Papua New Guinea Taxation Review

Issues Paper No.2: Corporate & International Taxation

Prepared by
the Taxation Review Committee

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FOREWORD

In 2013, the O'Neill-Dion Government committed to comprehensively review PNG's revenue regime with the main aim of ensuring that PNG's revenue regime remains relevant, efficient and effective.

Government revenue is critical to funding essential services and infrastructure for Papua New Guinea, to share the benefits of prosperity across families, communities and regions and to lay the foundations for future growth. Consequently, this Review is a high priority of the Government and an important platform of its economic and fiscal strategy.

The last comprehensive taxation review was undertaken in 2000. PNG has undergone substantial economic, fiscal and technological developments over the past 13 years, so it is timely that another review is done to ensure the country's tax system is modern, robust, is congruent with economic, social, technological and political changes, and is able to support the country's medium and long-term economic and social development objectives. While formally titled a 'Tax Review', the Review will, in fact, consider other sources of revenue, including non-taxation revenues.

This paper, the second in a series of Issues Papers to be released as part of the Review process and focusses on PNG's Corporate and International Tax regime.

PNG's Corporate and International tax regime is an integral part of PNG's overall tax system. Company taxes are an important source of revenue for PNG and serves as an important fiscal instrument to attract, stimulate, grow and retain capital and investments from international and domestic corporations. It will continue to be so in the years to come.

In addition, given its reliance on international investment, how PNG's tax system interacts with other tax systems and the international tax system more broadly, is important.

Recognising the mobility of international capital and the impact of taxation on investment decisions, PNG needs to ensure that it has a corporate tax system that is competitive and continues to attract the investment needed to support growth. This competitiveness is not simply a question of the rates and types of taxes, but also the stability and predictability of the regime.

At the same time, PNG needs to ensure it has the frameworks, and administrative capacity in place to protect the integrity of its corporate tax base. Countries around the world are increasingly recognizing the challenges that outdated international tax principles and the tax planning opportunities that this presents poses to corporate tax bases.

This Issues Paper considers a range of issues and potential areas of reform on the country's corporate and international tax regime. In doing so the Paper draws on a number of suggestions that have been put forward to the Review Committee during its 'Blue Sky' consultation process. This Paper provides an opportunity to further explore these and other issues, and to source reactions from stakeholders on the potential direction for reform in this important area of taxation.

The Committee wishes to thank those persons / organisations who have to date argued for areas of potential reform and looks forward to receiving submissions and comments on this Paper. The Committee welcomes future engagement with interested stakeholders on the future of Papua New Guinea's tax system.

Sir NagoraBogan, KBE

Chairman, Tax Review Committee

THE PAPUA NEW GUINEA TAX REVIEW

Tax Review Committee

The Government has appointed a Committee of 5 persons to undertake this Review. The Committee is comprised of the following distinguished Papua New Guineans, who collectively have significant experience in tax policy and administration, trade and business:

1. Sir Nagora Bogan (Chairman);
2. David Sode (Deputy Chairman);
3. Sir John Luke Crittin (Member);
4. John Lohberger (Member); and
5. Lady AivuTauvasa (Member).

The Committee formally commenced work on 1 September 2013 and has a timeline of 18 months. It will submit an initial report incorporating recommendations for the 2015 budget in October, 2014 with the final report incorporating medium to long term reform recommendations to the Government by April 2015.

The Committee is supported by a team of experts (Secretariat) whose role has been to provide technical and administrative support. The Secretariat is charged with conducting day-to-day activities of the Review, including research and analysis (drawing on international benchmarking standards and practices, global and regional trends in tax policy design and administration, and academic modelling), preparing papers and briefings for the Committee, drafting reports, and arranging and managing stakeholder consultations.

The Secretariat includes officers seconded from the Department of Treasury, Internal Revenue Commission (IRC), PNG Customs Service and the Department of Trade, Commerce and Industry. The Committee is also engaging international technical consultants and advisors as and where appropriate.

