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Palm Oil Industry Taxation Review

2014

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1. Introduction

This report has been prepared by PricewaterhouseCoopers Papua New Guinea (PwC) in consultation with, and on behalf of, New Britain Palm Oil Limited and the PNG Palm Oil Council. This submission deals with what we consider are potential barriers to growth and investment in agriculture in PNG and tax concessions that are required to facilitate investment in the industry.

The Terms of Reference of the Tax Review Committee is to assess and recommend to the government strategic measures, which will among other things:

- Align PNG's revenue system with its development aspirations of becoming a competitive middle income nation in the Asian century
- Improve the competitiveness and efficiency of PNG's taxation system to encourage investment, employment growth including overall economic development
- Consider options to change the tax mix between the levels of taxation on land (including resources), capital and labour
- Ensure that PNG's tax system remains fair, simple, user friendly and equitable
- Improve taxpayer compliance by considering options to enhance services to taxpayers and reduce the cost of compliance through the use of modern technology
- Ensure fees for non-tax revenues are appropriate, equitable and fair.

In recognition of the above terms of reference we request that The Tax Review Committee considers the matters we have raised in this submission.

The Income Tax Assessment Act currently contains tax concessions for primary producers and in our view it is critical these are retained and that no new taxes or increased taxes are imposed on the industry or the agriculture sector in general. We have also suggested some amendments to the Act that will benefit the industry, encourage investment and help address the Government's stated development goals. Agriculture is a key building block for PNG's development. It is a renewable industry that can serve to benefit the nation for many years to come.

2. Executive summary

Agriculture has traditionally accounted for approximately 25% of total GDP in PNG and statistics published by the National Statistics Office and estimates and projections released by the Department of Treasury indicate that the contribution of agriculture, forestry and fishing to total GDP was 27.9% in relation to the year ended 31 December 2012 although the contribution is projected to drop to in the region of 22% by the year ended 31 December 2018. The PNG palm oil industry has experienced significant growth since the 1970s representing in the region of 60% of the agricultural GDP between 1996 and 2005. Despite this growth there has been a decline in the development of the palm oil industry particularly in respect of capital investment. PNG has seen no new/green-field oil palm developments, which have resulted in actual palm oil production, since 1987. In our view this reflects the generally impeded growth and development in the country's agricultural sector. Production in some crops such as coffee and copra has in fact declined over recent decades.

A key reason for the lack of investment in the sector is the significant cost of doing business in PNG compared to other competing countries and particularly when compared to the major palm oil competitor jurisdictions in Indonesia and Malaysia. The lack of infrastructure development and maintenance in PNG, and high labour costs, and the very high costs associated with locally sourced goods and services, mean that PNG needs a competitive tax system to ensure investment funds are attracted to the country.

In this submission we have set out:

1. A summary of the existing tax concessions that are available to the agriculture /primary production industry and a discussion of why it is essential that these are retained.

2. A discussion of the proposed export duty to be imposed on unrefined palm oil and the impact this will have on the industry in PNG

3. A suggestion for enhancements to the current tax system that will benefit the industry

3. The agricultural sector

The agricultural sector accounts for approximately 25% of the GDP of PNG (source 2014 National Budget). Statistics published by the National Statistics Office and estimates and projections calculated by the Department of Treasury, as disclosed in the 2014 National Budget, indicate that the contribution of agriculture, forestry and fishing to total GDP was 27.9% in relation to the year ended 31 December 2012 although the contribution is projected to drop to in the region of 22% by the year ended 31 December 2018. In addition, beyond Papua New Guinea's urban areas agriculture remains the main economic activity and provides a subsistence livelihood for most Papua New Guineans.

We understand that in excess of 80% of the population (source, the New Agriculturist and the National Agriculture Development Plan) rely directly on agriculture to provide their basic needs. There are two sources of this information namely The New Agriculturist and the National Agriculture Development Plan. The New Agriculturist is an online journal which provides the latest news and developments in tropical agriculture and the source of the 80% statistic referred to above is an article which was published in March 2013. The National Agriculture Development Plan is a document published by the Ministry of Agriculture and Livestock.

