for example, by transforming interest income to capital gains through use of zero-coupon bonds).

The global income tax. The global income tax is levied on the sum of the taxpayer's income from all sources, in theory consistent with the Haig-Simons-Schanz principle for measuring comprehensive income (consumption plus net increase in wealth, or increase in purchasing power), to which a progressive rate structure is applied. This model was pursued by many countries in numerous previous tax reforms, aimed at broadening the tax base (including with capital income) and reducing marginal rates. It secures horizontal equity (equal treatment of taxpayers with the same level of income) as well as vertical equity through the progressive rate structure. It also has its problems: by including capital income, it may also allow deduction for losses (in some cases leading to a net overall revenue loss); it is administratively complex; some income components are hard to observe and to tax (such as accrued capital gains); and it generates fairly high marginal rates on capital income (with a high incidence among high-income individuals), which is also the most mobile component of its base. This means that this part of the tax base (through aggressive tax planning and use of foreign tax shelters) is easily eroded. Consequently, many countries are now applying lower rates to capital income.

The flat tax. First introduced by the Baltic countries and Russia, this tax has attracted some attention because of its administrative simplicity. However, it is a highly regressive tax, but some level of progressivity can be generated through a basic allowance. Existing flat taxes exhibit substantial differences, for example to the extent that tax rates on labor income are set equal to those of capital income (including the corporate income tax rate). It also appears questionable whether higher compliance and supply side effects are real (Russia is often cited as an example: while revenue increased considerably, it appears to have been the result mainly of increased enforcement, and the revenue increase has been shown to derive mainly from taxpayers that were unaffected by the reform). Additionally, if the rate is set at relatively high level to avoid revenue losses, it would adversely affect middle-income earners. Finally, while it may be relatively easy to administer, complexity in administration is primarily a question related to the tax base, and not the number of rates.

C. Taxing Labor Income

32. It is recommended to apply a moderately progressive tax scale on individual employment income (i.e., wages, salaries, benefits, service charge, and directors' fees) with

an appropriate zero-tax bracket. It is important to avoid several income brackets, and the choice of the first income threshold should balance revenue and progressivity objectives. For example, based on the 2017 HIES data, the proposed threshold in the 2011 Bill (MRV 360,000) is very high as it would exclude salary earners approximately up to the 95th percentile of the income distribution from the tax. Further, in practice the multiple rate structure with very wide income brackets would have had very little impact on revenue and progressivity. Particularly, the marginal tax rate for most of the top 5th percentile would be only 2.5 percent — implying an extremely low average tax rate for this income group. Moreover, the top rate of 15 percent applied on income of more than MRV 1.8 million would be applied only to a very modest fraction of the very top salary earners in the Maldives.

Box 3. International Experience with PITs

- The below table presents examples of PIT scales in small countries.
- Many countries in the broader region operate versions of a PIT. The revenue raising capabilities of these taxes vary considerably, from well below one percent of GDP in Sri Lanka and Cambodia, to more than two percent of GDP in India, Malaysia and Pakistan. The typical average revenue level is about 1½ percent of GDP, which translates to an average share of total taxes raised in these countries of about 11-12 percent. Small countries that implement a PIT broadly follow a similar pattern (See below table). Hence, a well-designed PIT should be expected to raise not less than 1 percent of GDP, and the potential revenue raising can be much higher.

Examples of PIT Scales and Revenues

	GDP per Capita (2017, USD)	Taxable Income (USD)	Income Tax Payable	PIT Revenue/GDP (%)	Tax-GDP ratio (%)
Barbados	17,758	0 to 17,500 Above 17,501	16% 33.5%	5.3	32
Cabo Verde	3,448	0 to 2,366 2,367 to 10,326 10,326 to 19,361 above 19,361	0% 15.5% 23.1% 27.50%	3.8	19
Mauritius	10,504	0 to 19,039 Above 19,040	10% 15%	1.8	20

33. Table 1 and Figure 3 present one example of a feasible option for a tax scale on employment income in the Maldives. Following a zero-tax bracket, the first tax rate is 10 percent which would be equal to the flat uniform tax rate on individual capital income recommended below (and the cross-border withholding tax rate). The top rate would be 15 percent—the same as the BPT rate.

Table 1. An Example of a Viable Tax Scale for the Maldives		
Income Bracket		Marginal Tax Rate
0 to 130,000 MVR	0 – bottom tercile of governmental salary distribution (i.e., the lowest 1/3 of the distribution)	0
130,000 to 275,000 MVR	bottom tercile – approximately the 90th percentile of governmental salary distribution	10%
> 275,000 MVR	top 10 tercile of governmental salary distribution	15%

Source: Illustration by IMF staff. Percentiles are based on government salaries.

34. The tax scale presented in Table 1 has the following progressive features:

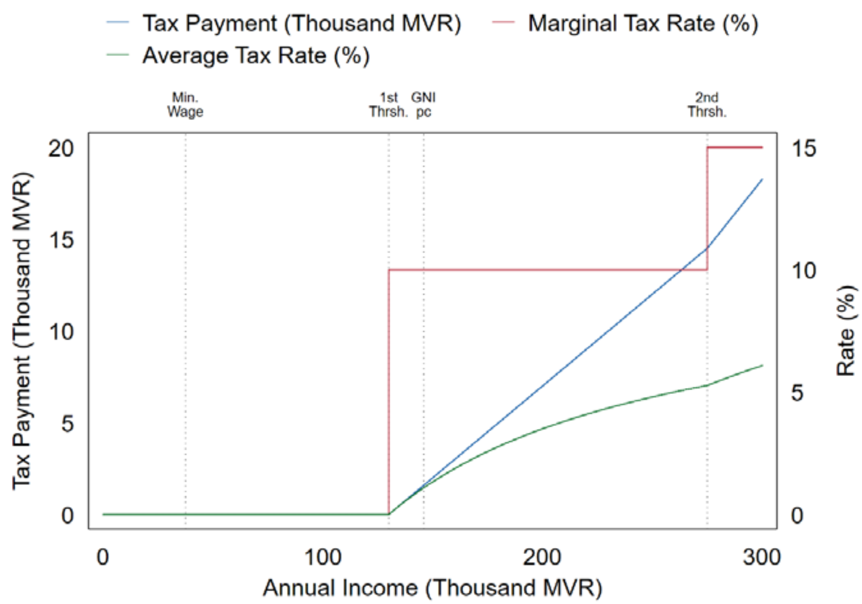
- **As shown in Figure 4 (Panel a), the first tercile of the governmental salary distribution would not be subjected to tax (i.e., it falls within the zero-tax bracket).** However, Figure 4 (Panel b) suggests that when considering the universe of wage earners using the HIES data, the 75th percentile would fall in the zero-tax bracket. Yet, it could be that the HIES dataset, to some extent, overrepresents low wage earners (i.e., the correct economy-wide figure is somewhere between the first tercile and the 75th percentile), but the general point remains valid: As governmental jobs are relatively well-paid, choosing the first threshold of 130,000 MVR would imply that *more than* one third of the universe of wage earners in the Maldives (likely more than 50 percent) will not be subject to a tax on employment income. These numbers indicate that a significantly higher value for the first threshold (more than MVR 130,000) would be ineffective in achieving any of the stated policy objectives and thus unwarranted.

- **The average tax rate increases as the employment income level raises starting from the second income bracket.** Figure 3 depicts how tax payments vary with the income level and the corresponding average tax rates (i.e., tax payment divided by employment income). The threshold for the first bracket is below, but close to, the level of the Gross National Income (GNI) per capita (about MVR 146,000); i.e., a salary equal to the GNI per capita would pay a tax only on the amount in excess of the tax-free threshold (i.e., MVR 16,000), which would be a tax of MRV 1,600. This implies that the average tax rate for an individual with a salary equal to the GNI per capita would be 1.1 percent.

- **The top PIT rate would apply only to the top 10th percentile of the governmental salary distribution.** According to the HIES data, this figure would be even smaller (only the top 1 percentile). To give specific examples (see Figures 3, 4, and 5):

- The average tax rate for an individual at the top 5th percentile (i.e., a salary of MVR 400,000) would be 8.3 percent.
- The average tax rate for an individual at the top 10th percentile (i.e., a salary of MVR 300,000) would be 6.1 percent.
- These rates would be modest in international comparison

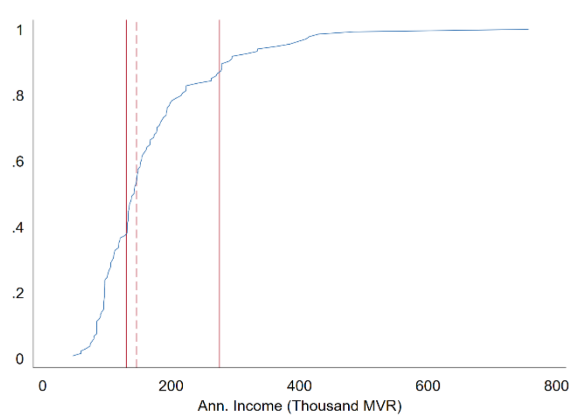
Figure 3. An Example of Personal Income Tax Scale and Average Tax Rates



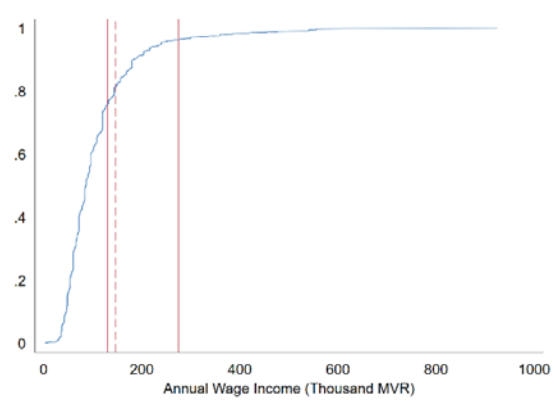
Source: IMF staff calculation.

Figure 4. Cumulative Distributional Function of Annual Employment Income

(a) Government Salaries Table

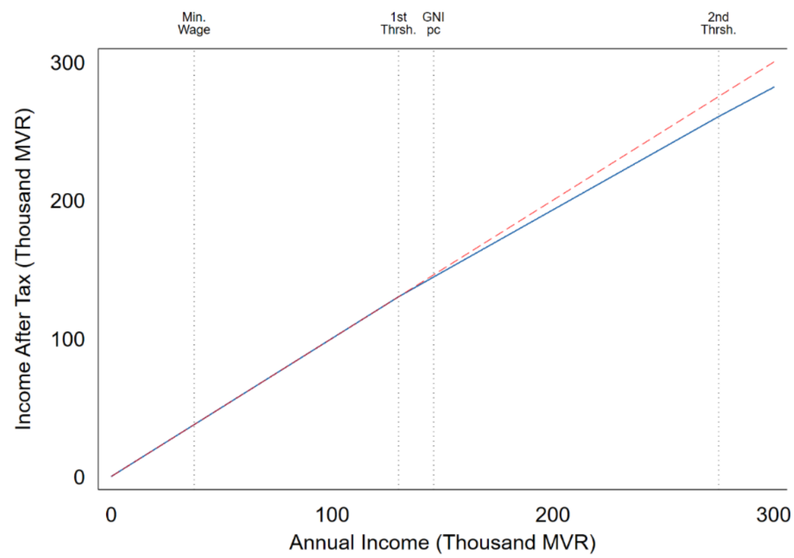


(b) Household Survey Data



Source: IMF staff calculation. The solid vertical liens depict the income threshold. The dashed line depicts GNI per capita in 2017.

Figure 5. Before- vs. After-Tax Employment Income



Source: IMF staff calculation.

35. One alternative to the zero-tax bracket is to offer a tax credit—which directly reduces the amount of the tax while maintaining a positive tax rate from the first MVR. This system can be designed to replicate the same tax relief given in Table 2 to the lower end of the income distribution but would imply higher a marginal tax rate on the top of the distribution. The exact choice of the tax rates and income brackets requires a follow-up study.

Recommendations

- Introduce a moderately progressive tax scale on employment income (possible with two rates 10 and 15 percent).
- The zero-bracket threshold should not be too high. For example, one option is to set it at the first tercile of government salaries.
- Allow maximum utilization of withholding mechanisms and avoid providing deductions.

D. Taxing Capital Income of Individuals

The Need for a Uniform Rate

36. The tax on employment income should be complemented by a uniform tax on all individual capital income (dividends, interest income, and capital gains) of 10 percent consistent with the principles of the DIT. Under the present tax system, the scope of capital income taxation is narrow. It is limited to taxation of capital income derived by a business under the BPT. However, there is no separate taxation of specific capital income sources such as interest income, dividends, and capital gains.

37. Differences in the taxation of personal capital income would have undesirable effects.[15] The uniform tax rate on capital income prevents tax arbitrage. Disparities in effective tax rates across different sources of personal capital income has efficiency costs by distorting portfolio choices of individuals. It opens up loopholes by inviting tax arbitrage in the form of incentives to convert taxable returns to lightly or non-taxable returns such as capital gains. Furthermore, it violates equity considerations by allowing lower effective rates on income accruing mainly to the better off segments of the population.

Capital Gains Tax (CGT)

Rationale

38. A key issue in this process will be the introduction of a CGT at the individual level. Currently, there is no CGT applicable in the Maldives. However, gains made on the disposal of any business asset (whether revenue or capital in nature) are subject to BPT. The definition of "business" includes the leasing of immovable property (commercial and residential)[16] and, therefore, any gain made on the disposal of the leased property is subject to BPT. While not explicitly stated in the definition of "business", it would be argued that all activities of a company or partnership are business activities.[17]

39. The rationale of a capital gains tax is normally provided with reference to the following objectives:

I. Prevent tax evasion through re-characterization of highly taxed income sources to lightly taxed capital gains;

II. Generate revenue;

III. Improve horizontal and vertical equity of the tax system; and

IV. Minimize the efficiency costs associated with distortions of individual portfolio decisions in the absence of the tax.

40. Given the broad scope of the BPT, the absence of a CGT impacts largely on the investment assets of individuals. This is essentially immovable property that is not leased out

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[15] The taxation of rental income would remain under the BPT; see Subsection D.
[16] Section 43(a) of the BPTA.
[17] In the case of partnerships, section 2(b) of the Partnerships Act of Maldives (1996) defines "partnership" to mean "a business association of two or more persons to carry on as co-owners a business for profit and bearing a separate name" (emphasis added). Consequently, by definition, the activities of a partnership are business activities.

and financial assets, such as shares. The proposal to extend the tax base to cover capital income should also extend to capital gains.

41. CGT should apply to a list of taxable assets. Given the broad scope of taxation of capital assets under the BPTA, CGT can be limited to the following assets that are likely to generate capital gains:

I. Immovable property located in the Maldives. Immovable property should have its ordinary meaning under the law of the Maldives, including leases and other interests in immovable property. To avoid doubt, the definition of "immovable property" should include mining and petroleum rights. An exception should apply to immovable property that is the principal place of residence of the taxpayer.

II. Interests in entities (such as companies and partnerships) where the value of the entity is derived, directly or indirectly, principally from immovable property located in the Maldives (indirect transfers of immovable property). See further discussion at para. 68 below.

III. Shares and other interests in entities resident in the Maldives.

IV. Options or rights over an asset referred to in (I) – (III) above.

42. The definition of taxable asset should exclude any asset that is subject to the BPTA. In other words, the current position whereby all assets of a business are subject to tax under the BPTA should continue after the introduction of CGT.