Objectives and Scope

The objectives of the Review are:

- To align PNG's revenue system with its development aspirations of being a competitive middle income nation in the Asian century;
- To realign the tax system to diversify the economic base by leveraging and strategically deploying windfall gains derived from non-renewable extractive sectors to support, stimulate and grow renewable and sustainable sectors such as agriculture, fisheries, tourism, forestry, added value processing, including growing and developing Small to Medium Enterprise (SME) sector.
- To improve the competitiveness and efficiency of PNG's tax system so as to attract capital and grow, retain and encourage investment, employment and economic development;
- To enhance the fairness and simplicity of PNG's taxation system;
- To recommend practical options to change PNG's tax mix between the levels of taxation on land (including resources), capital and labour;
- To improve taxpayer compliance including considering options to enhance services to taxpayers and reduce the cost of compliance through the use of modern and user friendly technology; and
- To review PNG's non-tax revenues with the aim of ensuring that fees are appropriate and fair.

The Review is broad and includes considerations of personal income tax (PIT) corporate income tax (CIT), excise and customs tariff arrangements, the goods and services tax (GST), mining and petroleum taxation, property and capital gains tax, non-tax revenue (including charges and levies), tax administration (including taxpayer compliance and the efficiency, simplicity, collection effort and protocols of PNG's tax administration), small business taxation and the advantages and disadvantages of tax incentives.

Consultation Process

The Committee is consulting widely with stakeholders. International experience shows that broad and effective consultation is critical to the proper, fair design, successful delivery, implementation and sustainability of any tax reform measures. The Review is being done through five (5) stages:

Step 1. 'Blue sky' consultation. In December 2013, the Committee (through newspaper advertisements) invited all interested parties to give the Committee, their perspectives on the broad directions for reform and key priority areas. The due date for submissions was 30 April 2014, which was later extended to mid-May 2014. To date some 44 submissions have been received. These submissions unless identified as confidential, are available for viewing via the Tax Review website (www.taxreview.gov.pg). Submissions provided as part of this consultation will help guide the direction of the Review, ensure that key areas of public interest are addressed plus will help build a consensus for the need for reform.

Step 2. Consultation on Issues Papers. The papers will cover specific taxation areas and issues identified above (this particular paper on CIT being the second). The purpose of this stage of consultation is to promote more targeted discussion and debate, to assist the Committee draft its recommendations. More issues papers will be released throughout 2014 and the first quarter of 2015.

Step 3. Tax Symposium. This symposium was jointly hosted by the Committee and the National Institute of Research (NRI) on 29-30 May, 2014 in Port Moresby. Various international and local tax experts were invited and presented technical papers in respect of major reform areas as per the terms of reference. Outcomes of the symposium provided an additional rich throve of reform options for consideration by the Committee and provided an additional repository of information and data for future reforms.

Step 4. Use of social media. The Committee also used the powerful tool of social media as a modern medium to generate informed dialogue and discussions on tax reform in Papua New Guinea. It hosted a web site with information on the work of the Committee and has a specific tax reform face book blog with over 1,500 followers. Matters of substance generated by the social media is also included for consideration by the committee.

Step 5. Consultation on Draft Final Report. The final stage of public consultation will focus on the Draft Final Report prepared by the Committee. The Draft Report will draw on the feedback gained from both previous stages of consultation which will be put forward for further discussion and eventually the Committee's evaluation of all relevant areas and aspects of taxation and non-tax revenue. All of the above combined, will help form the reform recommendations for the Government.

As part of the overall Review process, consultation has and will continue to include open forums in provincial centres. To date, open forums have been held in Lae, Kokopo, Madang and Port Moresby. Time constraints have prevented the Committee from visiting other provinces at this stage.

To ensure transparency, the Committee runs quarterly updates of its work through advertising in the print media and direct mailing to stakeholders.

Notices of regional forums are and will continue to be widely advertised in the Post Courier and The National newspapers so as to allow the public and relevant stakeholders to read more about the issues including the timetable of exchanges with the Committee and the Secretariat.

All submissions should be sent via mail and/or email to:

Head of Secretariat
Tax Review Secretariat
c/- Department of Treasury
PO Box 542, Waigani, NCD

Email: papers@taxreview.gov.pg

Submissions in response to this paper are due by 29 August 2014.