The country benefits from hundreds of plantations producing coffee, copra, rubber, tea and palm oil which represent the main agricultural exports of the country. Agricultural exports make up in the region of 18% of the country's exports (source, the New Agriculturist).

During the 1970s there was rapid growth in the cash economy largely in response to the development of primary export industries. During the 1980s this growth continued at a steadier pace reflecting increased competition and some lower commodity prices. The agricultural sector was largely static in the early 1990s and has declined in more recent years. The agriculture sector's share of GDP declined from 27% to 17% between 1996 and 2005 although it is noted that palm oil accounted for 59% of the agricultural sector's contribution to GDP over this time demonstrating the importance of palm oil production in PNG. Palm oil contributed 59.4% of the value of the PNG agricultural exports in 2012 once again a significant and positive result (sources, the PNG Palm Oil Council).

Whilst there is huge agricultural potential, the lack of adequately maintained transport and other infrastructure represent significant barriers to the growth of the agricultural sector. The Government has previously estimated that 30% of PNG's land has moderate to very high agricultural potential but less than 4% is used for commercial agricultural production (source the New Agriculturist). Through the Papua New Guinea Development Strategic Plan 2010-2030 the Government has committed itself to developing road networks to link rural areas to trade hubs and improve extension services (sources the National Agriculture Development Plan).

The National Agricultural Development Plan (2007-2106) ("NADP") was formulated by the National Department of Agriculture to recognise the fact that over recent years estimated growth in the agricultural sector has been well below expectations. In the NADP it was recognised that PNG is an agricultural nation with huge potential and that the agricultural sector plays a significant role by providing broad-based income and employment to the vast majority of the population in the country; most of which lives in rural areas.

The NADP stated the following goals to assist in the development of the PNG agricultural sector:

- To stimulate growth and sustainable development of the agricultural sector
- To improve income and employment opportunities of the majority of the rural population
- To improve the capacity of institutions to generate technologies and extension services
- To increase government institutional support to agriculture

In recognition of these aims we believe that support is required from the Tax Review Committee via minor changes to the Income Taxes Act and continued access to the existing tax concessions.

There were several issues identified in the NADP as barriers to the development of the agricultural sector including:

- roads and transport infrastructure and communication
- law and order
- the PNG land tenure system
- government financing for agriculture
- natural resource management
- on shore processing
- marketing and promotion.

In particular we note that the NADP identified that onshore processing should be encouraged principally because of job creation and that value subtracting schemes which aim to penalise the grower through taxes, tariffs and other prohibitive practices which worsen the position of the primary producer must be discouraged. This issue is considered particularly relevant in relation to the PNG palm oil industry as discussed below in respect of the high tax costs of operating in PNG in comparison with the other major world producing palm oil countries.

The renewable nature of the agricultural sector

The agricultural sector has been a key industry in PNG for many years and its longevity should be a key factor to consider in any future tax planning. It is vitally important that the agricultural sector is made to flourish in PNG and it is considered that governmental support is required as a consequence of increased global competition; particularly in the palm oil industry, as indicated below. As discussed above the contribution of the agricultural sector to GDP is forecast to decline during the period to 31 December 2018 and in our view it is imperative that government support continues to be provided so that agriculture can provide a significant contribution to GDP in the future as has been the case over several previous decades.

4. The palm oil industry

The palm oil industry represents a significant area of growth and palm oil production has been increasing in a roughly linear fashion for the last 4 decades. From 1971 to 2013 palm oil production rose in PNG from 3,000 MT to 630,000 MT (source United States Department of Agriculture) and further growth can occur if some of the high tax and other costs of doing business in PNG are removed and additional industry incentives are introduced. It is worth pointing out that that growth in palm oil output in most country's that embrace this crop is exponential; this contrasts significantly with PNG.

We note that oil palm development is spread across six Provinces namely West New Britain, New Ireland, Milne Bay, Oro, Morobe and Madang Provinces. The private milling companies responsible for these developments have contributed to the oil palm industry as being recognised as one of the most vibrant and successful industries in the country. A special feature, which distinguishes the palm oil industry from other industries in PNG, is its full adoption of a nucleus enterprise model that directly engages local landowners in oil palm production and provides vital services such as health, education and road infrastructure, in addition to contributing significantly to provincial and national economies. It is the private milling companies that drive the industry and provide services to farmers Our client, New Britain Palm Oil Limited, is the largest oil palm plantation and milling operation in the country accounting for over 82% of production nationally.

