KPMG
Level 3
Credit House
Cuthbertson Street
Port Moresby

P O Box 507
Port Moresby
Papua New Guinea

Telephone +675 3212022
Fax +675 3212780
e-Mail pg-fmkpmgpng@kpmg.com.au

Confidential

To Sir Nagora Bogan, KBE
Papua New Guinea Tax Review Committee

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From Dick Nijdam, Jacob Lackenby - Taxation Services

Ref Tax Memo to PNG Tax Review Committee (15.05.14)

cc Colin Milligan

Comprehensive Fiscal Regime Review (Taxation and Non-Taxation) - 2013-2015

Sir Nagora Bogan,

Following the first Tax Consultation meeting conducted at the Crown Plaza Hotel on 24 April 2014 as moderated by Lady Aivu Tauvasa, we would like to present the following items for the Tax Review Committee's (hereafter Committee) consideration. These items are a preliminary view on possible changes to the current tax regime and are for discussion purposes only. We may add more items or topics at some later time during the review process, if appropriate, or may further expand on any of these items.

Please note that the items as set out below have not been provided to us by any of our clients nor have we been engaged by any of our clients to bring these items forward to your Committee. The points as set out below are our personal views of the possible changes of the fiscal regime in Papua New Guinea (PNG) only.

We bring the following items forward to your Committee.

1. **Income tax rates**

Papua New Guinea (PNG) has separate income tax rates for companies depending on whether a company is regarded as a tax resident or non-resident. The income tax rates are 30% for resident companies and 48% for non-resident companies.

Under application of a non-discrimination clause in a double taxation convention (DTC or income tax treaty), the above income tax rate for non-resident companies might not apply based on the policy position that foreign enterprises conducting business operations in PNG should not be taxed differently compared to resident companies. We refer for instance to the DTC between the Government of the Republic of Singapore and PNG in Article 24, paragraph 1: "The nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances and under the same conditions are of may be subjected".

A similar (but updated) non-discrimination clause (Article 24) is also included in the Model Tax Convention on Income and Capital as drafted by the Organisation for Economic Cooperation

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and Development (OECD) that is used by many States to come to a bilateral tax convention with another State. The non-discrimination clause is used broadly and is included in many DTC's.

The result of applying to a non-discrimination clause as defined above is that in general both resident companies and non-resident companies conducting business operations in PNG are subject to a similar income tax rate as to their derived profits, which is in PNG's situation an income tax rate of 30%.

We would separately like to highlight that other countries that historically had separate rates for income taxes to foreign enterprises conducting business operations in their country have moved to align rates for resident and non-resident companies e.g the People's Republic of China (PRC or China). Until 2008, although both resident companies and foreign enterprises were subject to a statutory rate of 33%, China effectively used different income tax rates for resident companies and foreign enterprises conducting business operations in China where foreign enterprises were taxed at a lower rate due to many preferences and tax holidays. This resulted into so-called round tripping and to inversion type of investment structures where some resident companies would export or retain their capital offshore in a foreign company to re-invest into China as a foreign enterprise. In an overall review of the income tax regime the different effective rates were abolished to come to one corporate income tax rate of 25%.

The current higher income tax rate of 48% for non-resident companies conducting business operations in PNG also can be regarded as a disincentive to invest into PNG due to the different income tax rate structure. The rate is also high compared to the average corporate income tax rates as applied by countries worldwide. The average rate of the basic central government statutory corporate income tax rate is 26.7% across the 34 member countries of the OECD. For your information, we refer to the following link : – Under C. Corporate and capital income taxes – Basic (non-targeted) corporate income tax rates: http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial

Some argue that the difference in rates is due to the dividend withholding tax that applies on the distribution of profits or retained earnings by a resident company to its foreign shareholders. By combining the income tax rate to resident companies of 30% with the dividend withholding tax rate of effectively 11.9% (=70*17%), this leads to an overall effective tax rate of 41.9% compared to the 48% that applies to non-resident companies conducting business operations in PNG.