For any other general enquiries, email: info@taxreview.gov.pg

NOTE: To ensure there is transparency in the consultation process, all submissions are published on the Tax Review website (www.taxreview.gov.pg) unless the submission is by justification, marked '**CONFIDENTIAL**'.

EXECUTIVE SUMMARY

This paper includes a broad discussion on possible areas of reform to PNG's corporate and international tax system. The paper deals with a number of specific issues many of which have been raised with the committee through consultation mechanisms to date. However, the paper also deals with a series of high level structural considerations or themes including the following:

- What are the appropriate corporate tax rate settings that will allow PNG to remain an attractive destination for capital investment;
- What opportunities exist to improve administrative arrangements for large corporate entities operating in PNG that will improve certainty for business and the health of the tax system more broadly;
- Are PNG's corporate tax integrity settings sufficient to protect the country from base erosion and profit shifting, a topic currently receiving unprecedented international attention; and
- What are the opportunities for international collaboration? Is PNG getting the most out of international tax bodies and forums?

The paper's consideration of PNG's corporate tax rate also includes consideration of the higher non-resident rate applying in PNG, an issue raised by a number of industry representatives. The rate of (and in some cases the design of) the various withholding taxes are also discussed.

The administrative arrangements applying to PNG's larger corporate entities has been raised in many submissions. This paper seeks feedback on whether the country should move towards a self-assessment model as a means of simplifying the system both for taxpayers and the IRC. Similarly, options for simplifying depreciation arrangements are explored.

Feedback is also sought on PNG's international tax arrangement, including whether or not the country should be committed to a program of new treaty negotiations or redirect the focus of international collaboration to areas that may be of greater value to PNG. The paper identifies and seeks feedback on some of these opportunities.

The paper includes a discussion on sector specific issues, including the role that export taxes can play in the fisheries sector and other hard to tax sectors, this section is relevant to a number of the structural questions mentioned above, it can play a role in base broadening and enhancing integrity. Broader input on other sector specific taxation issues are also sought.

Many of the submissions made to date have raised the issue of training incentives in the law, discussion is included on whether the training levy should remain.

Finally, the paper includes a brief discussion on some of the other miscellaneous issues that have been raised in the course of the Review. Unfortunately, given the breadth of issues raised, it has not been possible to include all such issues in this paper. Nonetheless, the Committee will continue to consider all issues as part of its Review process.

Consultation questions

Below are the various consultation questions posed throughout the paper. They are intended to act as prompts only and stakeholders should feel free to raise any other related views/issues.

Corporate Tax Rates and Withholding Taxes

Question 3.1- are PNG's current corporate tax rates appropriate? Are they competitive? Is there a need to consider some change in the medium to long term?

Question 3.2 – if PNG were to seek to change the effective corporate tax rate in the future, would this be best achieved through altering the statutory rate?

Question 3.3 – does the higher non-resident corporate tax rate influence investment structures in PNG? Does it act as a deterrent to some foreign investment?

Question 3.4 - what are stakeholders' views on lowering the non-resident corporate tax rate? Should it be reduced to 42%? Are there arguments to support maintaining it at the current, higher rate?

Question 3.5 - in addition to international competitiveness arguments, are there any other reasons for PNG to consider reducing its withholding tax rates?

Question 3.6(a) – if the non-resident corporate rate was reduced, is there any reason that the foreign contractor withholding tax rate should continue to be determined on its current basis (a portion of the gross value of the contract, taxed at the non-resident corporate rate)?

Question 3.6(b) – if not, are there any other reasons why the rate should be reduced? Increased?

Question 3.7 – should the Commissioner-General's discretion to allow a foreign contractor to be assessed on an actual profits basis be replaced with a provision that operates as a matter of law (i.e. upon application) without the need for the Commissioner-General to exercise her discretion?

Question 3.8 – do you as stakeholders agree with the policy rationale underlying a management fee withholding tax? As stakeholders do you have any concerns about how the withholding tax has been implemented in PNG and what are those concerns?

Assessment and Collection of Corporate Income Tax

Question 4.1(a) – should PNG consider moving towards a self-assessment system? Is it appropriate for this to be limited to larger corporate taxpayers in the first instance?