Methodology of Taxation

43. There are two methodologies for the taxation of capital gains: (i) taxation on a periodic net basis; or (ii) separate taxation of individual gains. Taxation on a periodic net basis means that a taxpayer's CGT liability is calculated annually by reference to the taxpayer's net capital gain for the year. This is calculated as the total of capital gains derived during the year reduced by the total of capital losses incurred during the year with CGT imposed on the net amount. Under this approach, CGT reporting and payment would be combined with BPT reporting and payment. Under the separate taxation approach, CGT would be reported and paid separately for each capital gain within a specified time (such as one month) after the transaction that has generated the gain has occurred. Under both approaches, there must be recognition of capital losses.

44. As CGT transactions are irregular transactions, the simplest methodology of taxation is to impose the tax separately on each capital gain at the time that the gain arises. Timing the CGT liability contemporaneously with the transaction is likely to better ensure compliance, particularly as a taxpayer may have only one CGT transaction for a tax year. The rate of CGT should be 10 percent to align with the rate applicable to capital income.

Transitional Rule

45. As capital gains usually accrue over several years, it is necessary to include a transitional rule applicable to taxable assets held by a taxpayer at the commencement of CGT. There are two options for the design of the CGT transitional rule. First, pre-CGT assets may be "grandfathered" meaning that the CGT applies only to taxable assets acquired on or after the commencement of the CGT. The alternative is a valuation day approach under which pre-CGT assets are given a cost equal to the market value of the asset at the commencement of CGT.

46. Despite being the simpler approach, there are two main concerns with grandfathering. First, it will delay CGT revenue for the Government as the gain that has accrued on pre-CGT assets after the commencement of CGT remains untaxed. Second, grandfathering of pre-CGT assets encourages the entering into of arrangements that aim to convert post-CGT assets into pre-CGT assets.

47. The valuation day approach is preferred despite the compliance burden involved in valuing taxable assets. Importantly, though, the taxable assets to which it is proposed that CGT applies (immovable property and financial assets) should be readily able to be valued at the commencement of CGT.

Recommendations

- Introduce a uniform tax rate on all individual capital income including capital gains.

E. The BPT and Taxing Small Businesses

Issues

48. The BPTA imposes BPT at the rate of 15 percent on the taxable profit derived by an individual or entity (company or partnership) carrying on business. A tax-free threshold of MVR 500,000 applies to all taxpayers (individuals and entities). In broad terms, taxable profit is calculated by reference to the financial accounting profit of the taxpayer provided it has been prepared in accordance with IFRS or other international financial accounting standards recognized in the Maldives but subject to any modifications in the BPTA or the BPTR. For, example, depreciation rates for tax purposes are specified in the BPTR. Individuals with a total annual turnover of less than MVR 3,650,000 can elect to account for the BPT on a cash basis. A taxpayer that has a net loss for a tax year can carry the loss forward for 5 years.

49. The definition of "business" includes the leasing of immovable property (commercial and residential)[18] and, therefore, rental income is taxed under the BPTA. A taxpayer can elect to claim a notional deduction equal to 20 percent of the gross rental income

[18] Section 43(a) of the BPTA.

derived rather than claiming a deduction for the actual expenditures incurred in deriving rental income.

50. There are some limitations on deductions for certain types of expenditures to protect against possible base erosion that can arise because of the incomplete income tax base under current law. A limitation applies on the level of deductible payments that can be made by a company to directors and employees who are associates of the company. This is necessary because of the absence of a PIT applicable to salaries and wages, and directors' fees. A thin capitalization rule applies under TR-2018/B64 that may limit the level of deductible interest payments made by a taxpayer, although TR-2018/B68 provides that the rule does not apply to SMEs. This rule applies to all interest payments and is not limited to foreign investment. In the domestic context, the rule is necessary because of the absence of a tax on interest income derived by individuals. In the absence of the rule, the shareholders or other owners of an entity could extract profits from the entity as tax-fee interest payments through excessive debt capitalization. The thin capitalization rule is discussed in more detail below.

51. There is no taxation of dividends paid by a resident company. Dividends paid by a resident company to another resident company are excluded from the taxable profit calculation of the shareholder company. This is consistent with international norms and avoids cascading of tax at the corporate level. Dividends paid to a resident individual are not taxed as there is no tax on capital income. Dividends paid to non-residents are also not taxed as there is no withholding tax on dividends. This means that the effective tax rate on corporate profits is equal to the 15 percent BPT rate.

52. There is a separate bank profits tax applicable to banks operating in the Maldives. The tax is imposed at the rate of 25 percent against the net profit of the bank. The rules on the calculation of the net profit of the bank are only very briefly stated in the Bank Profit Tax, which stipulates that more detailed rules are provided administratively by the Ministry (and presumably now also MIRA).

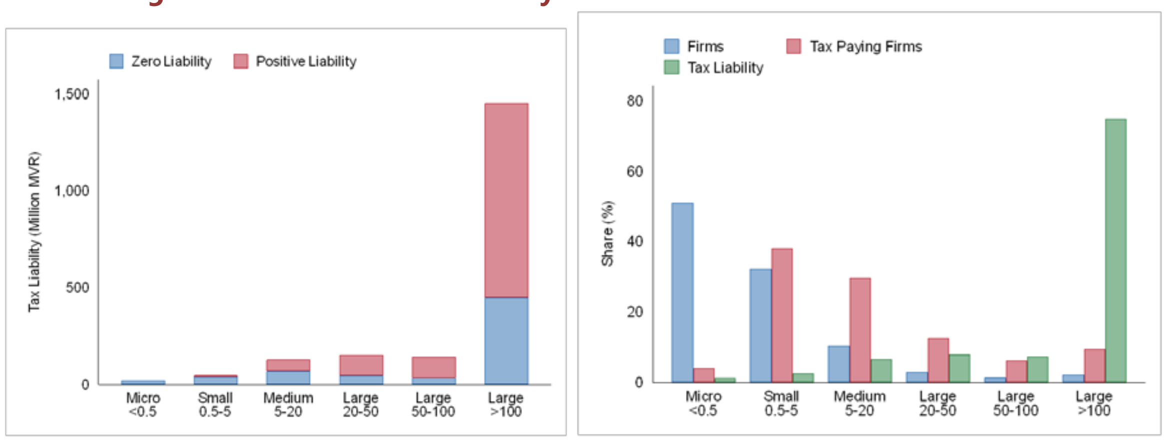
53. Overall, in the domestic context, the BPT is reasonably well designed; however, the international tax provisions of the BPT could be improved to more effectively tax foreign investment. The discussion below considers reform of the BPTA in the domestic context, namely the introduction of a presumptive tax for small business, and reforms consequent upon the introduction of the PIT. Discussion of international tax is in Chapter IV.

The Need for a Presumptive Tax

54. The BPT generates very low revenues from businesses below the GST threshold (MRV 1 million, see section VI) but with high administrative and compliance burdens. In 2017, Figure 6 shows that, under the BPT, about 60 percent of firms are businesses with revenue below MRV 500,000, and these paid altogether only 1 percent of BPT revenue. Among these firms (5,456 firms) only 69 firms had a positive tax liability. In contrast, the top 1.3 percent of firms (i.e., 107 firms) paid approximately 75 percent of total BPT revenue. Thus, almost the entire BPT is being collected from businesses above the GST threshold.

55. A turnover tax with a uniform rate should replace the BPT on businesses with turnover below the GST registration threshold. Many of these businesses are self-employed individuals. This presumptive tax is relatively simple to administer and would significantly lower compliance costs on small businesses and administrative costs for MIRA. Note that voluntary registered businesses for the GST should continue to be under the BPT. Unregistered businesses for the GST should continue to pay the GST on inputs. Table 3 presents international examples of thresholds and rates of presumptive tax regimes.

Figure 6. Distribution of PBT Payments Based on Turnover Thresholds



Source: IMF staff calculation based on data from MIRA. Numbers on the horizontal axes are in million MVR.

56. The uniform rate of the presumptive tax should be moderate, e.g., 3 or 4 percent, in line with international best practices. At a rate of 4 percent, neutrality with the tax scale presented in Table 2 would be roughly, but not fully, maintained. For example, if the presumptive rate is 4 percent, a business with an income of MRV 275,000 (at the beginning of the top bracket) would pay a tax of MRV 11,000. However, the presumptive tax does not consider costs. For instance, if the cost for that business is 25 percent, then the effective presumptive rate becomes 5.3 percent (i.e., 11,000/206,250), which is equal to the average tax rate on a salary of 275,000 (based on the scale in Table 2). As costs go down or income of businesses go up, the effective presumptive tax rate declines. However, the simplicity feature of this presumptive regime is very attractive. Moreover, it is recommended to subject microbusiness, e.g., with turnover below MRV 250,000, to a flat (registration) fee instead of the presumptive regime.

57. Legal persons and individuals providing professional services such as lawyers, accountants, and physicians, should be taxed under the BPT even if they fall below the GST registration threshold. This group of professionals has the capacity to maintain proper accounting standards and tends to earn high margins in their businesses. This recommendation enhances the neutrality between the taxation of business and employment incomes.

The BPT: Reform of the Domestic Tax Rules

58. There are a number of reforms that can be made to the domestic operation of BPT consequent upon the recommendations made in this Report.

I. **With small businesses moved into the simplified tax regime, it is no longer necessary to include an MVR 500,000 tax-free threshold under the BPT.** The allowance of a tax-free threshold is part of the policy of taxing individuals according to their ability to pay. The purpose of the tax-free threshold is to allow all individuals a basic amount to live off before tax is imposed. The presumptive tax will apply to most individuals carrying on a business and, therefore, the BPT will apply mainly to companies. As a company is an artificial entity created by law, it does not have an ability to pay; only an individual has an ability to pay. Consequently, the flat tax applies to profits without a tax-free threshold. The tax-free threshold under the BPT should be removed.

II. **As employees and directors will be subject to PIT, it is no longer necessary to include a ceiling on the deductibility of salary and wages, and directors' fees.** These payments will then be deductible to the company and taxable to the employee or director under the PIT. To continue the ceiling on the amount of the deduction may lead to double taxation with part of the remuneration being both non-deductible to the employer and taxed to the employee/director. The general anti-avoidance rule can apply where salary and wage payments are made to associates at levels that do not correspond with the value of the service provided.

III. **Banks should be taxed under the BPT rather than being subject to a separate tax.** This will provide for the application of consistent tax rules across all business taxpayers. The imposition of a 10 percent withholding tax on dividends paid to non-residents means that the effective rate of tax under the BPT on the distributed profits of banks is 23.5 percent, which is only marginally lower than the current 25 percent rate under the Bank Profits Tax. If a non-resident bank operates in the Maldives as a branch (PE) rather than as a subsidiary, a branch remittance tax can apply to equalize with the tax treatment of dividends paid by a subsidiary.

Recommendations

- Replace the BPT with a uniform turnover tax (e.g., 3 or 4 percent) for all businesses below the GST threshold. (Legal persons and individuals providing professional services (such as accountants, lawyers, and physicians) should be taxed under the reformed BPT).

- Repeal the MRV 500,000 basic allowance and the ceiling on the deductibility of salary and wages, and directors' fees.

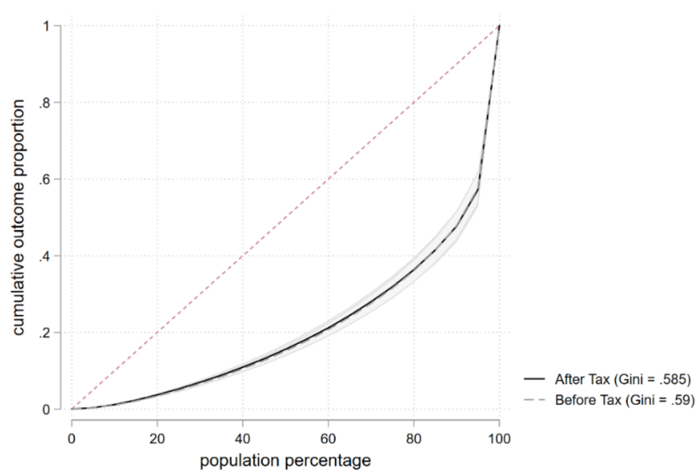
- Banks should be taxed under the BPT rather than being subject to a separate tax.

Table 2. Selected International Presumptive Tax Rates

Country	Sales Threshold (USD)	Presumptive tax rate (%)	Corporate income tax rate (%)
Eastern Europe			
Armenia	122430	5 (trading), 3.5 (production)	20
Azerbaijan	346000	4 (in Baku), 2 (outside Baku)	20
Belarus	584246	5	18
Latvia	45600	15 (includes payroll tax)	20
Poland	5508000	0.8	19 (15 for small companies)
Russia	840000	6	15
Uzbekistan	120000	4	14
Africa			
Algeria	255000	5	19
Congo (DRC)	122000	1 (goods), 2 (services)	35
Congo (Brazzaville)	170000	7.7	30
Cameroon	85000	2.2	33
Kenya	49000	3	30
Mauritania	810000	3	25
Rwanda	55000	3	30
Seychelles	74000	1.5	25
Tanzania	8800	3 to 5.3	30
Uganda	40500	1.5	30
Zambia	67200	3	35
Asia			
Indonesia	331200	1	25

Source: Wei and Wen (2019).

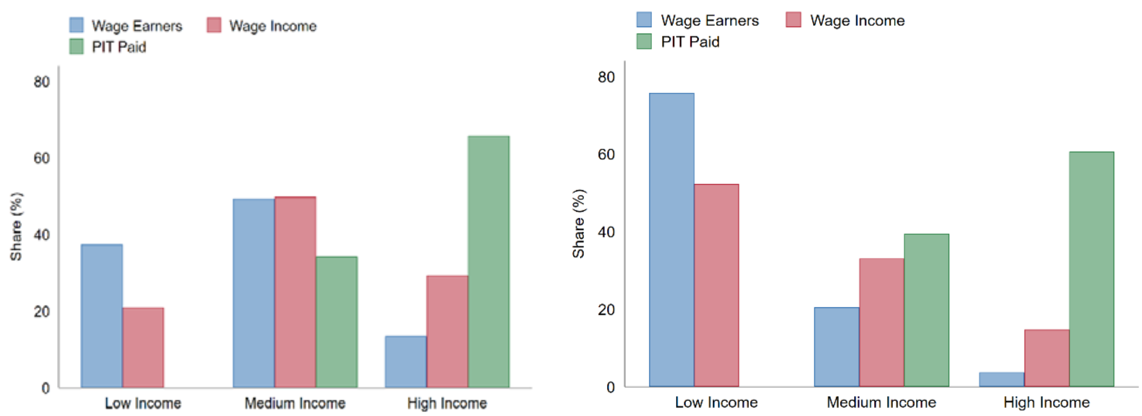
Figure 7. Distributional Impact of a PIT in the Maldives



Source: IMF staff estimates.

Figure 8. Shares of Post-Reform Tax Paid by Income Group

(a) Government Salaries Table *(b) Household Survey Data*



Source: IMF staff estimates.

F. Distributional and Revenue Analysis of a PIT

59. The impact of the above proposed PIT (i.e., the progressive tax scale on employment income, the flat capital tax rate, and the presumptive tax regime) on income distribution would be modest, but an important step in the right direction. Using the HIES data, this report estimates that the Gini coefficient based on the pre-tax income in the Maldives is 0.59. The after-tax Gini coefficient (if the recommended options were to be implemented) only slightly improves to 0.58. Figure 7 displays the pre- and after-tax Lorenz curves. The relatively small effect on the Gini coefficient is largely driven by the large share in the HIES data that would fall in the zero-tax bracket. To the extent that the HIES dataset potential underestimates top income earners, the improvement in income equality would be larger. As expected, however, the progressivity of the system implies that about 60 percent of the PIT tax (including the presumptive tax) will be paid by the high-income group (Figure 8).