This might be true from an economic perspective but the income tax and dividend withholding tax are borne by different tax payers, i.e. the income tax is due by the resident company whereas the dividend withholding tax is due by the foreign shareholder. Therefore, legally, these taxes are due by separate tax payers where the dividend withholding tax could become a tax credit to the foreign shareholder in its home country as well.

For the reasons set out above, we are of the view that the income tax rates for both resident companies and non-resident companies conducting business operations in PNG should be aligned and that different rates should no longer be applied.

Consequently, the foreign contractor withholding tax should also be reduced to 7.5% (from 12%) if the income tax rate to non-resident companies is being amended to 30%.

2. GST reduced rating

PNG applies two rates for supplies of goods and services, a zero-rate and regular 10% rate. Further, some transactions are exempt for GST purposes which limits the refund of underlying input GST.

GST is a “spending” tax that is paid or due upon supply of goods or services by registered taxpayers. The tax can be seen as a disproportionate tax as the tax is more burdensome to those taxpayers on lower incomes. For instance, the cost of a loaf of bread for a truck driver compared to a bank director is significantly higher relative to monthly income for the truck driver compared to the bank director. Therefore, the consumption tax is disproportionately borne by those least able to afford it.

In order to reduce or minimize the disproportionate aspects of the GST, the European Economic Community in its resolution (77/388/EEG) introduced a separate (reduced) rate (Article 12, par 4) and special scheme for small undertakings (Article 24, par 1) for the supply of specific goods or services. The reduced rate used by certain European countries applies to providing goods for some of the basic needs of persons including food items, items that are regarded important for cultural, political or social reasons like books and newspapers, and some health care items including certain medicines. Services that can be provided under the lower rate are mostly vocational services, like a barber and cleaning services.

While PNG’s economy is anticipated to continue growing in the near future and the possible disparity between rich and poor people becomes more evident in society, the introduction of a reduced GST rate for basic needs for the supply of goods and services could mitigate the implications of a disproportionate tax system.

We therefore suggest introducing a 3 or 4% GST rate as a separate bracket for the purposes as set out above.

3. Depreciation for accounting purposes

For the purposes of computing the depreciation allowance for plant for income tax purposes, a schedule of rates is being used. We understand that this schedule has not been updated regularly and in practice many organizations do not use the table correctly to calculate tax depreciation.

The depreciation allowance allows a percentage of depreciation on the underlying asset as determined based on its estimated effective life.

For accounting purposes, accounting depreciation is calculated based on an assets remaining economic life.

While the concepts behind accounting and tax depreciation may vary slightly, the underlying principle remains the same, that an asset's benefit is utilized over its expected life.

In practice we experience clients having a lot of issues keeping their tax Fixed Asset Register (FAR) up-to-date. The underlying reasons include:

- the tax FAR is only used to determine taxable profits in the annual income tax return or for financial reporting purposes;
- the schedule of rates are not regularly updated to reflect prevailing conditions, advancements in technology or other aspects that may require updating the schedule;
- The schedule of rates is outdated and very limited such that determining a rate for a "unique" asset is impractical.

We therefore suggest companies whose accounts are audited by a chartered accountant have an option to use the depreciation amounts as determined for accounting purposes, for preparing their income tax return. The requirements in PNG are generally such that the audited financial statements are required to be lodged together with the annual return with the Registrar of Companies (ROC).

Companies may also decide to use the schedule of rates instead (the default situation).

In practice, a number of organisations already align their tax and accounting depreciation schedules therefore this may represent a significant reduction in compliance costs for organisations.

Companies could also be allowed to use the depreciation for accounting purposes and in addition make adjustments where preferable depreciation for tax purposes is allowed. For instance, accelerated depreciation rates can still be obtained even where an election has been made to otherwise use their accounting depreciation rates for tax purposes.

4. Dividend income participation exemption system

A PNG resident company that received dividends is to include the dividends as taxable income and claim a rebate under Section 216 of the Income Tax Act 1959. Therefore, effectively the dividend income is not subject to taxation in PNG where the costs incurred in generating the income can be claimed as a tax deduction.