Objectives specific to the oil palm industry, identified in the NADP, include the expansion of downstream processing.

Difficulties and costs of doing business in PNG

It is widely recognised that doing business in PNG presents difficulties and hurdles to overcome that many other countries do not experience and this represents a barrier to the growth of the palm oil industry and agricultural industries in general. Statistics released by the World Bank Group during 2014 rank PNG 113TH out of 189 economies with regard to the ease of doing business which represents a fall of five places from its 2013 ranking.

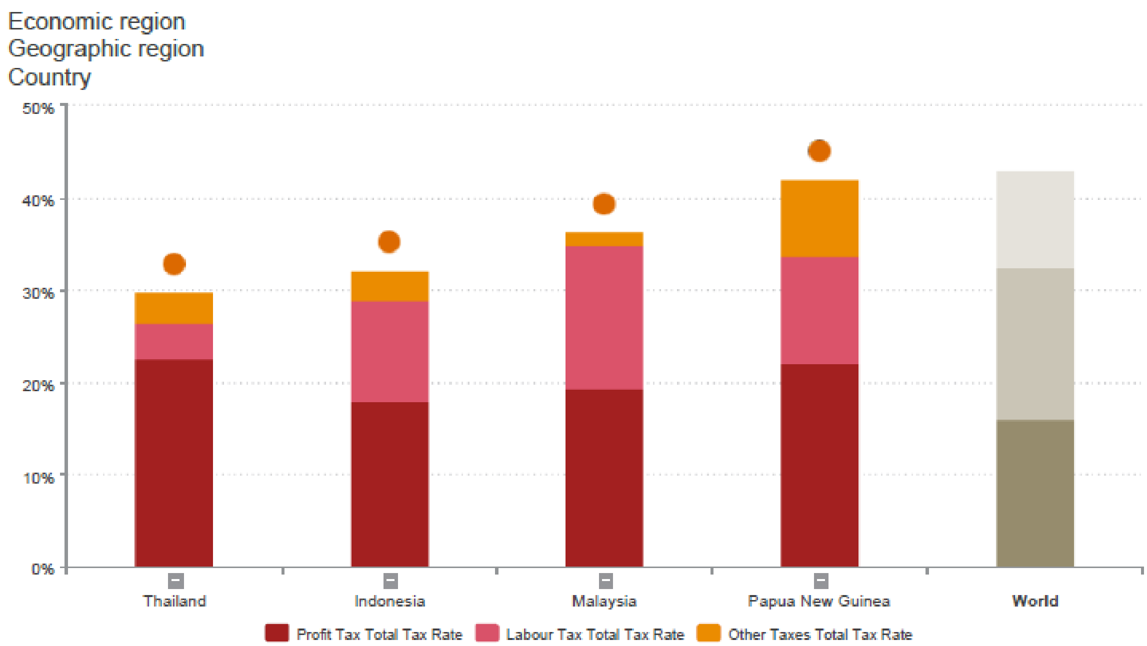
An important factor to note is the very high cost of doing business in PNG for the palm oil industry in comparison to competing countries in SE Asia. Comparatively higher costs include labour costs, costs of raising finance i.e. interest rates, costs of local sourced goods and services and extremely high transport costs.

It is noted that there are significant costs which restrict investment in PNG such as labour and transport. We note that Indonesia is the largest palm oil producer in the world, where their labour, transport costs and locally sourced goods and services are significantly lower. The poor state of infrastructure in PNG, and the country's terrain, means transport of palm oil via land is not possible. Consequently, sea transport is the only practical option. The cost of producing a tonne of palm oil in PNG is in excess of 30% more expensive than PNG, and the cost of building a palm oil processing mill is twice as expensive. The cost of shipping market-ready palm oil from NBPOL's refinery in Kimbe to Port Moresby is significantly more expensive than the cost for Indonesian refineries to ship their cheaper oil from Jakarta to Port Moresby! These issues together with some of the matters discussed below demonstrate the need for government to support the palm oil industry via tax concessions.