60. The overall revenue impact of the PIT reform (including the presumptive regime) is estimated to be a revenue increase of approximately 650 MRV million (about 4.2 percent of total tax revenues collected in 2018). This constitutes a modest increase in total revenue (note that rental income is currently taxed). Figure 9 suggests that sectors that are directly or indirectly related to tourism contribute about 40 percent of the total estimated PIT revenue. Total revenue gains can be seen by summing all three bars in Figure 9.

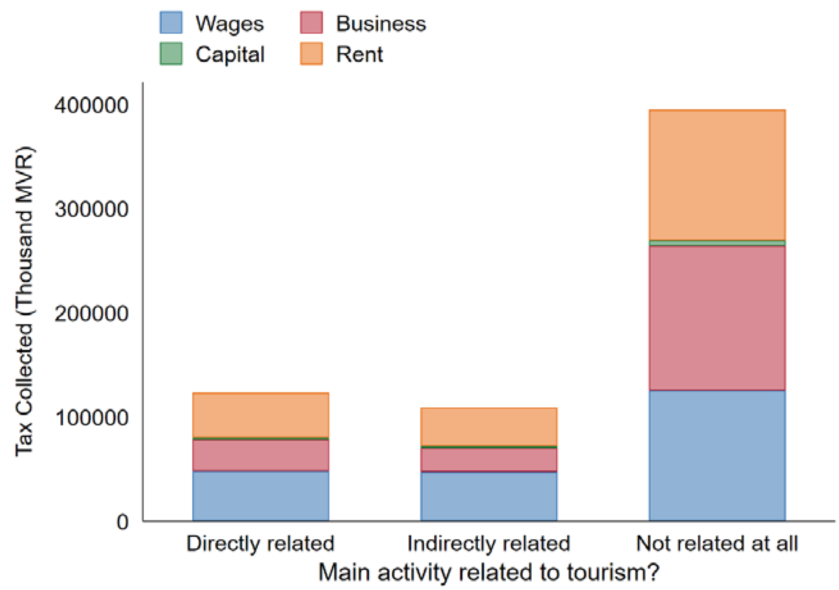
61. It is important to emphasize that informality lowers the revenue potential and ability of the system to redistribute income. Given that the PIT primarily will be collected by formal businesses (via withholding mechanisms), informal jobs and incomes undermine the PIT.

62. The accuracy of the above estimates critically depends on the quality of the HIES data and ignores the informal economy. A detailed analysis of the impact of a proposed PIT on revenues and inequality should be conducted (e.g., by the TPU) to guide the reform.

Recommendation

- Prepare a detailed study of a proposed income tax reform including its distributional impacts.

Figure 9. Overall Estimated Revenue Gain from the Proposed PIT Reform



Source: IMF staff estimates.

IV. INTERNATIONAL TAX

A. Background

63. **International tax means the taxation of income and gains that arise from cross-border transactions.** In broad terms, international tax comprises the provisions in the domestic tax law that provide for: (i) the taxation of the foreign income of residents; and (ii) the taxation of the domestic income of non-residents. In the case of the latter, the domestic tax law provisions may be excluded or modified by a tax treaty (bilateral Double Tax Agreement, "DTA"). This chapter focuses on the international tax rules in the BPTA. Tax treaties are discussed in Chapter V.

64. **Consistent with current international norms, the BPTA taxes resident companies on worldwide income ("residence principle") and non-resident companies on Maldives source income ("source principle").**[19] For a capital importing country like the Maldives, the main focus of international tax is the source principle, i.e. the taxation of Maldives source income of non-residents.

[19] Individuals are taxed on a territorial basis, i.e. resident and non-resident individuals are taxed only on Maldives source income.

65. Taxation under the source principle is "schedular" in nature in the sense that different rules apply depending on the character of the income derived by a non-resident. The character of the income determines: (i) the source rule applicable to the income (i.e. the jurisdiction to tax); (ii) the method of tax (assessment or withholding); and (iii) the rate of tax. Consequently, for non-resident taxation, the definitions of the different classes of income are important, particularly where a non-resident derives income that is not attributable to a PE in the Maldives.

66. The schedular nature of non-resident taxation is reflected in the design of the BPT. The 15 percent BPT tax rate applies to the taxable profit of a PE of a non-resident in the Maldives. Separate taxes at the 10 percent rate apply to a range of other payments, including royalties, equipment lease payments, and fees paid for management, personal, and technical services. This tax is collected by withholding. There is no taxation of dividends or interest paid to non-residents. Further, there is no separate taxation of rent payable to a non-resident on immovable property in the Maldives, which means that the normal BPT rules apply. This will depend on whether the immovable property is regarded as a PE of the non-resident owner.

B. Source Rules

67. Because of the scheduler nature of non-resident taxation, it is usual to set out clear rules in the tax law providing for the determination of the geographic source of income ("source rules"). Source rules are usually structured so as specify income that is domestic source income (i.e., Maldives source income), with other income treated as foreign income. It is also usual to provide a separate rule for each class of income within the tax base for non-residents.

68. There is not a comprehensive set of source rules specified in the BPTA, although "attributable to a Maldives PE" acts as a general source rule for taxation of business profits of a non-resident. With one exception, no connection to the Maldives is specified for the payments that are subject to the 10 percent withholding tax. Technically, any income of the type specified in the BPTA as taxable to a non-resident wherever paid, is subject to the 10 percent tax. The exception is rent for the viewing of films as this is limited to the viewing of films in the Maldives. It is important that a source rule is specified for royalties (which includes equipment lease payments), and management and technical fees. Based on international norms, these amounts should be treated as sourced in the Maldives if: (i) paid by a resident of the Maldives other than as an expenditure of a foreign permanent establishment of the resident; or (ii) paid by a non-resident as an expenditure of a PE in the Maldives. This sourcing rule also ensures that the tax can be collected from the payer as the payer has a close connection to the Maldives.

69. It is important that non-residents are taxed on indirect transfers of immovable property located in the Maldives (asset category (II) above).[20] Given that the value of an interest in an entity equates to the value of the assets of the entity, it would be relatively easy to

[20] For a detailed discussion, see Platform for Collaboration on Tax (2018).

use indirect transfers of immovable property to avoid BPT or CGT on the disposal of immovable property. Consequently, the taxation of indirect transfers is an integrity measure intended to protect the taxing right applicable to gains arising from the disposal of immovable property located in the Maldives. Further, the taxation of indirect transfers is consistent with international norms as reflected in Article 13(4) of the OECD Model Tax Treaty. This means that it is internationally recognized that the Maldives has the right to tax gains on indirect transfers of immovable property in the Maldives.

70. The taxation of indirect transfers of immovable property should apply under both the BPTA and CGT. In this regard, it is noted that, currently, there is no taxation of indirect transfers under the BPTA. Regardless of whether or not the CGT is implemented, the BPTA should be amended to tax indirect transfers.

Recommendation

- Include a comprehensive set of source rules in the BPTA.

C. Gaps in the Base for Taxing Non-residents

71. Currently, there is no taxation of dividends and interest paid to non-residents. The 10 percent withholding tax applicable to royalties, and management and technical fees, should be extended to dividends and interest. For dividends, this can be seen as a type exit charge on repatriated profits and a way of capturing tax on any under-declaration of taxable profit under the BPT. For interest income, this is an important measure to limit base erosion through financing transactions (see further discussion below). Definitions of "dividends" and "interest" will need to be included in the BPTA. The definition of "dividends" must be broad enough to cover payments that are, in effect, disguised dividends (such as upstream loans). The definition of "interest" should align with the broad definition in TR-2018/B64. This tax treatment aligns with international norms as provided for in Articles 10 and 11 of the OECD and UN Model Tax Treaties, and also with the Maldives Model Tax Treaty. Further, the mission was advised that, as a result of a recent case, there is some uncertainty as to the scope of taxation of royalties derived by a non-resident. This should be settled as a priority and, if necessary, clarifying amendments made to the BPTA.

72. Rental income derived by a non-resident from the lease of immovable property located in the Maldives is taxable on an ordinary assessment basis.[21] The 10 percent withholding tax applies only to rental income derived from leases of equipment and similar property. Consideration could be given to extending the withholding tax to apply also to rental income from the lease of immovable property, particularly where the property is "passively" leased out by a non-resident may not constitute a PE in the Maldives. The withholding tax would

[21] Sections 3(c)(1) and 4(b)(1) of the BPTA

be non-final and creditable against the assessed liability on the taxable profit of the non-resident.

73. There is some uncertainty as to the taxation of a gain on disposal of immovable property located in the Maldives, particularly where the property is leased out. As the activity of leasing out immovable property is a business activity under the BPT, the immovable property is a business asset and, therefore, a gain derived on disposal of the immovable property is included in taxable profit. However, for a non-resident company, the gain is taxed only if it is attributable to a PE in the Maldives.[22] As stated above, immovable property that is "passively" leased out by a non-resident company may not constitute a PE in the Maldives. There should be taxation of the gain arising from the disposal of immovable property located in the Maldives regardless of whether or not there is a PE. This aligns with international norms as provided for in Article 13(1) of the OECD and UN Model Tax Treaties, and also with the Maldives Model Tax Treaty.

74. The taxation of gains from the disposal of immovable property located in the Maldives can be avoided through an "indirect transfer" of the property. As an integrity measure, therefore, there should also be taxation of a gain arising on disposal of an interest in an entity (such as a company or partnership) where the value of the entity is derived, directly or indirectly, principally from immovable property located in the Maldives. This aligns with international norms as provided for in Article 13(4) of the OECD and UN Model Tax Treaties, and also with the Maldives Model Tax Treaty. This issue arises both under the BPT and CGT and is explained further above.

Recommendations:

- Extend the 10 percent withholding tax to apply also to dividends and interest paid to non-residents.
- Consider extending the 10 percent withholding tax on rental income from the lease of movable property to rental income derived by a non-resident from the lease of immovable property located in the Maldives where the non-resident does not have a PE in the Maldives. The withholding would be creditable against the assessed liability on the rental income.
- Provide for the taxation of gains derived on a direct or indirect transfer of immovable property located in the Maldives.

D. Permanent Establishments

75. Under international norms, the source country has the primary taxing right over business profits. However, this is subject to an important qualification, namely that the non-

[22] Section 3(1c)(2) of the BPTA. It is noted that section 3(c)(1) of the BPTA applies only to rental income.

resident must have a sufficient economic presence in the source country to justify the taxing right. This is defined by reference to the PE concept. If business profits are not attributable to a PE in the source country, then, under international norms, the resident country has the sole taxing right over the income. An exception to the PE requirement for management and technical fees is now accepted for developing countries with the inclusion of new Article 12A in the UN Model Tax Treaty.

76. The Maldives asserts jurisdiction to tax business profits derived by a non-resident if the profits are attributable to a PE of the non-resident in the Maldives.[23] As stated above, this means that "attributable to a PE" is the source rule for taxing business profits of non-residents. Consequently, there is no Maldives tax on business profits if: (i) a non-resident does not have a PE in the Maldives; or (ii) the business profits derived by a non-resident are not attributable to a PE that the non-resident has in the Maldives. The definition of PE is, therefore, central to the taxation of business profits of non-residents.

77. The definition of PE in the BPTA should, at least, be aligned with the definition of PE in the Maldives Model Tax Treaty. This will ensure that the Maldives is able to fully assert taxing rights over business profits assigned to it under its tax treaties. It is noted that the current BPTA definition of PE is, in several respects, narrower than that under the Maldives Model Tax Treaty. In particular, the BPTA definition does not include the services and insurance PE rules.[24] Further, the BPTA definition needs to be updated for the BEPS changes to the PE definition as (very recently) has been done already for the Maldives Model Tax Treaty.

78. In other respects, the definition of PE in the BPTA is broader than in the Maldives Model Tax Treaty. In particular, there is no preparatory and auxiliary activities exception or independent agent exception. This is not uncommon for the domestic law definition of PE, although consideration could be given to including an exception for a representative office. This would be justified on the grounds of administrative convenience because of the difficulty in allocating profits to mere representation activities.

79. The scope of taxation of PEs is also narrower under the BPTA than under the Maldives Model Tax Treaty. The BPTA limits taxation to the business profits attributable to a PE. The taxing right under the Maldives Model Tax Treaty is broader following the UN Model Tax Treaty. Article 7(1) of the Maldives Model Tax Treaty also permits taxation of: (i) income from sales in the Maldives of goods or merchandise of the same or similar kind as those sold through the PE; and (ii) income from other business activities (such as provision of services) carried on in the Maldives of the same or similar kind as those carried on through the PE. This broader taxing right also needs to be provided for in the BPTA to be effective.

[23] Section 3(c)(2) of the BPTA.

[24] See Article 5(3)(b) and (6) of the Maldives Model Tax Treaty.

Recommendations

- Align the PE definition in the BPTA with the definition in the Maldives Model Tax Treaty, including updating for BEPS changes.
- Consider including an exception for a representative office.
- Align the scope of taxation of PEs under the BPTA with that provided for in the Maldives Model Tax Treaty

E. International Tax Avoidance

80. The incomplete nature of source taxation does pose some revenue risks for the Maldives. First, the separate taxation of different classes of income offers planning opportunities for non-residents to recharacterize their transactions so as to derive a class of income that is either untaxed or taxed at a lower rate. It is important, therefore, that there are clear and comprehensive definitions of the different items of income that are subject to separate taxation. Second, the significant increase in cross-border trade in services, particularly within multinational enterprises (MNEs), has seen service fees emerge as a major base erosion and transfer pricing risk for developing countries. Third, intragroup financing of subsidiaries (and PEs) also raises base erosion risks.

81. As a member of the BEPS Inclusive Framework, the Maldives will be subject to a peer review process on the implementation of four minimum standards. It is understood that the review in relation to BEPS Action 5 (on 'harmful tax practices') has been initiated including reviewing the 5 percent rate on foreign income and the Special Economic Zone (SEZ) regime. Importantly, the Maldives will be required to implement country-by-country (CbC) reporting for large MNEs and provide for an improved mechanism to resolve cross-border tax disputes. While BEPS Action 4 on limiting interest deductions is not a minimum standard, MIRA has recently issued a tax ruling implementing the EBITDA approach to limiting interest deductions above 30 percent of profits, in line with Action 4 (see below).

Taxation of Cross-border Services

82. The disaggregation of economic activity within MNEs poses a problem for source taxation of foreign investment. It is likely that foreign investment into the Maldives is structured so that only the core activity is actually undertaken in the Maldives with a range of value adding activities provided by related parties located outside the Maldives (often in low tax jurisdictions) in return for the payment of service fees or royalties. For example, for a subsidiary operating a resort in the Maldives, it is likely that a range of services are provided to the subsidiary by related companies outside the Maldives including marketing, access to branding and other intangibles, bookings, leasing, logistics, and treasury functions. The payments made for these services give rise to base erosion and transfer pricing risks.

83. Management and technical fees, and equipment lease rentals (treated as royalties), paid to non-residents are particularly vulnerable to base erosion. The payer of the fee or rental is able to deduct the fee or rental at the 15 percent BPTA rate and the non-resident recipient of the fee is subject to the lower 10 percent tax on management and technical fees, and royalties, collected by withholding. The mission was advised that there is some uncertainty as to whether the 10 percent tax applies comprehensively to all classes of service fees. Because of this uncertainty, some service (or service-like) payments may be escaping the 10 percent tax. The base erosion in these cases is more serious.