Question 4.1(b) – how much of a priority is this for PNG?

Integrity Frameworks

Question 5.1 – do stakeholders consider that there is a need to update PNG's Transfer Pricing Rules? How much of a priority should this be?

Question 5.2 – do stakeholders agree that thin capitalization rules should extend to the finance sector with provision of a higher gearing ratio? What ratio might be appropriate in the PNG context?

Question 5.3 – does the current approach to the definition of 'interest', 'debt' and 'equity' in the ITA create any issues beyond the thin capitalisation rules?

Question 5.4 – is there a need for PNG to consider introducing any new integrity frameworks to better project its corporate tax base? What are stakeholders' views on the frameworks described below?

International Tax Agreements

Question 6.1– given the many and variety of challenges facing PNG's tax system, should negotiation of new DTAs be a priority?

Question 6.2 – do stakeholder's agree in principle to the need for PNG to review on a regular basis whether its existing treaty network continues to serve the country's interests?

Question 6.3 - given the resource cost of entering into double tax agreements should consideration be given to joining the Multilateral Convention on Mutual Administrative Assistance in Tax Matters?

Question 6.4 – should PNG pursue enhanced international engagement with other tax authorities including, for example, through membership of appropriate international tax forums?

Depreciation

Question 7.1(a) -what priority should be given to updating the depreciation schedule?

Question 7.1(b)–as part of efforts to update the effective life tables, should consideration be given to further simplifying the tables?

Question 7.1(c)– what do stakeholders think about other options to further streamline the depreciation regime in PNG (allowing the use of accounting depreciation rates or allowing self-assessment for low-risk companies).

Question 7.2 –how valuable, in terms of simplification, to a business would be enabling the immediate expensing of low value assets? What threshold would be appropriate?

Question 7.3 –do stakeholders agree that simplifying the tax system is of more importance in relation to smaller businesses?

Question 7.4 – does PNG need 'blackhole' expense rules or are existing administrative arrangements effective?

Question 7.5 – what value do the current depreciation concessions provide to taxpayers? Would stakeholders support removing such concessions in exchange for the broader simplification of the regime?

Question 7.6 – are there any other means of simplifying or improving PNG's depreciation regime?

Incentives to encourage training

Question 8.1 - what are stakeholder's views on the ongoing value of both the training levy and the double deduction for education? Should either/both features of the system be removed/retained?

Sector specific taxation issues

Question 9.1 - what are stakeholder's views about the role of export taxes? Do you agree that they can have a role as a revenue collection instrument in sectors where taxation collection is particularly challenging?

Question 9.2 - what are stakeholder's views on the current revenue arrangements applying to the fisheries sector? Is there a need to reconsider how the taxation system interacts with the fisheries sector? What impact would the reintroduction of an export tax on the fishing sector have?

Question 9.3 - what other sectors of the economy warrant consideration to be given to using alternative taxation instruments?

Other issues

Question 10.1 – do stakeholders support the introduction of foreign dividend account rules in PNG? How critical is such a regime in the short term given PNG's economic development?

Question 10.2 –what integrity issues would the introduction of such a regime raise for PNG? How might these issues be addressed? Is there merit in considering the implementation of such a regime alongside broader efforts to increase PNG's collaboration with other revenue authorities?

Question 10.3 – should PNG introduce a broader corporate transparency regime, following on from commitments to implement the Extractive Industries Transparency Initiative (EITI)? What issues could this raise?

Question 10.4– do stakeholders support the introduction of transfer of loss rules for members of wholly owned groups in PNG? How vital or useful is such a regime in the short term?

Question 10.5– what are the likely integrity issues if such a regime was introduced? How might these integrity issues be addressed?

Question 10.6 – what do stakeholders think about how the income tax law currently treats share buy-backs? Does the current system create uncertainty? How critical is the need to address this uncertainty in the short term?

Question 10.7– is there a need for the Review to reconsider expanding the current unit trust provisions in the law? What kind of issues could arise if this was done?