Tax rates

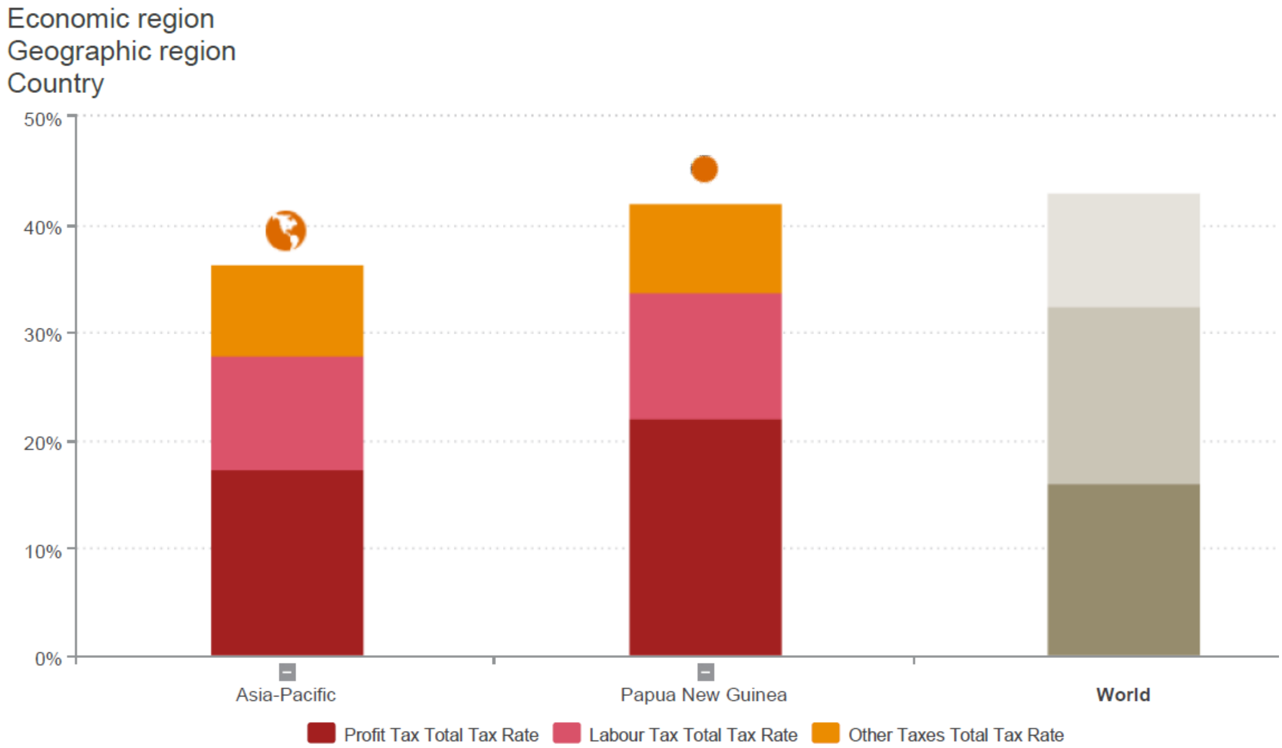
There is a higher tax cost associated with doing business in PNG in comparison to other countries in the world. In particular, there is a significantly higher total tax cost percentage for entities doing business in PNG in comparison to neighbouring Indonesia, which is the world's largest producer of palm oil. In addition, other major palm oil producing countries, such as Malaysia and Thailand, also have a lower total tax cost in comparison to PNG. The situation is demonstrated by the graph below.

The following graph shows that the total tax cost for PNG is 42.1%, which is notably higher than 29.8% for Thailand, 32.2% for Indonesia and 36.3% for Malaysia respectively.



Source: PwC Paying Taxes 2014 analysis

Whilst PNG's total tax cost of 42.1% is slightly lower than the average World rate of 43% the total tax cost for the Asia Pacific region is 36.4% (see below). The Asia Pacific region includes other countries that are considered to be comparable for these purposes due to their similar climates and working conditions, and owing to the fact that this region includes the major palm oil producers of the world.