84. The application of the 10 percent tax on services could be clarified by aligning the application of the tax with new Article 12A of the UN Model Tax Treaty. Article 12A applies to "fees for technical services", which is defined, in broad terms, to mean any "service of a managerial, technical or consultancy nature". The fundamental concept underlying the definition of fees for technical services is that the services involve the application by the service provider of specialized knowledge, skill, or expertise. Article 12A is included as Article 13 in the Maldives Model Tax Treaty.

85. As part of the disaggregation of economic activity, it is common for there to be a separate subsidiary established within a MNE to provide a centralized payments service for members of the group. Under such an arrangement, a non-resident person (related or unrelated) providing services or leased equipment to a Maldives subsidiary of the MNE sends its invoice to the payments subsidiary rather than to the Maldives subsidiary that received the service or leased equipment. The invoice is paid by the payments subsidiary, which then seeks reimbursement from the Maldives subsidiary. An issue then arises as to whether the reimbursement is subject to the 10 percent withholding tax. It may be argued that the payment made is a mere reimbursement of expenses rather than a management or technical fee, or royalty, and, therefore, the 10 percent tax does not apply. It is understood that currently there is a dispute on this issue. The situation should be clarified through the inclusion of a rule in the BPTA that treats the reimbursement as having the same character as the payment that it is reimbursing and, therefore, is subject to the 10 percent withholding tax.

86. As many of the service payments made by a Maldives subsidiary will be made to a related party, the disaggregation of economic activity also gives rise to transfer pricing risks. In other words, the fees charged may be inflated to further shift profits out of the Maldives. These fees should be deductible only to the extent that the service provided is supported by functions, assets, and risks ("FAR") in the foreign subsidiary providing the service and, therefore, the fee charged is consistent with an arm's length price for the service. The OECD Transfer Guidelines for Multinational Enterprises and Tax Administrations 2017 should be applied in allocating FAR to different parts of a MNE and in determining the arm's length price. This should be provided for in the Regulations to the BPTA.

87. One particular transfer pricing risk in the tourism sector is the practice for resorts to "sell" bulk rooms at a discount to offshore booking companies. These booking companies may be related or unrelated parties. The booking company then sells the rooms online to customers at a mark-up with the customers making payment direct to the booking company. The profit earned by the booking company on accommodation provided in the Maldives is then made by a non-resident from a source outside the Maldives (as the booking company does not have a PE in the Maldives). Consequently, for a booking company that is a related party to the resort company, this arrangement results in the shifting of some of the profits of the Maldives subsidiary from the provision of accommodation and other services to guests to the related booking company outside the Maldives. In this case, though, the sale of rooms to an unrelated on-line booking company (such as "hotels.com") can provide a comparable uncontrolled price for determining the arm's length price of the sale of rooms to a related booking company. Importantly, any profit allocated to the related booking company must be supported by FAR in that subsidiary.

88. It is observed that this practice also has implications for GST. The accommodation, restaurant, and other services provided by a resort to a guest is clearly consumption in the Maldives and, under the destination principle, is taxable in the Maldives. However, where the guest books through an offshore booking company, the full cost of the consumption is not taxed under the GST. The amount paid by the offshore booking company to the resort is subject to GST. Importantly, this must be regarded as a payment for consumption in the Maldives rather than for an export of a service by the resort. However, the amount paid by the guest to the booking company is not subject to GST. Consequently, the value added by the booking company is not taxed in the Maldives. Depending on the country of location of the offshore booking company and the rules on exports of services in that country, it may be that this value added is not subject to GST anywhere. For the sale of rooms to a related booking company, the arm's length price for BPT purposes should also be used for the purposes of valuing the supply made by the resort to the offshore booking company.

Recommendations

- Clarify the definition of "management and technical fees" to ensure that there is comprehensive coverage of services subject to the 10 percent withholding tax.
- Specify in the Regulations that the OECD Transfer Pricing Guidelines (2017) apply to determine the arm's length price for services and intangibles provided by related parties offshore.
- Apply the same arm's length price for the purposes of calculating the GST on services provided by related parties offshore.

Thin Capitalization

Equity vs. Debt

89. **The financing of a Maldives subsidiary of an MNE also poses BEPS risks.** An MNE is likely to finance a Maldives subsidiary through a mix of equity and debt. The BEPS risks arise because of the different tax treatment of equity and debt. Currently, the use of debt financing results in the profits of a Maldives subsidiary that are used to pay interest on the debt being largely untaxed. While some level of equity will be required under non-tax laws, MNEs have considerable flexibility as to how they finance their subsidiaries. Importantly, this is in-house financing, so an MNE can put whatever legal "label" (debt or equity) it wishes on the financing so as to maximize the tax benefits.

90. **The different tax treatment of equity and debt creates a bias in favor of MNEs using debt to finance a Maldives subsidiary.** The tax parameters under the current law that bring about this outcome are: (i) BPT at 15 percent; (ii) no tax deduction for dividends; (iii) a deduction for interest; and (iv) no dividend or interest withholding tax. This results in an effective tax rate for an equity investment of 15 percent and for a debt investment of zero percent. Consequently, debt financing gives rise to significant base erosion through the interest deduction for the borrower with no corresponding taxation of the interest income to the non-resident lender.

91. **This Report recommends the imposition of a 10 percent withholding tax on dividends and interest paid to a non-resident.** For interest, this will reduce (but not eliminate) base erosion with the interest deduction at the 15 percent BPT rate now offset by taxation of the interest income to the lender at the 10 percent withholding tax rate. Consequently, the effective tax rate on a debt investment would increase to 10 percent. However, the imposition of both dividend and interest withholding tax will only marginally reduce the overall bias in favor of debt investment. The imposition of dividend withholding tax increases the effective tax rate on an equity investment to 23.5 percent as compared to the effective rate of tax on debt investment of 10 percent.

92. **The bias in favor of debt investment can be exploited by MNEs through the use of excessive interest rates on in-house debt financing, through the use of excessive levels of debt investment (i.e. thin capitalization), or through both.** The issue of excessive interest rates is a transfer pricing issue and the BPTA includes a measure to counter the use of excessive interest rates on debt financing with the deduction for interest expense subject to a ceiling based on a 6 percent interest rate.[25] Consequently, the focus for tax planning for the financing of Maldives subsidiaries will be largely on thin capitalization practices. In broad terms, thin capitalization means using an excessive level of debt financing as compared to equity financing.

[25] Section 11(a)(5) of the BPTA. The ceiling on the interest rate does not apply to interest paid to an approved bank or financial institution.

In other words, there is an excessively high ratio of debt-to-equity in a subsidiary's capital structure.

BPTA and Thin Capitalization

93. The BPTA does not include a provision to counter thin capitalization practices. Under the BPTA, interest is fully deductible provided that: (i) it is incurred wholly and exclusively for the purpose of producing income; and (ii) the rate of interest does not exceed 6 percent. MIRA has recently issued a ruling on thin capitalization (TR-2018/B64), which limits the amount of an interest deduction to 25 percent of the taxable profit of the taxpayer before interest, tax, and capital allowances. This ratio was subsequently increased to 30 percent. Tax rulings are binding on taxpayers.

94. The thin capitalization rule in TR-2018/B64 is based on the approach recommended by the OECD under BEPS Action 4. In broad terms, under the BEPS Action 4 recommendation, a taxpayer's interest expense for a tax year is only fully deductible to the extent of the taxpayer's interest income for that year. If the taxpayer's interest expense exceeds the interest income (i.e. net interest expense), the excess is deductible only in the amount of a specified ratio to be set in the range of 10 to 30 percent of the taxpayer's earnings before interest, tax, depreciation, and amortization ("EBITDA") for the year.

95. The limitation of interest deductions by reference to EBITDA is a departure from the traditional approach to thin capitalization, which is based on a legislatively mandated acceptable debt-to-equity ratio. Under traditional thin capitalization rules, a deduction is denied for interest payable on debt that exceeds a specified debt-to-equity ratio with "debt" and "equity" determined by reference to IFRS classifications. The debt-to-equity ratio used by countries has been lowered over recent years and now is commonly either 2:1 or 3:2. Importantly, traditional thin capitalization rules apply only to foreign controlled resident companies as that is where the base erosion risk typically exists. On this basis, the traditional thin capitalization rule is an anti-avoidance rule.

96. The EBITDA rule operates as a general limit on the deductibility of interest. The rule is not confined to non-resident investment and can apply to interest payments made between two residents. This can be justified in the Maldives context as, currently, interest derived by resident individuals as part of a passive investment activity is not taxable and, therefore, base erosion opportunities can also arise domestically. Consequently, the owners of resident companies can extract profits from the company tax free through debt financing. This Report also recommends the imposition of a 10 percent withholding tax on interest paid to resident individuals. As in the non-resident context, this will reduce but not eliminate the base erosion risk with debt financing in the domestic context.

97. Importantly, though, there will not always be base erosion in a purely domestic financing transaction. The interest payable under a loan transaction between two businesses is likely to be deductible and taxable at the same rate (15 percent). In this context, the EBITDA rule can result in double taxation with interest being both non-deductible and taxable. This is a consequence of the EBITDA rule being a "blunt" instrument for limiting interest deductions.

98. A particular argument put forward in support of the EBITDA approach is that it provides for a single rule that deals with both excessive interest rates and excessive debt capitalization. This avoids having one rule to deal with excessive interest rates (transfer pricing rules and the 6 percent interest rate ceiling) and another rule for excessive debt capitalization (traditional thin capitalization rules). It is noted, though, that TR-2018/B64 makes no change to the ceiling on the deductible interest rate of 6 percent. In fact, the treatment under TR-2018/B64 of interest that is not deductible as a result of the 6 percent ceiling on the deductible interest rate is unclear (see Appendix I).

99. Given that, under the current law, there are base erosion opportunities with both domestic and international financing transactions, it is appropriate to apply the EBITDA approach to thin capitalization. However, it was observed in Chapter II that TR-2018/B64 may lack legal support and, therefore, it is preferable that a thin capitalization rule should be included in the BPTA. Importantly, the EBITDA ruling is framed in broad terms with little technical detail. This might be driven by the fact that a ruling applies to both domestic and international base erosion. Despite this, further work should be done on the design of the EBITDA rule, including a global ratio option, which will be important for non-resident investors. The design issues are discussed in Appendix I.

Recommendations

- Include a thin capitalization rule in the BPTA.
- Review the technical detail of the thin capitalization rule in TR-2018/B64.

F. Tax Concessions

Repeal the Lower Rate on Foreign Income

100. A resident company registered under the Companies Act is liable for tax at the lower rate of 5 percent if the only income derived by the company are certain specified classes of foreign income.[26] The concession applies if the income is:

I. Income from a business carried on wholly outside the Maldives.

II. Income from debt and similar instruments issued by a non-resident person.

[26] Sections 2 and 7(a) of the BPTA.

III. Income from debt and similar instruments issued by a resident person for the purposes of a capital project carried on outside the Maldives.

IV. Royalties payable by a non-resident person.

V. Income from any immovable property located outside the Maldives.

101. The mission understands that authorities are considering removing the preferential rate of 5 percent. This preferential tax regime ringfences a specific category of income. The mission agrees that this tax concession should be terminated implying a consistent tax treatment of foreign income derived by residents; i.e., all foreign income would be subject to the 15 percent BPT rate with a credit allowed for any foreign tax paid in respect of the income.

Recommendation

- Remove the 5 percent concessional rate on residents deriving exclusively foreign income.

Special Economic Zones (SEZs) Concession

102. The Special Economic Zones Act (SEZA) provides for a range of tax incentives for the developers of SEZs and investors in SEZs. Developers are entitled to the following tax incentives: (i) exemption from import duty on imports of capital goods; (ii) exemption from BPT; (iii) 10-year exemption from GST; and (iv) 10-year exemption from withholding tax. The tax incentives available to investors in an SEZ vary depending on the industry and the nature of the investment, but include tax holidays from BPT, withholding tax, and GST.

103. The SEZ tax incentives target a wide range of investment activities, some of which relate to sectors (such as tourism) for which the Maldives has a comparative advantage. Further, there are often non-tax factors that matter more for investors when making an investment decision, such as macroeconomic stability, the cost of doing business, corruption, protection of property rights, and the functioning of the legal system. Consequently, the offering of tax holidays typically results in the Maldives unnecessarily foregoing tax revenue.[27] There are number additional arguments against providing tax holidays:

I. The intention of a tax holiday is to offer a foreign investor a tax exemption period to allow the foreign investor time to establish operations in the country before transitioning to the normal tax regime. The reality, however, is that tax holidays often become open-ended. This may be through the renewal of the tax holiday or through the foreign investor simply establishing a new company to take over the tax holiday activity in a way that "disguises" the real ownership of the new company.

[27] See IMF (2014) and Klemm and Parys (2012).

II. Tax holidays often attract "mobile" investment, i.e., foreign investment that relocates to another country once the tax holiday ends so that there is no long-term benefit to the economy. This is common for tax holidays for some manufacturing activities, such as textiles.

III. While a tax holiday is targeted at attracting foreign investment, it may not be particularly difficult for locally-owned businesses to take advantage of a tax holiday through the creation of "fictitious" foreign investment.

IV. A foreign investor that carries on multiple activities with one benefiting from a tax holiday and another that is fully taxable may enter into transactions that shift profits from the taxable activity to the tax holiday activity. This can be achieved through inter-company charges and manipulating the allocation of costs (i.e., transfer pricing). It is also common for tax holiday companies to engage in transactions that shift capital allowances to other taxpayers that can immediately benefit from them. For example, this may be achieved by entering into a finance lease with a financier for the acquisition of capital equipment. This can have the effect of transferring the capital allowances from the tax holiday company to the financier.

V. Importantly, a tax holiday may simply have the effect of shifting the foregone Maldivian tax revenue from the Maldives to the country of residence of the foreign investor. This will be particularly relevant when the residence country provides relief through a foreign tax credit.

104. The tax incentives should be removed from the SEZ Act. It is understood that, to date, no foreign investors have been granted tax incentives under the SEZ Act as it is very recent. Consequently, there is no need to provide transitional arrangements for the removal of the tax incentives.

Recommendation

- Repeal all tax concessions in the SEZ Act.

Foreign Investment Agreements

105. Business profits of a foreign investor who is a party to a foreign investment agreement ("FIA") entered into under the Law on Foreign Investment are exempt from BPT to the extent provided for in the agreement.[28] The exemption applies only to FIAs entered into after the commencement date of the BPTA.[29] There are no conditions or guidelines, including time limits, specified in the Law on Foreign Investment for the granting of a BPT exemption under an FIA. Under the Law on Foreign Investment, an FIA in the tourism sector is entered into by the Ministry of Tourism and an FIA in other sectors is entered into by the Ministry

[28] Section 14 of the Law on Foreign Investment and section 15(a)(3) of the BPTA.
[29] Section 15(b) of the BPTA.

of Economic Development. Importantly, there is no obligation for MOF to be consulted before a decision is taken by the relevant Ministry to enter into an FIA.

106. For the same reasons as discussed above for the SEZ tax holidays, it is recommended the option of including a tax exemption in an FIA is deleted from the Law on Foreign Investment. The concessions granted to a foreign investor under an FIA should be limited to non-tax matters. This is particularly the case for the tourism sector where the Maldives has a comparative advantage. If the tax exemption option is retained, then, to align with best practices for such incentives, the following should apply:

I. Clear and transparent conditions and guidelines for granting a tax exemption under an FIA should be included in the Law on Foreign Investment.