A similar outcome could be using a dividend income participation exemption system that exempts for instance 95% of the received dividends income. Because the dividends would be classified as exempt income, the related costs are not deductible. Only 5% of the dividend income and the pro-rate related costs will be subject to tax in PNG. Alternatively, 100% of the received dividend income could be categorized as exempt income and therefore all related costs are not deductible.

There is another aspect about the rebate system that could make the introduction of a dividend income exemption system more preferable.

Currently, under the rebate system, the rebate is claimable notwithstanding whether the underlying profits (that lead to the distribution of the dividends) have been subject to income tax in the source country. This will enable simple off-shoring of funds by PNG investors to generate a rate of return by investing in a company established in a country with low or no applicable income tax rates. The returns of the investments can subsequently be repatriated to PNG investors tax free – not being subject to income tax and dividend withholding tax in the source country, and effectively not being subject to income tax in PNG under the rebate system.

While the economy in PNG is potential growing in the near future and wealth is being generated, these types of structure might become more common. The dividend income participation exemption system could reduce the PNG tax base risk by requiring additional criteria that have to be met when claiming the exemption, like for instance:

a. The PNG resident company owns at least 5%[1] of the (nominal) share capital and/or voting rights in the subsidiary, or has invested a minimum amount of for instance PGK 2,000,000 in the subsidiary as capital investment;

b. The underlying profits that lead to the distribution of the dividends have been subject to income tax at a rate of at least 10% in the source country – which can be shown to the IRC by the underlying assessment as issued by the foreign tax office, and

c. Where sufficient evidence as required under b. above cannot be provided then the taxpayer can still claim the exemption if the dividends are stemming from profits generated by active (i.e. not passive) business operations in the foreign country in line with the business operations as conducted by the PNG resident company.

If the criteria as set out above are not met, then the dividends are subject to income tax in PNG and a tax credit can be offered for income tax paid on these profits in the source country, if any, to the extent that the taxes paid do not exceed the tax payable in PNG on these profits. The criteria as set out above should reduce passive investments by taxpayers in order to prevent possible tax minimization strategies.

The dividend income participation exemption only applies to dividend income and not capital gains on the disposal of the shareholding. It also can apply to both investments by resident companies in domestic and foreign shareholdings but does not apply to individual/resident shareholders in PNG.

Based on the above, we suggest that the introduction of a dividend income participation exemption system should be considered to replace the rebate system.

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[1] The prescribed percentage of shareholding could be determined in line with reporting requirements under the Securities Act. We refer to Part VII, Section 112 of the Securities Act for the definition of "prescribed percentage" and "substantial shareholder" and Section 113 of this Act in which the meaning of a "relevant interest" in a voting share is defined. We also refer to the Section 115 of the Act in which the substantial shareholder is required to notify the listed company, or upon changes of a relevant interest of a person in a listed company in accordance to Section 116 of the Act.

5. Dividend withholding tax system

Dividends derived from sources outside PNG by a resident company requires the resident company to account for dividend withholding tax to be withheld and paid to the IRC, which in practice is rarely understood by companies.

The introduction of a dividend income participation exemption might result in abolishing this system. The reason is that the underlying dividend income is exempt income for income tax purposes and therefore no withholding tax should be due on such income.

In addition, if the dividend income participation exemption is applicable, it should no longer be required to withhold dividend income withholding tax on distributions of dividends by PNG resident companies to its PNG shareholding company where this income qualifies as exempt income.

This will improve the cash-flow of the companies that otherwise would only be allowed to offset the incurred dividend withholding tax upon subsequent distribution of dividends to its shareholders under application of Section 189D of the Income Tax Act 1959. It also prevents having to reclaim dividend withholding tax from the IRC in certain instances.

The dividend income participation exemption does not impact Section 189B jo. 189D of the Income Tax Act 1959 as it only applies to companies. Hence, the dividend withholding tax obligation does still apply in these situations.