Source: PwC Paying Taxes 2014 analysis

In recognition of the significant tax cost differentials referred to above we consider that it is imperative that existing tax concessions available to the agricultural sector are maintained and improved.

Decline in the development of the palm oil industry

Since a World Bank study in the 1960s, which recommended palm oil development for PNG, palm oil projects were established that decade; namely the Hoskins oil palm project (now New Britain Palm Oil Limited WNB) and the Bialla oil palm project (now Hargy Oil Palms Ltd). In the following two decades palm oil projects were established at Popondetta (1975), Mine Bay (1985) and New Ireland (1987). There have been no new/green-field palm oil developments established since the 1980s (oil palm developed at Ramu Agri Industries involved conversion of existing agricultural land). Growth of PNG's palm oil industry over the last two decades has largely been due to the expansion of existing developments. Despite the challenges, the value and quantity of palm oil exported from PNG has increased significantly over the last twenty years, despite high production costs and other constraints; this clearly demonstrates the significant contribution and huge potential palm oil offers to the PNG economy.

We note that New Britain Palm Oil Limited is active in exploring investment opportunities by preference in PNG, but also elsewhere in the World. The company operates 11 Crude Palm Oil (CPO) mills in PNG and has established refining and fractionation plants for down-stream processing at Kumbango in West New Britain. In 2010 NBPOL established a palm oil refinery in Liverpool to supply the UK market, which is traditionally where most of PNG's palm oil is shipped to. The Liverpool refinery is the world's first large-scale palm oil refinery dedicated processing solely segregated, identity preserved certified sustainable palm oil (CPSO). Incentives in PNG for capital investment would allow the company to explore many exciting and innovative development opportunities in-country that would have major economic benefits for the country. We also note that the palm oil industry is by far the largest employer in PNG after the government (sources PNG Palm Oil Council)

Major issues for sustainable palm oil production in PNG

During 2008 and 2009 a comprehensive stakeholder analysis was conducted as part of the PNG Oil Palm Research Association's strategic planning process. The main issues identified as affecting sustainable palm oil production in PNG over the next ten years were categorised as:

- Crop production and development
- Human resources availability
- Social stability
- Government
- Environmental issues
- Rural livelihoods
- Land access and availability
- Infrastructure

A list of the top ten ranked issues identified two notable categories which were poor state of infrastructure (including its development, support and maintenance) and the lack of government support at national and provincial levels. It was identified that that there was a need for appropriate government policies and regulation to assist sustainable palm oil development. The poor state of roads, bridges and communications was highlighted together with the need to better target public investment in infrastructure to support development.

5. Tax concessions

We refer below to some existing tax concessions available to the agricultural sector which it is important are maintained.

We have included some comments specifying highlighting the importance of these concessions to the palm oil industry.

EXISTING CONCESSIONS

Description	Comments
Accelerated depreciation *Section 73(7) and 73(9) of the Income Tax Assessment Act* 2 concessions that provide 100% write off for capital expenditure on plant and articles: • Manufacturing equipment - where plant or equipment, not previously used in PNG, with an effective life not exceeding five years is used in a manufacturing process and is installed ready for use a taxpayer may elect in any year to increase the amount of tax depreciation otherwise allowable in respect of the industrial plant by the lesser of: – the amount remaining after deducting from the taxpayer's income all other allowable deductions from that income – the sum ascertained at the end of the year of income of depreciated value of that plant • Primary production equipment - tax depreciation allowable as a deduction is available at a rate of 100% for new plant and equipment falling within various categories including property, being plant or articles used directly for the purposes of agricultural production.	It is likely that significant expenditure incurred in relation to the palm oil industry should qualify for an income tax deduction under either S73(7) ITA 1959 or S73(9) ITA 1959. This means that accelerated depreciation of up to 100% of the expenditure incurred may be claimable as an income tax deduction on the majority of plant and articles acquired during a particular year. It is considered important that these concessions are maintained to encourage continued investment in the palm oil industry and the agricultural sector which is a key Government objective as discussed above.
Section 97 of the Income Tax Assessment Act A 100% deduction is available for expenditure on land for use in primary production e.g.: • Eradication of pests • Destruction, removal of timber, scrub, undergrowth • Destruction of weeds etc. • Ploughing and grassing • Draining • Construction of dams, tanks etc. • Construction of roads and bridges	Companies operating in the palm oil industry should be able to benefit from significant income tax deductions on an annual basis and the continued availability of income tax relief under Section 97 of the Income Tax Act is considered to be important. It is stated in a March 2013 article published by The New Agriculturist that the Government estimates that 30 per cent of PNG's land has moderate to very high agricultural potential but less than 4 per cent is used for commercial agricultural production. As such this incentive for expenditure on land for primary production is considered to be important in an attempt to maximise land us for agricultural production.