II. It should be a requirement that the Ministry entering into an FIA must consult with the MOF before agreeing to any tax exemption so that the revenue foregone can be identified and a clear cost/benefit analysis undertaken in relation the exemption.

III. It should also be a requirement that any FIA with a tax exemption is approved by the Peoples' Majlis or, at least, it is required that the FIA is laid before the Peoples' Majlis, including being accompanied by the cost/benefit analysis of the tax exemption.

Recommendation

- Remove the option of including a tax exemption in an FIA.

V. TAX TREATIES

A. Background

107. As discussed in Chapter IV, the tax rules in the BPTA applicable to cross-border transactions may be excluded or modified by a tax treaty. A tax treaty is an international agreement between two or more countries (referred to as "Contracting States"). The preamble to a tax treaty usually states that the purpose of the treaty is to provide relief from double taxation. This is provided for in Article 23 of tax treaties. Today, though, most countries provide relief from double taxation unilaterally.[30] This means that the main role of a tax treaty is the allocation of taxing rights (and, therefore, tax revenues) as between the Contracting States for income or gains arising from economic activity occurring between the Contracting States. This is done by a tax treaty limiting the taxing rights of a Contracting State as a source country.

[30] In the case of the Maldives, Chapter 5 of the TAA provides for unilateral double tax relief through the foreign tax credit.

108. Most tax treaties are based on the OECD Model Tax Treaty[31] or the UN Model Tax Treaty.[32] The UN Model Tax Treaty is based on the OECD Model Tax Treaty but with greater protection of source country taxing rights, particularly in relation to business profits, royalties, and management and technical fees. Most developing countries rely on the UN Model Tax Treaty in their treaty negotiations.

109. Currently, the tax treaty with the United Arab Emirates (UAE) is the only tax treaty entered into by the Maldives that is in force. It is understood that tax treaties are under negotiation with Bangladesh, Hong Kong, Malaysia, Seychelles, and Singapore. The Maldives is a signatory to the South Asian Association for Regional Cooperation Limited Multilateral Agreement on Avoidance of Double Taxation and Mutual Administrative Assistance in Tax Matters ("SAARC Treaty"). The primary concern of the SAARC Treaty is the provision of mutual administrative assistance between the Contracting States (exchange of information, and reciprocal assistance in the collection of tax and service of process). The application of the SAARC Treaty for the avoidance of double taxation is limited to the remuneration and scholarship income derived by professors, teachers, researchers, and students. The Maldives has also entered into treaties with India and the Netherlands on international transportation income.

B. What Are the Benefits for Maldives from Tax Treaties?

110. In broad terms, the effect of a tax treaty for the Contracting States is to "trade off" reduced taxing rights as a source country in return for increased taxing rights as a residence country. Consequently, if the trade and investment flows between the two Contracting States is roughly equal, a tax treaty is likely to have limited impact on the overall revenues of each Contracting State. In this case, the effect of a tax treaty is to change the composition of revenues collected from cross-border transactions with reduced tax revenue collected from non-residents offset by increased tax revenue collected from residents. In other words, a tax treaty shifts revenue collection from source taxation to residence taxation.

111. For capital importing countries like the Maldives, however, tax treaties result in an overall reduction in tax revenue. The loss in tax revenue collected from non-residents is not offset by the increase in tax revenue collected from residents. Where outbound investment is low (as is the case for the Maldives), tax treaties can result in a significant revenue loss for the Government. Further, the prevalence of treaty shopping practices whereby residents of third countries structure their arrangements so as to invest through a treaty country means that the revenue loss from a treaty is likely to be greater than estimated. Even if taxing rights are well protected under the Maldives Model Treaty, each tax treaty is the result of a negotiation and, therefore, particular treaties may have narrower taxing rights than under the Maldives Model Treaty.

[31] The OECD Model Tax Convention on Income and on Capital.

[32] The UN Model Double Tax Convention between Developed and Developing Countries.

112. Given that the Maldives provides a relatively low tax environment for foreign investors, there is a legitimate question as to whether the Maldives needs to enter into tax treaties. The BPT rate applicable to business profits is 15 percent, which is low by international standards and, currently, there is no tax on dividends and interest paid to non-residents. Even if a tax is introduced on dividends and interest as recommended in this Report, the suggested rate of 10 percent largely aligns with the rate limit on such income in the tax treaties of many countries. Royalties are taxed at 10 percent, which, again, is the rate limit for royalties under the tax treaties of many countries. Management and technical fees are also taxed at 10 percent under the BPTA, which aligns with the tax rate in many developing countries for such payments.

113. In light of the low domestic tax environment for foreign investors, it is likely that the main focus of a potential treaty partner will be on the removal of the 10 percent tax on management and technical fees. If this taxing right is not preserved in a tax treaty, the fees would be treated as business profits and, therefore, not taxable in the Maldives in the absence of a PE. This would have serious revenue implications for the Maldives given that it is common for foreign investors in the tourism and banking sectors to pay large management and technical fees to related parties offshore.

114. The new Article 12A in the UN Model Treaty allows developing countries to preserve their taxing rights over management and technical fees under their tax treaties. This is a major departure from the OECD Model Treaty, which provides for residence country only taxation of management and technical fees (in the absence of a PE). Article 12A of the UN Model recognizes that management and technical fees are a serious base erosion issue for developing countries. The inclusion of Article 12A in the UN Model Tax Treaty, in a sense legitimizes, the 10 percent tax on management and technical fees in the BPTA and, therefore, it should not be negotiated away in a tax treaty.

115. It is sometimes argued that a tax treaty is beneficial to developing countries because there are administrative mechanisms in the treaty to facilitate the detection and prevention of tax evasion and avoidance. These mechanisms include exchange of information, and reciprocal assistance in recovery of tax and service of process. However, these mechanisms exist in other international agreements, such as a tax information exchange agreement (TIEA)[33] or the Multinational Convention for Mutual Administrative Assistance (MAC). Importantly, for the Maldives, these treaties do not involve the giving up of any taxing rights. Consequently, tax treaties are no longer the exclusive source of mutual administrative assistance arrangements.

116. For the reasons set out above, it can be argued that it is unnecessary for the Maldives to enter into tax treaties as the existing tax system is a sufficient incentive, of itself, to encourage foreign investment. However, it is acknowledged that, from time to time,

[33] The Maldives has already entered into a TIEA with India and has signed a TIEA with the Republic of South Africa. Further, the main focus of the SAARC Treaty is mutual administrative assistance between the Contracting States.

there may pressure to enter into a tax treaty, for example, to achieve closer economic relations with another country. This is stated in the preamble to the UAE Treaty as a purpose of the Treaty. It is important, therefore, that the MOF develops a tax treaty policy to ensure that future tax treaties are entered into only where there are clear benefits to the Maldives, such as increased foreign investment or facilitation of closer economic relations, to justify the resulting loss in revenue.

117. The Maldives should consider putting a moratorium on the negotiation of tax treaties until after the current tax reform project is finalized. This will avoid the negotiation of tax treaties that are inconsistent with the tax laws after implementation of tax reform.

C. On Forming a Tax Treaty Policy

118. Because of the potential negative impact on tax revenues in the Maldives, it is important for the Ministry to develop a tax treaty policy. The tax treaty policy should include the following components: 1) The negotiating team; 2) Clear guidelines for choosing treaty partners; 3) A baseline for negotiations: 4) The use of a Maldives Model Tax Treaty in negotiations that is shared with a potential treaty partner to strengthen Ministry's negotiation position; 5) The preparation of a Tax Treaty Impact Statement once a treaty has been negotiated but before it is signed.

Negotiating Team

119. As explained above, a tax treaty results in the reduction of taxing rights over Maldives source income derived by residents of the other Contracting State. This is essentially a policy matter and, therefore, the negotiating team should be headed by the Ministry, with technical input provided by MIRA. As a tax treaty is a country-to-country negotiation, it may also be prudent to include a representative from the Ministry of Foreign Affairs in the negotiations.

Guidelines for Choosing Tax Treaty Partners

120. It is essential that clear guidelines are developed for choosing treaty partners. It is certainly not incumbent on the Ministry to negotiate a tax treaty with every country that seeks a treaty with the Maldives nor would this be in the country's best interests.

121. The main argument for capital importing countries, like the Maldives, to enter into a tax treaty is that it will facilitate existing trade and investment into the country, and attract new investment. In choosing a treaty partner, the starting point is to consider the current level of trade and investment coming into the Maldives from the potential treaty partner. If that level of trade and investment is significant, there is likely to be a greater justification for negotiating a tax treaty with that country. Where there is little or no current trade and investment with a potential treaty partner, then greater care must be taken in making the decision to negotiate with that country. In particular, an investigation should be undertaken to determine whether there are impediments to such trade and investment and a realistic assessment must be made as to whether a tax treaty will help remove or overcome those impediments. If it is unlikely that a tax treaty will have any significant impact on the level of trade or investment coming into the Maldives, then there is justification in negotiating a treaty with that country.

122. The guidelines should prohibit negotiations with any country whose tax rules or practices pose a revenue risk to the Maldives. Countries that either have no income tax, a preferential regime for foreign income, or that tax only on a territorial basis, pose a potential revenue risk for the Maldives. A treaty negotiated with a such a country is likely to result in double non-taxation of any income that Maldives is required to exempt from tax under the treaty.

123. Further, in negotiating a tax treaty, the clear intention of the Maldives should be that treaty benefits are limited to genuine residents of the other Contracting States. Consequently, in choosing a treaty partner, it should be clear that the potential trade and investment coming to the Maldives from that country is genuinely sourced from that country. Some countries negotiate a broad treaty network to facilitate treaty shopping. In this case, the aim is to attract residents from outside the country to establish a base company in the country to take advantage of the broad tax treaty network. The base company may be established under a preferential tax regime in the country or the country may be a territorial tax country. If the Maldives negotiates a tax treaty with such a country, the revenue loss from the treaty can be expected to be much greater than would be the case if the application of the treaty were confined to genuine residents of the other country.

124. It is acknowledged that the inclusion of an anti-treaty shopping rule (such as a limitation of benefits ("LOB") Article) in a tax treaty will limit the impact of treaty shopping. However, such rules may not necessarily counter all possible treaty shopping abuses, particularly in relation to services. Consequently, it would not be prudent to enter into a tax treaty with a high-risk country with the expectation that the inclusion of an anti-treaty shopping rule will completely protect the Maldives from treaty shopping under that treaty.

Baseline for Negotiations

125. The tax treaty policy should set out the baseline for negotiation of a tax treaty. This will identify those provisions of a tax treaty that the Maldives is prepared to negotiate on and those that are non-negotiable. The baseline should be that a treaty must, at least, include the following:

I. A positive rate of tax on dividends, interest, royalties, and management and technical fees.

II. The taxation of indirect transfers of immovable property located in the Maldives as provided for in Article 13(4) of the Model Tax Treaties.

III. An anti-abuse rule.

126. Where the tax treaty policy provides that there is to be no negotiation on a particular subject matter (such as zero rates), it is essential that the negotiation all tax treaties abides by this baseline. As soon as one treaty is negotiated that departs from the agreed baseline, the Maldives will be under pressure to give the same benefit in all future treaty negotiations, which may be difficult to refuse. In other words, such a treaty will, in effect, set a new baseline for future negotiations.

Model Tax Treaty

127. The Maldives has a model tax treaty that it uses in treaty negotiations. This is consistent with best practice and allows treaty negotiations to focus on areas of disagreement as between the two countries. It is essential that the Maldives Model Tax Treaty is fully integrated with the adoption of the tax treaty policy. In particular, the Maldives model treaty must set out the baseline for negotiations. The Maldives Model Tax Treaty has recently been updated for BEPS developments. This is discussed further below.

Tax Treaty Impact Statement

128. As a tax treaty will involve a loss of revenue through the reduction in Maldives' taxing rights as a source country under the treaty, a Tax Treaty Impact Statement should be prepared before a treaty is signed. This will facilitate a cost/benefit analysis in relation any potential tax treaty. A Tax Treaty Impact Statement should set out the following:

I. The reasons for choosing the other country as a treaty partner, including a statement of the current volume of trade and investment into the Maldives from the country.

II. An assessment of how the tax treaty will increase the level of trade and investment into the Maldives, or other otherwise improve closer economic relations.

III. A statement of any other benefits to the Maldives that may be obtained under the treaty.

IV. A quantification of the potential revenue loss for Maldives under the treaty.

D. Model Tax Treaty

129. As noted above, the Maldives has a model tax treaty that is used in treaty negotiations. The Maldives Model largely follows the UN Model Tax Treaty, but with the rate limits on dividends and interest aligned with the OECD Model. The Maldives Model has just been updated for BEPS changes to the OECD and UN Models.

130. In several respects, the Maldives Model Tax Treaty provides for broader source country taxing rights than asserted under the BPTA. In particular, the Maldives Model: (i) includes the limited force of attraction rule for taxing business profits as provided for in the UN Model Tax Treaty; (ii) provides for a positive rate of tax on dividends and interest; and (iii) provides for taxation of indirect transfers of immovable property. In this regard, it is noted that a tax treaty does not impose tax, rather tax is imposed under the BPTA, and, therefore, a taxing right provided for under a tax treaty has no legal effect unless it is also provided for in the BPTA.

131. It is very positive that the Maldives Model Tax Treaty has recently been updated to align with the 2017 OECD and UN Model Tax Treaties. However, consistent with the inclusion of an anti-fragmentation rule for the preparatory and auxiliary activities exception in Article 5(4), a similar anti-fragmentation rule could be included for the services and construction PE inclusions in Article 5(3). Both these PE inclusions are vulnerable to fragmentation of activity between related persons to fall below the relevant 6-month threshold.

Recommendations

- Given the low tax environment in the Maldives for foreign investors, review the policy of negotiating tax treaties. At the least, adopt a moratorium on the negotiation of tax treaties until after the current tax reform project is concluded.
- The Ministry to take the lead in tax treaty negotiations with technical input provided by MIRA.
- Develop a Tax Treaty Policy applicable to all treaty negotiations. This should include a baseline for negotiations that identifies matters that are non-negotiable and the preparation of a Tax Treaty Impact Statement.
- Consider revising the Maldives Model Tax Treaty to also include an anti-fragmentation rule for the services and construction PE inclusions.

VI. GST

A. Background

132. In less than a decade, the system of indirect taxes in the Maldives has been significantly reformed and modernized. This has first and foremost taken the form of the introduction in 2011 of a VAT-like general consumption tax—the GST—to replace a rudimentary tax system relying to a large extent on import tariffs. This important reform took place in tandem with a significant strengthening of tax administration through the establishment of MIRA starting in 2010.

133. This chapter discusses remaining shortcomings of the GST and lays out options for possible further reform of the tax. The main focus is on tax policy issues although it is recognized—as also clearly illustrated in previous reforms—that policy reforms typically require improved administrative capabilities. The chapter discusses options for further improvements to the GST.

B. GST Revenue Issues

134. At present, the standard GST rate is 6 percent, but the rate is 12 percent in the tourism sector. The average (weighted) tax rate of about 8.6 percent, which is clearly at the lower end of the spectrum of rates applied internationally (Figure 10).

135. The Maldivian GST, at 9.2 percent of GDP, raises a significant amount of revenue in spite of the relatively low rate. The GST collection is at the higher end of the spectrum when compared to VAT-to-GDP ratios in a large sample of countries in the broader region, including island economies. This raises questions about the underlying determinants of the seemingly high revenue raising capabilities of the Maldivian GST.