For listed companies in PNG, upon distribution of profits or retained earnings to its shareholders, withholding of dividend withholding tax is required unless the IRC has agreed that no withholding is required upon request of the PNG shareholding company where the latter qualifies for the application of the dividend income participation exemption.

The proposed amendments as set out above do not impact the current situation as to distributions of profits on capital account that are not subject to dividend withholding tax.

6. Training levy and double deduction for staff training costs

The Training levy return is not very effective in practice. This may be good news as this could mean that taxpayers are spending sufficiently on eligible training expenses in order to offset the taxable amount of training levy being 2% on the amount of the annual pay-roll less qualifying expenses. However, it also appears rather easy to generate qualifying expenses to reduce the taxable amount for training levy purposes.

For these reasons the training levy could be abolished. In order to promote taxpayers spending costs for training its (citizen) employees, PNG could consider expanding the double deduction scheme or introduction of a tax credit scheme for incurring eligible training expenses in the Income Tax Act 1959.

7. Tax benefits to SME's

Smaller and Medium sized enterprises (SMEs) often incur significant costs in setting up their business operations during the first years of existence. Therefore, any costs of compliance should be encouraged to stimulate this sector of the economy. In particular, the tax system could provide some of the following:

- Depreciation concessions (accelerated depreciation, pooling, immediate write-offs for low cost assets);
- Deductions for capital costs arising on establishment of businesses;
- Quarterly (or annual) lodgement obligations for salary or wages tax, business payments tax and GST;
- Lower income tax bracket(s) for taxable income to PGK 100,000 or PGK 200,000.

8. Substituted Accounting period for income tax purposes

Section 12A of the Income Tax Act 1959 allows taxpayers with the leave of the Commissioner General to adopt a substituted accounting period for income tax purposes instead of a fiscal year (i.e. calendar year).

The approval by the Commissioner General however might include a condition based on Section 12A(3) of the Income Tax Act 1959 that is generally regarded as "over-kill", as a result taxpayers might not adjust their fiscal year to a substituted accounting period. The aforementioned condition as stipulated in the Income Tax Act 1959 should therefore be amended.

9. Grouping for salary or wages tax and business payments tax

Given the increasing growth anticipated within PNG and the increasing complexity of business structures, the number of organizations with multiple subsidiaries is likely to increase. Compliance costs are also one of the key prohibiting factors of doing business in PNG.

To assist with organizations meeting their compliance obligations, companies who are in a subsidiary/parent relationship or are ultimately 100% owned by the same parent company may be eligible to form a group for the purpose of calculating and reporting salary or wages tax and business payments tax.

Practically, this will have the effect of minimizing compliance costs by requiring that a single monthly remittance can be lodged rather than multiple remittances.

10. Calculation of thin capitalization based on group net assets

Currently, the thin capitalization provisions apply to entities on a standalone basis. This prohibits and limits the ability of a group of companies to obtain overseas financing at a level that is fair to the group as a whole.

The equity of a group of companies would generally be comprised of the individual equity of the parent entity plus its subsidiaries, however thin capitalization requires that calculations be performed for individual entities. This can be problematic where a foreign loan agreement has been entered into and there are guarantees between related parties.

One potential solution could be to permit the debt to equity test to be applied across an entire group while still requiring that a deduction be denied in the entity that holds the debt. This is a commercially realistic approach as in practice loans may be granted with reliance upon the support of other related parties which may not be appropriately reflected in financial statements for a standalone entity.

11. Future developments

Future developments for amending tax legislation could include:

a. Group consolidation for income tax purposes providing taxpayers the opportunity to lodge one income tax return for a group of PNG resident companies where it owns 100% of the shares in a subsidiary

b. Allowing taxpayers an option to add a percentage of assessable income or fixed amount to taxable income instead of adding-back actual non-deductible costs in accordance to Section 68(10-12) of the Income Tax Act 1959 (expenses as to entertainment etc.).

c. A specific income tax regime for shipping based on volume or weight of the loads in order to compute taxable income as an tax incentive to these companies. One might think of alternative income tax regimes for other economic sectors as well, for instance the agricultural sector.