Transfer deductions to shareholders *Section 97A of the Income Tax Assessment Act* A primary production company which has incurred primary production expenditure may relinquish, wholly or in part, deductions for expenditure in items 1 or 2, in favour of its shareholders. The amount of the loss surrendered to each shareholder is in proportion to the respective amounts of their paid up capital and the total deduction available to a shareholder may not exceed the total amount paid on their shares. A shareholder may waive their entitlement if they so wish.	This concession is considered valuable during years in which losses are incurred e.g. as a consequence of low commodity prices.
Agricultural extension services *Section 97B of the Income Tax Assessment Act* A 150% deduction is available for expenditure on extension services provided to smallholder primary producers including the provision of advice and training and technical assistance in relation to their primary production to assist growers with production, processing, packaging and marketing problems. To qualify the expenditure must be incurred under an Approved Agricultural Production Extension Services Plan.	It is noted that income tax relief is no longer available for research and development expenditure under Section 95 of the Income Tax Assessment Act and consequently it is considered that this concession should be maintained
Infrastructure tax credit scheme *Section 219C of the Income Tax Assessment Act* A tax credit is available to taxpayers engaged in primary production (amongst other industries). The credit operates by deeming relevant eligible expenditure to be tax paid by the taxpayer. The maximum amount of credit that can be claimed is limited to the lesser of the amount actually spent and, in the case of taxpayers engaged in primary production, the amount of tax payable or 1.5% of the assessable income for the year. If the taxpayer's expenditure for a particular year exceeds this limit the excess can be carried forward for a period of two years.	This is considered to be one of the most important tax concessions and is discussed in further detail below.
Tax holiday – Rural Development Incentive *Section 45I to 45M of the Income Tax Assessment Act Regulation 6AA of the Income Tax Regulations* This provides a ten year exemption from income tax where certain new businesses are established in specific (prescribed) rural development areas. Relevant businesses include agricultural production of any kind	This concession whilst useful for new businesses does not provide exemption from income tax for established companies in PNG

SUGGESTED TAX CONCESSIONS/CHANGES

Infrastructure tax credit scheme

We propose amendments to credits in respect of prescribed infrastructure projects under Section 219C ITA 1959 so that:

- a tax credit of up to 2% of assessable income derived in the year of income is available
- there is no limitation in relation to the amount of tax payable
- Where the 2% limit is exceeded the excess expenditure can be carry forward indefinitely as opposed to only for a period of two years or at least for a period of 20 years consistent with the special tax credit which was obtained in relation to the PNG LNG project.
- Grouping of tax credits so that excess expenditure incurred can be surrendered to other group companies to use as tax credits for offset against recipient companies' income tax liabilities for the year in which the expenditure is incurred by the surrendering company

We propose the above investments because we consider that the existing rules whereby there is a restriction of claimable tax credits to the amount of tax payable or 1.5% of assessable income represent a barrier to investment particularly in years of reduced profits or when losses are incurred. The volatility of world crude palm oil commodity prices over recent years has impacted upon the generation of profits and as such tax credits claimable for qualifying expenditure have not been significant. To ensure the long term growth of the PNG palm oil industry it is considered important that incentives for capital investment are available. We note above the terms of reference of the Tax Review Committee includes the encouragement of investment. In addition, we have highlighted above the need for government support for infrastructure projects (see sections on NADP and major issues for sustainable palm oil production in PNG) and an amendment to Section 219C ITA 1959 would be a way of assisting in this regard.