136. This report documents that a 1 percentage point GST rate raises less revenue from the tourism sector than that from the non-tourism sectors. The difference is 28 percent (rows (6) and (7) in Table 3). While overall GST revenue raised in the tourism sector is significantly larger than that raised in the domestic sector, the underlying tax base (or taxable supplies, see row (4)) is almost 30 percent higher in the domestic sector than in the tourism sector. Potential explanations include:

I. *Number of GST payers*: significantly larger number of taxpayers in the domestic sector than in the tourism sector (row (9)), although businesses in the tourism sector on average may be considerably larger in economic terms than domestic businesses.

II. *Possible Erosion of the GST Base through Transfer Mispricing*: Transfer mispricing practices can impact the GST base in the Maldives. It is understood that a common practice in the Maldives is to sell "tourist packages" to affiliated operators located abroad, who in turn sell the services to foreign final customers. While the GST (and BPT) from such transactions is generally collected from domestic resorts, if the sold package is underpriced (i.e., the price deviates from the arm's length principle) it results in part of the overall value added (profit margin) not being fully captured by the local GST (and BPT) collections reinforcing the recommendation to adopt modern transfer pricing legislation.[34]

III. *GST refund*: In the present Maldivian GST system, no cash GST refunds are provided to registered persons (even exporters). The GST refund is instead provided through a

[34] The issue of transfer pricing and the BPT is addressed in Chapter IV of this report.

corresponding downward adjustment to BPT liability.[35] This will automatically increase reported, nominal GST revenue (row (2)), and simultaneously decrease reported nominal revenues of other affected taxes. Since GST refunds are an integral part of the GST system, the reported revenue will thus deviate from true economic values, and hence overstate the revenue capacity of the GST.

IV. *Cross-sectoral differences in the way the GST is administered*: While the GST in the two sectors is structurally identical, administration and enforcement may well differ.

Table 3. Key Parameters of the Existing GST

Item	Non-Tourism GST	% of Total	Tourism GST	% of Total	Total
(1) Tax rate, %	6.0	--	12.0	--	--
(2) Revenue, million MVR	2,683	39.0	4,199	61.0	6,882
(3) Tax/GDP-ratio, %	3.6	--	5.6	--	9.2
(4) Taxable sales, (2)/(1), million MVR	44,717	56.1	34,992	43.9	79,709
(5) Average rates, (2)/(4), %	6.0	--	12.0	--	8.63
(6) Revenue per %-point of rate, (2)/ (1), million MVR	447	56.1	350	43.9	797
(7) Sectoral percent. differences in (6)	+28	--	-22	--	--
(8) Sectoral GDPs, million MVR	N.A.	--	14,913	--	74,866
(9) Number of taxpayers	11,567	85.8	1,912	14,2	13,479

Source: IMF staff calculation based on data obtained from MIRA.

C. The Present GST: A 'Dichotomized' VAT?

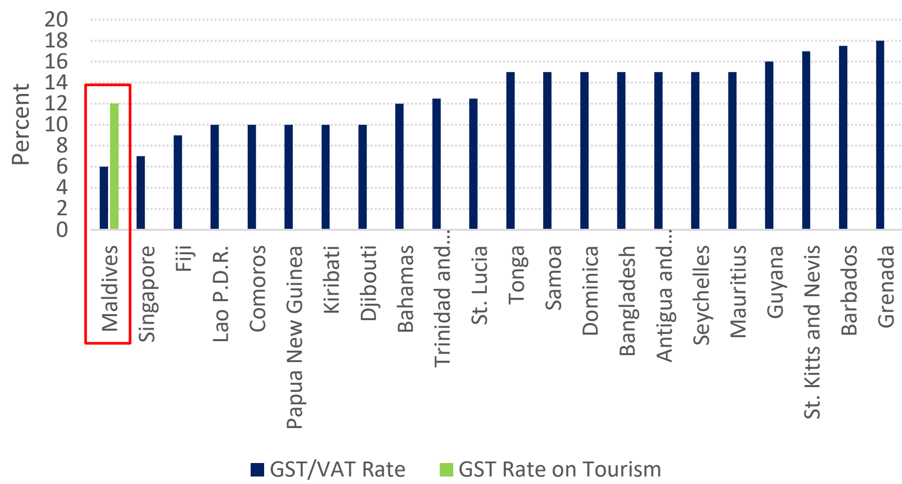
137. With its present basic design features, the GST in the Maldives is in some key aspects (but also with an important exception) comparable to the many multistage invoice-credit based VAT systems adopted globally, particularly since the 1990s. More than 160 countries now operate a VAT.

138. The most important deviation from a standard VAT is the separation between the tourism sector and all other sectors of the economy. This 'dichotomy' of the present GST is unusual when compared to standard VATs, and can be said to run counter to the basic economic objectives of a VAT. It is explicitly formalized in the GST law and regulations. Section 14 of the GST Act states that GST tax chargeable under the law is categorized into two separate categories: (a) tourism goods and services; and (b) general goods and services apart from those under (a). The Act proceeds to define which goods and services are to be considered tourism and which are

[35] The present mission focuses on tax policy issues, and can only refer to advice provided by experts in tax administration as well as suggest areas where the authorities may want to seek future technical assistance by experts in tax administration. The Maldivian authorities may consider seeking technical assistance on this issue.

not, and the tax rates to be applied to each of these categories. The GST Regulations (Chapter 1, section 3(c)) specifies that if a person carries on taxable activities in both areas, these must be reported to MIRA separately. However, in practice, sales between tourist and non-tourist companies are treated under normal VAT rules concerning charging and crediting VAT.

Figure 10. GST/VAT Rates in Selected Countries



Source: Data are taken from the IBFD and other sources.

139. It is useful when discussing issues of VAT design to keep in mind, as a point of reference, the basic policy objectives of the VAT. Being a tax predominantly on domestic private consumption—typically by far the largest component of GDP—the central objective of a VAT is to raise a large share of total taxes in a non-distortionary manner, by applying a uniform rate to the broadest possible base. A well-designed VAT is neutral with respect to its effect on relative prices and international trade (by treating all exports, as well all imports, alike for tax purposes consistent with the destination principle), as well as savings (by treating present consumption in the same manner as future consumption) and investment (by allowing full input tax credits for investment costs). In contrast, general consumption taxes, like the VAT, are generally ill-suited to achieve other policy objectives such as social objectives and equity, or objectives of economic stabilization, which generally are better achieved through other policy instruments.

140. Excises would supplement the GST in generating potentially important additional revenues from taxes on goods characterized by inelastic demand and often significant negative externalities. This would include excises on tobacco, alcoholic products, fuels, and motor vehicles. Excises on these products should be introduced in tandem with trade liberalization and reduction in tariff rates on the same products. The core focus on the report, however, in on the GST, and the issue of future excises will not be further addressed. One further option to raise revenues in the short-term is to increase the airport service charge.

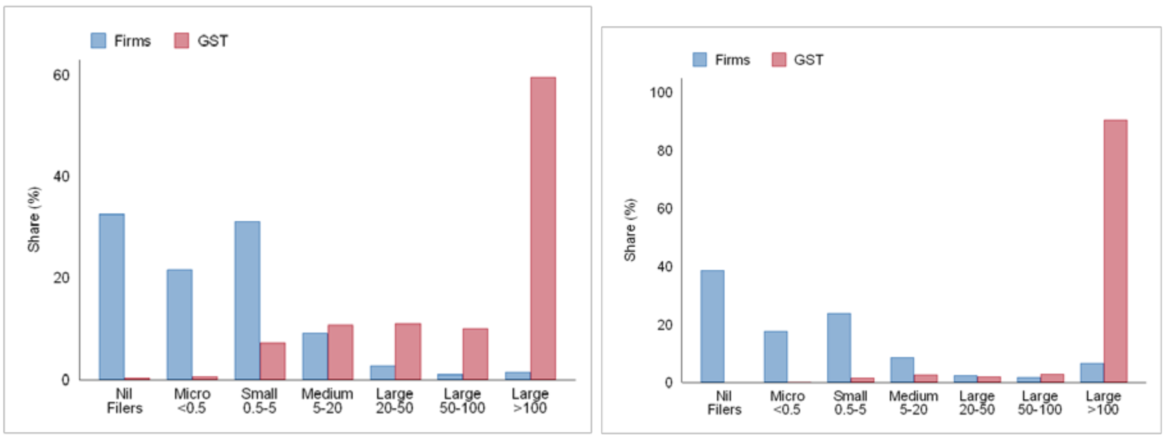
Recommendations

- In the short-to medium term, and in view of the relatively low rates of the GST particularly in the non-tourism sector, rates could be gradually harmonized by increasing the 6 percent rate, as needed by revenue requirements.

- Introduction of a modern broad-based VAT at a uniform tax rate should remain an overarching policy objective, but mainly for the medium- to long-term.

Figure 11. Distribution of GST Payments Based on Turnover Thresholds

(a) Non-Tourism Sectors *(b) Tourism Sector*



Source: IMF staff calculation based on data from MIRA. Numbers on the horizontal axes are in million MVR.

D. Keep the GST Threshold at its Present Level

141. The choice of registration threshold for the GST/VAT has proved a central element of GST design.[36] The present registration threshold in the Maldives is set at a turnover level of MVR 1,000,000, roughly corresponding to US$64,500 at present exchange rates. However, importers of goods to the Maldives and suppliers of tourism goods and services are required to register, even if the value of their supplies does not exceed the limit of MVR 1 million.[37] Very importantly, the present legal provisions allow for businesses with turnover under the registration threshold to voluntarily request to register with the MIRA for GST purposes. This allows a number of smaller businesses to register for GST in cases when this is advantageous to them (e.g. if they primarily make supplies to larger registered businesses). It is also noteworthy that unregistered businesses below the threshold may still contribute to revenues when GST applies to their inputs.

[36] For detailed discussions of VAT threshold and other VAT issues, see Ebrill et. al., (2001).
[37] The detailed threshold provisions are laid out in Chapter 10 (Registration) of the GST Act.

142. It is highly recommended to keep the GST threshold at its present level. Recent political discussions have addressed the possibility of changing the present threshold (although no specific proposal has been presented to Parliament). It is extremely important to note that:

I. The main objectives of VAT thresholds are to reduce taxpayers' compliance costs and increase the efficiency of the tax administration by significantly cutting the work necessary to control a large number of small taxpayers whose contribution to revenue typically is small. A reduction in the threshold may significantly increase the number of registered taxpayers, thereby also increasing both administrative costs for MIRA and compliance costs for taxpayers.

II. The net revenue gain of reducing the threshold may be close to nil or even negative due to the highly concentrated tax base of the GST among the largest businesses. Figure 11 shows that about 90 percent of GST revenue in the tourism sector comes from less than 20 firms, despite that about 30 percent of registered firms are below the threshold. A similar pattern arises in the non-tourism sectors, where approximately 90 percent of the GST is collected from firms with turnover above MRV 5 million. Approximately 30 percent of registered firms in the non-tourism sectors are below the GST threshold, but contribute no more than 1 percent of GST revenue.

III. The present threshold level in the Maldives is aligned with the thresholds in place in other island economies and in neighboring countries in the broader region. Figure 12 clearly demonstrates this point by showing the similarities of the present VAT threshold in the Maldives with those of selected neighboring and other countries of a similar structure and development.

IV. Many taxpayers below the threshold are already contributing to tax revenue, albeit a small fraction in total:

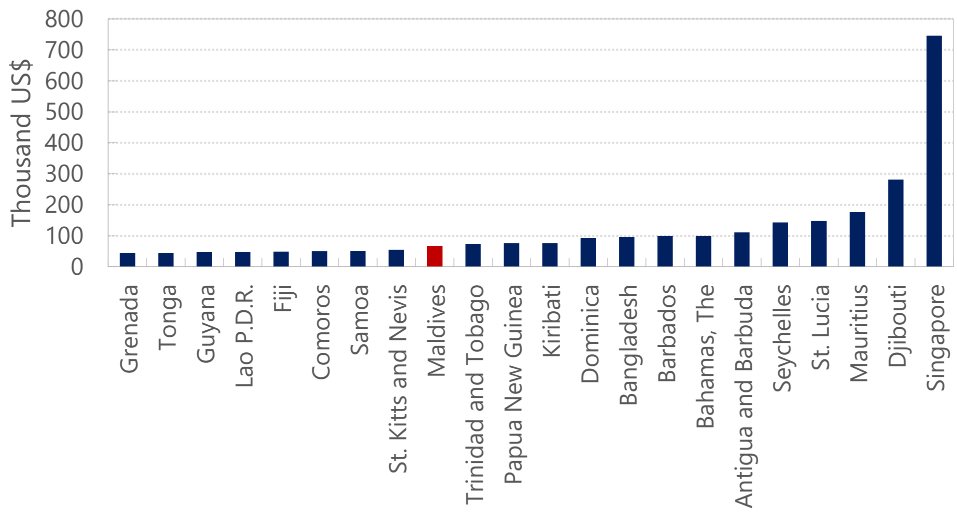
- All importers of goods and suppliers of tourism services are required to register for GST, even if turnover is below the threshold.
- There is a voluntary registration option for businesses with turnover smaller than MRV 1 million.
- Most unregistered businesses below the threshold contribute to revenue through GST payments on their input.

V. A simplified tax regime, in the form of a uniform turnover tax, for taxpayers with turnover below the threshold (as recommended in Chapter III), would reduce economic distortions (from differential tax treatment of businesses above and below the threshold) and ease the transition of businesses from the simplified to the regular GST regime. Hence, a simplified tax regime for taxpayers below the threshold should be introduced as discussed in Chapter III.

Recommendation

- Keep the GST threshold at its present nominal level for the time being.

Figure 12. GST/VAT Thresholds in Selected Countries (Thousands of US Dollar, 2018)



Source: Data are taken from IBFD and other sources.

E. Exemptions and Zero-Ratings

143. There are basically three justifications for the use of exemptions and zero-rating in a GST/VAT. First, to improve and enhance the progressivity of the tax through lower or no taxation of necessities on which low income consumers spend proportionately more of their income. Second, to apply these measures to 'merit' goods, i.e., goods that are considered welfare enhancing (whose consumption is associated with strong positive externalities) and would be consumed in sub-optimal quantities if taxed (such as for example education). Third, some goods are simply considered too difficult and/or too administratively costly to tax under a VAT (such as for example margin-based fees for financial services). All three justifications have to varying degrees been questioned and challenged over recent years, but in practice—once in place—exemptions and zero-ratings are often politically hard to eliminate or curtail.