CHAPTER 1: OVERVIEW OF SECTOR

Companies and businesses that are subject to PNG's corporate and international tax regime come in many different sizes and operate across numerous industries and geographic borders. Issue Paper No. 1 released by the Committee already provides an overview of the Mining, LNG and Petroleum sectors (many of the companies in which will have an interest in the issues raised in this paper, as well as the natural resource specific issues that were the focus of Issues Paper No.1).

Data from the Investment Promotion Authority which is responsible for registering companies in PNG, indicates that there are some 42, 522 registered companies in the country. IRC data indicates that, of these, there are just under 2000 companies that pay CIT, with 70-80% of revenues paid by the largest 250 companies. This suggests that a significant proportion of companies are non-operative companies (shelf-companies), fully operational as a “going concern” but not compliant with their tax obligations, or (likely smaller companies) that are operating in the informal sector and therefore not engaged in the CIT system.

Small business taxation (and the taxation of the informal sector) will be addressed in a separate paper.

Corporate Tax Receipts are an important source of tax revenue for PNG, collecting some K2.06 billion[1] in 2013 and having increased significantly since 2003 (see Figure 1).

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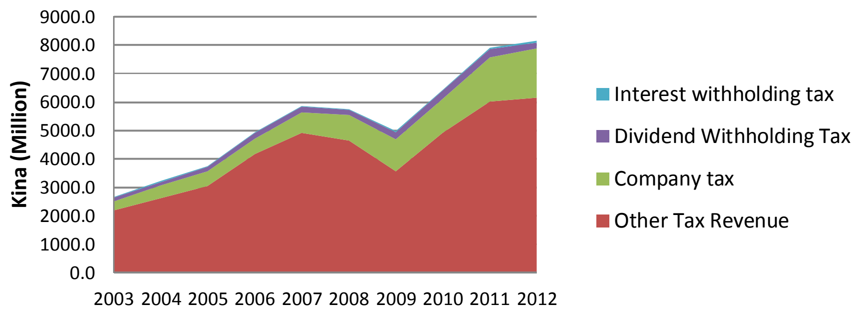
[1] This includes some Mining and Petroleum taxation payments

Figure 1: Corporate Tax Receipts (along with interest and dividend withholding tax receipts, over time

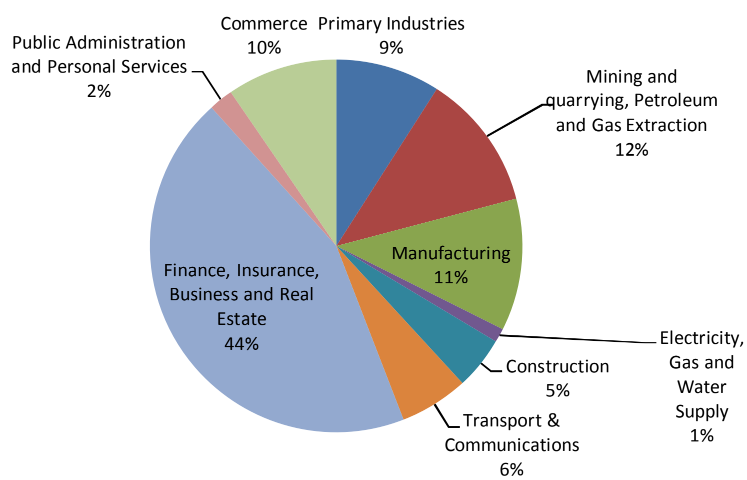


Source: Department of Treasury

Relative to developed countries PNG has a high reliance on corporate taxes, though this is broadly consistent with other developing countries.

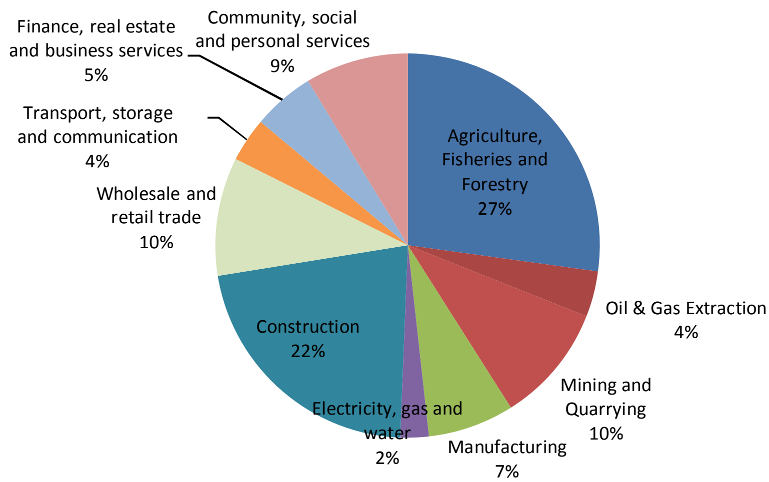
Figure 2 below demonstrates the sector breakdown of CIT receipts for 2013. For comparison, a breakdown of GDP by sector is also included at Figure 3.