We consider that it is important to recognise how the infrastructure tax credit scheme works in the sense that it represents a mechanism by which expenditure can be incurred in the various provinces of PNG to the benefit of the public e.g. on roads, bridges, schools and hospitals. It is widely recognised that the provincial and National Governments have insufficient planning, engineering or construction capacity in isolated regions to undertake infrastructure developments. As the Governments do not invest heavily in public infrastructure there is usually a requirement for capital projects to provide their own infrastructure which includes significant costs on public infrastructure. Essentially the scheme allows developers to construct and maintain approved community infrastructure using their own funds and at the end of the financial year claim a tax credit for the value of work completed up to a prescribed limit.

We note that New Britain Palm Oil Limited is a member of a PNG subgroup of companies including Kula Palm Oil Limited, Ramu Agri Industries Limited and Poliamba Limited. As discussed above, we propose an amendment to the infrastructure tax credit scheme to allow the surrender of tax credits to other group companies so that they can be used for offset against the income tax liabilities of other group companies in the event that there is a restriction to the amount of claimable credits for the company incurring the qualifying expenditure e.g. due to the amount of income tax payable.

Group relief/taxation

It is noted that group relief/taxation is not available in PNG such that losses can be surrendered to other group companies for offset against taxable income. In our view this distorts decision making in the sense that investments are made by companies generating taxable income in a particular year as opposed to by entities in a loss making position. This could result in short term decision making restricting the growth of loss making companies for which continued investment could result in profits being generated for many years to come. We have discussed above the need for the agricultural sector to contribute to the PNG economy for many years in the future and in this regard long term strategies are considered to be important to encourage future growth and development of the palm oil industry and agriculture sector.

Carry back of losses

Losses cannot be carried back to previous years to reduce taxable income giving rise to refunds of income tax. The impact of an inability to carry back losses, coupled with the absence of group relief/taxation rules, is that in our view PNG is uncompetitive in comparison to other countries.

Many developed countries now allow tax losses to be carried back and/or offer some form of group consolidation, group loss transfer, consortium relief or combination thereof including Australia, France, Germany, Ireland, Malaysia and Singapore. It is noted above that Malaysia, the world's second biggest oil palm producer, has a higher tax cost than PNG and this fact coupled with the availability of loss transfer via group relief results its tax system being considered to be more competitive than that of PNG.

This inclusion of loss carry back and group taxation rules would represent a significant improvement of the cash flow position of companies in the PNG palm oil industry which in turn could result in future investment and growth for the industry. We should be grateful if the Tax Review Committee would review this issue with a view to amending the Income Tax Assessment Act so that group taxation and loss carry back rules are specifically available to the agricultural industry.

Export tax

We note that there are proposals for an export duty to be imposed on unrefined palm oil and in our view this will have a significant detrimental effect on the industry.

Export duties for palm oil have been under review by the world's two largest producers over recent years. In an article published in 2012 it was announced that Malaysia would reduce export duty on crude palm oil and it was stated by the Malaysian Ministry of Plantation Industries and Commodities that the cut will allow the Malaysian palm oil industry to compete with other exporting countries. The rate was reduced from 23% to a range from 4.5% to 8.5%. This reduction followed similar reductions in Indonesia whereby rats were cut to 10% and 13% (source, Bloomberg website). It should be noted that both Indonesia and Malaysia have large domestic markets for refined palm oil products; PNG does not and will not.

The introduction of export duty in Africa has resulted in a reduction in production and it is considered that the proposed export duty for PNG produced palm oil will have a similar impact with the result that a lower proportion of the world's palm oil will be produced in PNG. It is already the case that in the region of 85% of the palm oil in the world is produced by Indonesia and Malaysia, countries considered to have favourable tax systems, and consequently it is important that an export duty is not imposed in PNG. We have discussed above the high costs of doing business in PNG and we note that there are already high exports costs associated with palm oil e.g. transport.

Imposition of an export tax on palm oil would also be in contravention of the signed and ratified interim Economic Partnership Agreement (iEPA) with the EU (Article 10.).