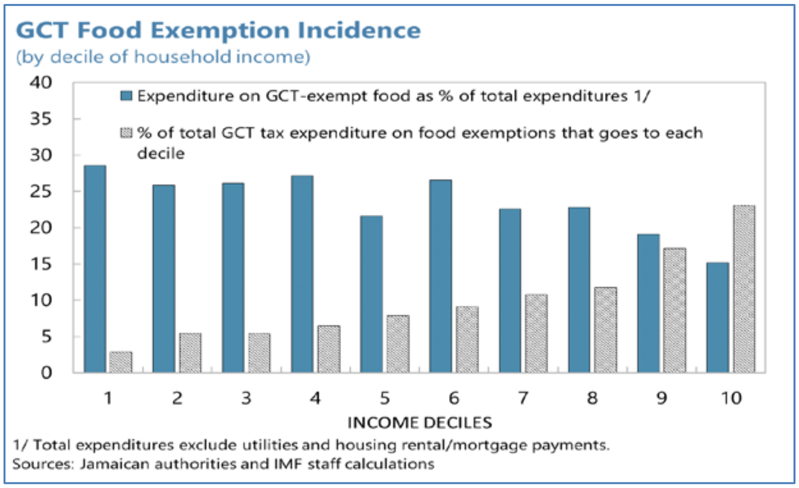
144. Concerning the use of exemptions as opposed to zero-rating, the term 'exemption' is (in a VAT context) somewhat of a misnomer, since exempt goods remain partly taxed. While no VAT is levied on their sales, no credit is allowed for the VAT on inputs used in their production; hence, the input VAT will typically be 'embedded' in the sales price, but with no credit allowed for the buyer since the exempt seller is considered outside the VAT system. In contrast, zero-rating completely removes the VAT from the goods, while the seller is still considered part of the VAT. It has been argued that administrative considerations on balance may make exemption preferable to zero rating (in part because exempt traders as noted are outside the VAT system). Furthermore, the EU Commission has viewed zero rating as a transitional measure that is tolerated only temporarily.

145. However, there are strong policy and administrative arguments against the use of exemptions and zero-rating. These measures generally erode the tax base and typically reduce revenues, thereby requiring higher tax rates to achieve a given revenue level with the adverse impact on economic efficiency that may imply. They also reduce economic efficiency by resulting in widely dispersed (and often non-transparent) effective tax rates across the spectrum of consumption goods. Also, some of the tax 'privileged' supplies are business-to-business (B2B), in which case zero-rating supplies does not affect revenue (but is conducive to fraud and higher administration and compliance costs). In contrast, exemptions of B2B supplies likely increase revenues but at the cost of reduced economic efficiency due to "cascading"—that is, double taxation of consumption resulting from exemption of intermediate goods. They are also very costly measures when aimed at improving progressivity (see discussion below). Furthermore, exemptions and zero-rating may substantially complicate tax administration by requiring that distinctions are made between taxed and non-taxed supplies by both traders and tax administration, thereby increasing both compliance and administration costs; and providing tax reliefs invariably leads to further and continued pressures and demands for broader tax reliefs across the spectrum of taxpayers and consumption items.

146. It is sound practice to estimate the amount of tax expenditures (or revenue losses) associated with the exemptions and zero ratings provided under the VAT. MOF should, in close consultation with MIRA, seek to develop tax expenditure estimates of the tax reliefs provided under the GST.

147. Particularly concerning the distributional impact of exemptions and zero-rating, the assumed progressivity enhancing impact of VAT reliefs for basic foods has been seriously questioned based on a number of country cases. Although the share of food in total consumption expenditures of low-income households generally is higher than that of high-income households—and the propensity to consume out of income is higher for low-income households as well—high-income households also buy food and spend much more doing so, because they generally eat more expensive foods. The result is that, despite the regressivity of the VAT, households in the higher income deciles benefit from the largest share of the associated tax expenditures. The data for Jamaica provided in Figure 13 give a representative picture of this phenomenon. Hence, the use of VAT reliefs to support low-income segments of the population generally is a poorly targeted and therefore costly (or cost-inefficient) policy instrument to support low income families. A more efficient policy would be to tax all items and distribute a share of the revenue directly to the poor through targeted social transfers, using for example a cash transfer program, preferably based on existing social support programs (if such are already in place).

Figure 13. Distribution of VAT Expenditures by Income Deciles (Jamaica, 2015)



Source: IMF TA Report.

148. In contrast to tax reliefs that are explicitly aimed at improving progressivity, there are items where the tax relief provided is likely regressive. In other words, if these items were fully taxed under the VAT, progressivity of the VAT (and thereby the overall tax system) would in all likelihood be improved. Assuming that these tax reliefs at present are not fully offset by other tax instruments (such as for example special excises designed to 'include' the VAT), this would be the case for fuels (which typically are consumed in much larger quantities by high income than low income individuals), electricity, and presumably also financial services, which generally are consumed proportionally more by higher income individuals. However, there may be other reasons for exempting some of these items despite the distributional concerns, such as VAT on financial services.

149. For the reasons given above, a set of recommendations concerning the use of exemptions and zero-rating has developed over time that aims at enhancing the soundness and economic efficiency of the GST/VAT. First of all, zero-rating should be applied only to exports, that is, all domestic zero-rating should be eliminated and, furthermore, exemptions should be limited to an absolute minimum, including taxing consumption items that would underpin the progressivity of the overall tax system. The core rationale is that extensive use of zero-rating and exemptions seriously undermines the working of the VAT as a consumption tax that is neutral and applied to a broad spectrum of supplies of goods and services to the domestic economy, and the associated tax expenditures in all likelihood erodes the tax base and reduces revenues.

Recommendations

- Restrict zero-rating to exports and repeal all zero-rating of domestic supplies

- Critically review and substantially narrow the spectrum of remaining exemptions to those that are critical to low-income households
- Estimate revenue consequences of these GST reform measures
- Expand direct social transfers to low-income families to counter higher consumption prices

F. VAT Applied to Electronic Commerce

150. A core concern in the ongoing discussion of the VAT is how to effectively capture the strongly growing volume of cross-border electronic commerce transactions in the tax net. This relates primarily to goods that are ordered and delivered online (i.e. digital products). The normal VAT rules applicable to the import of goods apply to goods ordered online but delivered as tangible goods. The essential difference between these two ways of accessing goods is that the delivery of tangible goods involves the goods passing through customs control with the VAT on the import collected at the border, while digital products do not pass through customs control. The VAT treatment of digital products is really just a subset of the larger issue of taxing imported services. For this purpose, digital products are treated as services rather than goods under modern VAT laws.

151. It is important at the outset to keep in mind a basic aspect of this particular and important VAT issue: the key *policy objective* of VAT reform also in this area is to secure economic efficiency, neutrality, and equity in the tax treatment of goods and services through electronic means exactly similar to the treatment of goods and services traded through other, more traditional channels. Hence, electronically traded goods and services should not be treated differently for tax purposes than other goods and services. This objective is also embedded in OECD's *International VAT Guidelines* which build on the principles of 'neutrality' (VAT is a tax on final consumption that should be neutral for business) and 'destination' taxation (internationally traded goods and services should be subject to VAT in their jurisdiction of consumption. These principles imply VAT treatment of E-commerce exactly equal to the VAT treatment of other goods and services.

152. It must also be emphasized that the challenges of capturing cross-border electronic commerce in the VAT in the Maldives and elsewhere are, predominantly a tax administration issue. A detailed discussion of international experiences and options in addressing the challenges is, therefore, beyond the scope of this report, which instead will briefly summarize the issues.

Table 4. Tax Treatment of Goods and Services and E-Commerce		
Purchasers	**Type of product**	
	Tangible products	Digital products
Registered traders	Taxation at the border	Reverse charge
Consumers and unregistered traders	Taxation at the border	***The key problem area***

Source: Based on McLure (2003).

153. It may be useful to briefly summarize the different types of cross-border e-commerce transactions. As summarized in Table 4, there are four categories of transaction depending on whether the transaction involves a tangible or a digital product, and whether the purchaser is a registered trader or a consumer (or an unregistered trader). As can be seen from the table, the only type of e-commerce transaction that is truly problematic is the supply of digital products to consumers. As stated above, VAT is collected at the border for goods ordered online but delivered as tangible goods.

154. In most countries where an invoice credit method is used, the VAT on cross-border B2B supplies of services (including supplies of digital products, such as online advertising) is usually collected by the reverse charge mechanism. Under reverse charging, the normal operation of the VAT is reversed with the VAT-registered person receiving the imported services charging itself VAT. If the recipient uses the imported services to make taxable supplies, then they can claim an input tax credit for the reversed charge VAT. Reverse charging does involve a departure from the multi-stage nature of the VAT, but is necessitated by the fact that the supplier of the imported services is not a registered person. In particular, reverse charging is a simplification measure to avoid the administrative burdens on foreign providers that deliver services in countries where they are not established and who would otherwise have to register for VAT and fulfill all VAT obligations in that country.

155. As indicated in Table 4, the difficulty is taxing B2C cross-border supplies of services (including supplies of digital products). It is not feasible to apply a reverse charge rule to B2C imported services as consumers are unlikely to comply and the costs of forcing them to comply would be very high. In this case, there is no option other than to require a foreign service provider to register for VAT if the level of their taxable transactions exceeds the registration threshold.

156. The focus of recent work of the OECD, including as part of BEPS Action 1, has been to devise a uniform standard for locating B2C imported services. This is based on making a distinction between "on-the-spot" supplies and "remote" supplies (including digital supplies). An on-the-spot supply is a supply in respect of which both the supplier and recipient are in the same location at the time of supply. For such supplies, the place of supply is the place of performance of the services. A supply of remote services is a supply in respect of which there is a separation of the place where the services are performed and the place where the recipient is located. In this case, the place of supply is the place of residence of the recipient of the supply.This is not determined by reference to fiscal residence of the recipient under the income tax, but by indicators of residence readily accessible by the supplier, such as the IP address of the recipient's device to which the digital product has been delivered, the recipient's billing address, the recipient's bank details, and the mobile country code of the international mobile subscriber identity stored on the SIM card of the device used by the recipient.

157. A number of countries have now introduced rules requiring foreign suppliers of imported services (including digital products) to register and charge VAT on B2C supplies to customers in the country. These rules must provide that a foreign service provider is able to wholly deal with the tax administration electronically. There remains, however, the obvious practical difficulty for a country like the Maldives to force such suppliers to register for the GST. Ultimately, though, the ability to tax B2C supplies of imported services (including digital products) is likely to involve a coordinated effort among countries, and the OECD and the EU are continuing to work on this.

Recommendations

- Set up internal working group with VAT experts from the MOF (the Tax Policy Unit) and MIRA to prepare a reform plan for adoption of VAT on E-commerce, based in part on OECD Guidelines.
- Engage with regional trading partners to ensure an internationally coordinated approach to adoption of VAT on E-commerce.

VII. PROPERTY TAXES

A. Background and Purpose

158. Taxes on property in the Maldives are at present rudimentary. Existing charges that could be considered as nascent sources of taxes on property include (1) a *stamp duty* at the rate of 0.01 percent on the registration of mortgages; and (2) a *tourism land rent tax*[38] levied on tourist resorts, hotels and guesthouses if built on land owned by the Government, at the flat rate of USD 8 per square meter of land (subject to caps and floors as specified in the Act[39]). The tax is recurrent (annual) and paid quarterly. The total revenue of the rent tax was in the order of MVR 1½ billion in 2017. The stamp duty on mortgages could be considered a (partial) tax on property

[38] Which, in the Tourism Act is considered a payment for rent and not a tax.
[39] See Tourism Land Rent Regulation 2010/R-20.

transfers, while the land rent tax could be considered a simple (and similarly partial) tax on land. There are no broader property taxes in place in the Maldives.

159. Modest reliance on property taxes is a policy characteristic of many emerging and developing economies. But the global trend has clearly been increased reliance on this source. Revenues of 0.1 - 0.5 percent of GDP seems to be the order of magnitude for selected countries in the broader region. While revenue raising from the property tax may be fairly modest, it is in many countries an important revenue source for local governments.[40] The Maldives has 209 local councils which are financed mainly by central government transfers. This Chapter provides a brief overview of the rationale of recurrent property taxes and summarizes key tax policy and administrative issues that must be addressed if the Maldivian authorities decide to engage in property tax reform.

B. The Rationale of Property Taxes

160. By being conducive to economic growth and higher equity, and in view of its untapped revenue potential, property tax reform could be designated an important priority in future tax reforms. Improved reliance on property taxation can have significant and positive impacts: it has been shown to be less distortive than other taxes, in particular income taxes,[41] and is a progressive tax. Introduction of a property tax could also contribute importantly to revenue, including potentially, and in a long-term perspective, for local governments.

161. The efficiency enhancing characteristic of immovable property taxes derives mainly from the immobility of the tax base. They are considered more efficient than other taxes with an impact on resource allocation that is less adverse—by not affecting decisions to supply labor and to invest and innovate (though the immobility argument should be qualified in the sense that only land is truly immobile). In particular, if a new (or increased) property tax is fully capitalized in property prices, present owners will suffer a one-off loss in wealth, while new owners will not be affected since the tax does not affect the rate of return and therefore is considered neutral to investment behavior. Property taxes are considered good local taxes by virtue of being borne mainly by residents, and will enhance efficiency to the extent they act as local benefit taxes. They can promote more efficient use of land and have been used to induce land development. Economic efficiency will also improve to the extent that property taxes replace taxes on mobile tax bases or highly distortionary property transfer taxes. Finally, and going beyond efficiency issues, there is increasing consensus that property taxes are beneficial for equity and the overall fairness of the tax system. But adoption of recurrent property taxes requires careful planning and significant investment in administrative infrastructure. The requirements in this regard are discussed in more detail below.

[40] See Norregaard (2013).
[41] See for example OECD (2010).

C. Understanding the Yield: The Revenue Formula

162. The revenue raising capabilities of the recurrent property tax are often discussed with reference to the so-called revenue formula for property tax collections.[42] This approach distinguishes between policy design and administrative capabilities in raising revenue. While the main emphasis here is on the policy measures, it is important to emphasize the need for strong administrative reform in supporting revenue raising. Property tax revenue in any country can be expressed as the product of two policy variables and three 'administrative' variables:

Revenue = Legal Tax Base × Tax Rate x Coverage Ratio × Valuation Ratio × Collection Ratio

163. The defined tax base refers to the properties identified in the law as being subject to property tax and the tax rate is simply the rate applied against the defined base. The three 'administrative' ratios, all varying between 0 and 1 (or 100 percent), are defined as follows. *The coverage ratio* refers to the proportion of properties that should be included in the base which have actually been identified and are included in the cadaster. *The valuation ratio* is the proportion of the full defined value (often with reference to actual market values) that is actually assessed for tax purposes. And the collection ratio refers to the proportion of assessed taxes (or tax liabilities) that are actually collected.

164. While ideally the three ratios should all be one or close to one, that is very rarely the case with important implications for revenue raising. For example, if the tax base in a country is defined as the full market value of land and buildings and equals $1,000, and the tax rate is 10 percent, one might expect tax revenue of $100. But if only 70 percent of the properties have been identified and included in the cadaster, if the properties are undervalued by 20 percent (only 80 percent of market value is assessed), and if the collection process is able to collect only 85 percent of actual tax liabilities, then the tax actually collected will be: $1,000 x 0.10 x 0.70 x 0.80 x 0.85 = $47.60.[43] This means that administrative deficiencies give rise to a 'loss' of more than half of potential revenue or, in other words that, without any legislative changes, strong administrative improvements could, in this case, lead to a doubling (or more) of the yield.

165. It follows that property tax policy and administration involve not only defining the base and setting the rates. It also involves managing the coverage, determining the taxable value, and administering the collections process.[44] Subsequent sections discuss policy and administration reform options for the property tax.

[42] See for example Kelly (2013).

[43] Actual ratio values, particularly in developing countries, may be substantially lower than those applied here.

[44] A broader discussion of the components of the revenue formula is provided in Norregaard (2013) op. cit.

D. Tax Policy Options for a Future Modern Property Tax

166. The definition of a broad tax base, including both land and buildings, has several advantages: choosing the broadest possible base allows for much lower tax rates with the lower distortions that implies; it may also enhance the equity of the tax; and it will facilitate over time application of property values in the tax base that approximate actual market values, since actual transaction values in the market comprise both land and buildings. However, it should be noted that the literature has emphasized the efficiency-enhancing properties of taxing only land since land is the only truly immobile tax base. Few countries, however, tax only land while a few tax land and buildings differently.[45]

167. With regard to valuation of property, the spectrum of methods covers fairly simple area-based or square meter-based methods, over use of rental values, to pure market-value based methods. The use of rental values generally reflects only the present—and not necessarily the alternative best—uses of property. A sound property tax system relies on a valuation method that secures a buoyant base which increases in line with actual market values and growth in the economy. This in turn requires a strong valuation method, but also regular valuation. There is broad agreement that a market value-based system is superior to an area-based (square meter) system as well as rental-based systems, with regard to both revenue buoyancy and equity. However, in many—particularly emerging and developing—countries, a value-based system may not be feasible because of the absence of a well-developed real estate market as well as administrative capabilities required to compile and apply market value information.

168. It is important that the guidelines used for determining property values be kept simple and transparent, based on clear guidelines to ensure consistent valuation methodology. It is also important, and consistent with developments in many countries, that technical valuation capacity be developed at the central level, including to facilitate in due course transition to a value-based property tax. Finally, to ensure values that are current, regularity of revaluations is necessary—the international norm being revaluations at least every five years, possibly with price indexation in the interim.

169. Tax exemptions, broadly consistent with international norms, should be applied. In particular, an exemption in the form of a basic zero-rated threshold for private residences would typically exclude a large share of the population with limited income and assets from the property tax, thereby reducing the administrative burden of the tax, while at the same time enhancing its progressivity and fairness.

170. For the Maldives, a property tax should, in the initial phase(s), rely on a simple area-based system. This could take the form of a flat m2 rate for land, much like the existing

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[45] Jamaica taxes only land values, while Denmark taxes land and buildings differently; see also discussion in Norregaard (2013) on the advantages and disadvantages of a pure land tax.

land rent tax in the tourism sector, which possibly could be *phased out with the introduction of the property tax*. The chosen m2 rate could possibly be differentiated depending on the location and nature of the land used. In a medium-term horizon, this system could be extended to include also buildings, while the long-term objective should be to move towards a market-value-based system. The authorities should seek technical assistance to develop a detailed road-map for the technical preparations and introduction of this reform.

E. Tax Administration Reforms Supporting a New Property Tax

171. As noted, the success of a property tax depends, in large measure, on the effectiveness of its administration. This includes in particular the following elements: comprehensive identification and 'capture' of all relevant properties in the tax register, based on extensive cooperation, information and data exchange between all relevant entities; preparation and upkeep of a fiscal cadaster for property taxes; development of the technical administrative 'infrastructure' and expertise for property valuation and regular re-valuation; and finally, effective collection of the tax.

172. Registration of property and the building of a modern, computerized fiscal cadaster is generally a very data-intensive process. It requires extensive cooperation on information and data exchange between all relevant entities that are involved (e.g., MOF, tax administration including its local offices, the ministry responsible for land management and urban planning, Ministry of Justice, possibly local governments, courts, statistical offices, Geographical Information System (GIS), etc.). The cadaster would as a minimum include the following information on each property: a description of the property; definition of its boundaries (with cadastral maps); ownership of the property; and the size of the lands and buildings. The process of building a fiscal cadaster could begin in the short term, and evolve over time. The process could, at least initially, rely on self-registration and self-appraisal by taxpayers, but these functions would, over time, be taken over by the administrative body responsible for the tax.

173. An effective appeals process is also important. A process should be provided that allows taxpayers to appeal if they find there is an error in the valuation of their property and/or in the calculation of the tax, including to allow for sufficient time for an appeal before the tax is due. The Maldives should develop a fair, transparent, and independent dispute resolution process for the property tax.

174. A property tax in the Maldives could initially be limited to the capital Male and tourist resorts on islands. But in the longer term, it should gradually be extended to the whole of the country. This should happen in tandem with gradual administrative improvements over time.

175. While *detailed* recommendations for *administration* of the property tax are outside the scope of this report, administrative measures will be essential to realize the full revenue potential of the property tax. Such measures, which are also important to secure the equity and efficiency or neutrality of the tax, should be implemented in parallel with the policy reforms laid out above. The key 'dimensions' in question are: (1) measures to secure comprehensive **registration** of property to raise the share of properties 'captured' in the tax cadaster; (2) measures to ensure proper **valuation** of property to broadly track market prices in the property market, including by regular updates to valuations; (3) measures to ensure strong **enforcement** of tax collection, including through audits and penalties for non-payment; and finally (4) efficient revenue **estimation capability**, including compilation of data to allow accurate simulations of revenue consequences of specific reform options. A challenge to progress along these 'dimensions' is that they typically require highly specialized technical expertise to plan and implement properly. On the other hand, there is ample international experience available on the nature and implementation of specific measures required to achieve these administrative goals. The Government should seek technical assistance to formulate a detailed roadmap for establishing an efficient property tax administration.

F. Property Transfer Taxes

176. Property transaction taxes are a prevalent revenue source in many countries. They are easy to administer and have high compliance rates because registration of legal ownership rights often depends on their payment. They are also a buoyant tax handle in an active property market. However, property transaction taxes have several adverse effects on markets. They reduce the turnover of property, thus 'thinning' the market and distorting the allocation of this component of capital. They also constitute an important element in the overall transaction costs of property, with a potentially adverse impact on registration of property. Furthermore, they may impose efficiency costs to the extent that their incidence falls on business inputs. Also, the strongly pro-cyclical nature of the tax makes it a volatile tax source, and it may adversely affect the mobility of labor making labor less willing to move in search of employment opportunities, further decreasing economic efficiency. From a compliance point of view, property transfer taxes create a strong incentive for collusion between buyers and sellers to *under-declare* the true market transaction price in order to reduce tax liabilities. Underreporting also makes the market prices reported from transactions less valuable as inputs in determining market values for a future recurrent property tax. For all these reasons, the Maldives should resist introduction of property transfer taxes.

Recommendations

177. The mission recommends for the longer-term a gradual and well-prepared move to a modern and comprehensive property tax preferably levied on the market value of property. This will require introducing a broader tax on most urban property based on market values. The recommendations made in this chapter may be summarized as follows:

Short to Medium Term

- Make a political decision whether or not to engage in a broad-based property tax reform.

- If a positive decision is made, set up a steering committee with representation from all relevant ministries and agencies to guide and monitor the reform process.

- Seek technical assistance to formulate a detailed multi-year roadmap and action plan for tax policy design and administrative reform, specifically aimed at:

    - Introducing a simple area-based m2 tax, initially for land only, and with a basic threshold
    - Limiting its coverage initially to the capital Male and tourist resorts
    - Establishing property registration for tax purposes
    - Establishing property valuation to track market developments
    - Supporting tax enforcement,
    - Improving estimation and simulation capabilities, and
    - Possibly phasing out the existing rent tax in the tourist sector.

- Start drafting a general property tax law in accordance with the recommendations provided above, and

Long Term

- Introduce the new property tax, and gradually move towards a market-value-based system that covers the whole of the country, when necessary administrative preparations are in place.

Appendix I. Design Issues with the EBITDA Rule

There are a number of design issues that need to be addressed with the implementation of an interest deduction limitation rule based on EBITDA. Further consideration needs to be given to some of these design issues. The main design issues are:

I. Meaning of interest.

II. The calculation of EBITDA.

III. The acceptable ratio

IV. The group ratio approach for MNEs.

V. The carry forward of excess interest expense and excess interest capacity.

Interest Expenditure

The rule in TR-2018/B64 applies to the gross interest expense of the taxpayer rather than the net interest expense (i.e. after reduction for interest income derived by the taxpayer). This is a departure from the BEPS Action 4 EBITDA recommendation, which allows a taxpayer's interest expense for a tax year to be fully deductible to the extent of the taxpayer's interest income for that year. The EBITDA limitation applies only if the taxpayer's interest expense exceeds their interest income (i.e. net interest expense). This will be important for non-bank financial institutions and money-lenders, which are not excluded from the operation of TR-2018/B64 (although insurance and leasing companies are excluded). TR-2018/B64 does not apply to banks as these are not subject to the BPT.

TR-2018/B64 includes a definition of "interest" that extends beyond the ordinary legal meaning of interest. In particular, the definition includes payments that are "economically equivalent to interest", although no guidance is given as to what is covered by this inclusion. For example, it may be limited to well recognized categories of interest-like amounts, such as bill discounts and payments of defaulted interest by guarantors; or it may be intended to cover amounts that are paid under hybrid financial instruments, such as dividends paid on redeemable preference shares. This needs to be clarified.

There are no definitions of "dividends" and "interest" in the BPTA and, therefore, these terms have their normal legal meaning for the general operation of the Act. This means, for example, that dividends paid under redeemable preference shares are treated as dividends under the normal operation of the BPTA. As such, they are already non-deductible to the company. If they are also treated as "interest" for the purposes TR-2018/B64, then this includes non-deductible amounts in the base against which the 30 percent limitation is applied.

It is also unclear how any interest that is denied a deduction as a result of the 6 percent ceiling on the interest rate is treated under TR-2018/B64. It appears that such interest is included in the amount of interest for the purposes of the rule. Again, this involves including amounts that are already non-deductible in the base against which the 30 percent limitation is applied.

Calculation of EBITDA

As stated above, EBITDA means earnings before interest, tax, depreciation, and amortization. EBITDA is a financial analytical tool designed to compare the profitability of companies after eliminating the effects of financing and accounting decisions (depreciation and amortization). Consequently, as a financial analytical tool, the components of the EBITDA calculation are based on the financial accounts of a company and, therefore, the reference to "earnings" is a reference to financial profit, and the references to "interest", "depreciation", and "amortization" are references to those respective amounts that are taken into account in calculating financial profit. Thus, as a financial analytical tool, EBITDA is calculated as the net profit of a company before tax with interest, depreciation, and amortization added back.

BEPS Action 4 proposed that the EBITDA calculation be based on a company's tax accounts rather than financial accounts. Consequently, in the tax context, the reference to "earnings" is a reference to taxable profit and this appears to be the meaning of "profit" in TR-2018/B64. The references to "depreciation" and "amortization" are to the depreciation and amortization tax deductions allowed for the relevant tax year. As the concept of EBITDA is being used to determine the amount of a taxpayer's deductible interest expense, the taxpayer's interest expense has to be ignored rather than added back, otherwise there will be circularity in the calculation.

There are several arguments provided in support of basing EBITDA on a taxpayer's tax accounts. First, it is considered simpler to use the tax accounts. Second, it reduces the risk of a taxpayer with a loss having to pay tax due to the disallowance of interest deductions. Third, if the tax accounts are used, it is more difficult to increase the limit on net interest deductions without also increasing the level of taxable profit.

The EBITDA calculation applies also when a taxpayer has a loss for a tax year. In this case, the starting point is the taxpayer's loss ignoring the interest expense. The amount of the loss is then reduced by the depreciation and amortization deductions.

EBITDA Ratio

The amount of a taxpayer's deductible interest expense for a tax year is limited to a fixed ratio of the taxpayer's EBITDA for the year. It is recommended in BEPS Action 4 that the ratio should be in the range of 10 percent – 30 percent. It was noted in the BEPS Action 4 Report that the following factors may support a ratio at the higher end of the range:

I. The country uses only the fixed EBITDA ratio with no group ratio rule (see below). This is the case under TR-2018/B64.

II. There is no carry forward of excess interest expense or excess debt capacity (see below). This is also the case under TR-2018/B64.

III. A country's interest rates are higher in comparison to those in other countries. The last recorded benchmark interest rate in the Maldives was 7 percent. This may be seen as high as compared to OECD countries.

IV. There are other limitations on interest deductibility to counter base erosion practices. As noted above, a limit of 6 percent on the interest rate continues to apply under the BPTA.

TR-2018/B64 initially set the EBITDA ratio at 25 percent. It is not clear how this was determined. The factors listed above could support a ratio at the top end of the range and this may explain why the ratio was subsequently increased to 30 percent.

It is noted that the same ratio applies to all taxpayers regardless of their business sector. This may distort economic activity as industries will have different risk profiles. While, for MNEs, this may be offset by the group ratio rule and the carry forward of excess debt capacity, these are not provided for in TR-2018/B64. This highlights the "blunt" nature of the EBITDA rule. This can be compared to the traditional thin capitalization rule under which the mandated debt-to-equity ratio operated as a safe harbor only with taxpayers having the option to demonstrate that, in their particular circumstances, the level of their debt capitalization was consistent with an arm's length debt capitalization.

It was suggested in BEPS Action 4 that a higher ratio (30 percent) could apply to small and medium businesses ("SMEs") as debt financing may be more expensive than for large businesses. TR-2018/B64 applied the same ratio to all business taxpayers - SMEs and large businesses. However, TR-2018/D68 not only increased the ratio to 30% but also provided an exception for SMEs. Given the current base erosion risks domestically because of the possible non-taxation of interest paid to owners of a company, consideration should be given to removing the exception for SMEs. The increase in the ratio to 30 percent should be sufficient relief for SMEs.

Group Ratio Rule

BEPS Action 4 suggests that countries may choose to support the fixed ratio rule with a group ratio rule for MNEs. The group ratio rule would apply only if the fixed ratio rule is exceeded. Under the group ratio rule, a taxpayer can deduct net interest expense up to the net *third party* interest/EBITDA ratio of the group based on the group's consolidated accounts. The group ratio rule takes account only of interest owed to unrelated parties (i.e., in-house debt is ignored). The advantage of the group ratio rule is that it recognizes that some MNEs may be highly leveraged with third party debt for non–tax (sector-specific) reasons.

While the fixed ratio rule is based on the taxpayer's tax accounts, the group ratio rule has to be based on the MNE's consolidated financial accounts. There may need to be further adjustments in calculating EBITDA on a group basis, such as the add back of impairment write downs. While the group ratio rule adds some flexibility for MNEs, it has not been included in TR-2018/B64. Properly implementing and enforcing the group ratio rule hinges on the resources and technical capacity of MIRA. As noted above, the absence of the group ratio rule may justify setting the ratio at 30 percent.

Carry Forward of Excess Interest Deductions and Excess Debt Capacity

If a taxpayer's net interest expense for a tax year exceeds the fixed ratio applied against the taxpayer's EBITDA amount, a deduction is disallowed for the excess interest. Under traditional thin capitalization rules, there is no carry forward of the excess interest expense. This reflects the fact that traditional thin capitalization rules are an anti-avoidance measure with the excess debt effectively treated the same as equity and the excess interest effectively treated the same as dividends. The same could apply under the EBITDA rule. However, as noted above, the application of the EBITDA rule is not confined to tax avoidance cases and operates as a general limitation on the deductibility of interest. For this reason, it was recommended in BEPS Action 4 that excess interest is carried forward under the same rules as apply to the carry forward of losses.

A more difficult issue is the carry forward of excess debt capacity for a tax year to the next tax year. Excess debt capacity arises for a tax year when the interest expense for the year is below the fixed ratio of EBITDA. The effect of the carry forward of excess debt capacity is to increase the amount of EBITDA in the following tax year.

TR-2018/B64 does not expressly provide for the carry forward of excess interest or excess debt capacity. However, it is understood that excess interest is carried forward. Presumably, the same carry forward period applies as for tax losses. As noted above, the absence of a carry forward rule for excess interest and excess debt capacity would justify a ratio at the high end of the BEPS Action 4 recommended range.

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