Figure 2: Corporate Income Tax Receipts (2013), by sector



Source: IRC data

Figure 3: Breakdown of GDP by sector (2013, Estimates)



Source: Department of Treasury, 2014 Budget

Of note, the Finance, Insurance, Business and Real Estate Sector contributed almost half of all corporate income taxes. This is driven largely by the PNG banking sector which alone contributed just under K500m in 2013, a reflection of the profitability of the sector.

The primary industry/agriculture sector contributed only a small proportion of CIT despite being by far the largest sector in terms of its contribution to GDP (27%). This can in part be explained by the dominance of small, subsistence farmers. Furthermore, the low contribution to CIT can be also attributed to a wide range of tax concessions/incentives available to the sector. However, a number of larger companies do operate in the sector, including in the production and export of palm oil, coffee, cocoa, copra oil and other cash crops.

Larger operations are also a feature of the forestry and fisheries sector. Notably, the forestry sector is dominated by large scale logging companies operating in West New Britain, East New Britain, Western and Gulf provinces – with the sector largely export oriented with a particular focus on the Chinese, South Korean and Indian markets.

The fisheries sector, whilst again important to the subsistence economy, also included commercial fishing in the country's South Pacific fisheries zone and related canning and processing activities. As with forestry, this is an export oriented industry, with approximately 90% of production exported.

The construction sector has been a significant contributor to GDP growth in recent years, primarily a result of the construction phase of the PNG-LNG Project. Although construction activity has fallen with the end of the construction phase for the PNG-LNG Project, this is likely to be offset to some extent by construction activity in the lead up to PNG hosting the 2015 Pacific Games and other high impact infrastructure projects such as road construction, port projects and property development by the private sector.

The construction sector's contribution to CIT receipts, relative to its contribution to GDP, is reasonably low. This may reflect the relatively high costs of construction in PNG.

The manufacturing sector in PNG remains relatively small, contributing an estimated 7% to GDP in 2013 and minor amounts to exports. The manufacturing sector is dominated by the processing of natural resources into finished products, including petroleum products, food, beverages including alcohol, tobacco, wood and wood products. A smaller contribution to manufacturing is made by basic metal industries, fabricated metal products, machinery and equipment, chemicals and plastic products.

The wholesale and retail trade sector, consisting predominantly of outlets involved in the buying and selling of final consumer goods, contributed an estimated 10% to GDP in 2013 and a similar amount to CIT receipts. The industry experienced significant growth between 2009 and 2012, an indirect consequence of the PNG-LNG Project and the disposable incomes it brought to PNG.

The transportation, storage and communication sector principally comprises transportation and storage services relating to Papua New Guinea's minerals extraction and oil and gas activities, and includes fixed and mobile phones and other communications. The sector was expected to contribute around 4% to GDP in 2013 and a slightly higher proportion in terms of corporate income taxes.

The electricity, gas and water sector, principally comprising utilities provided to businesses and individuals in Papua New Guinea, is a relatively small proportion of the economy (predominantly state monopolies) and, accordingly, a small contributor to corporate tax receipts (1%).

Chapter 2: Overview of PNG's Corporate and International Tax Regime

Under Papua New Guinea's tax laws, companies are required to pay income tax and to withhold and remit tax on various payments made to other entities. Income tax is imposed on a company's taxable income. The general corporate tax rate in PNG is 30 per cent for resident companies and 48 per cent for non-resident companies. Special rates apply to petroleum and mining companies and are considered as part of Issues Paper 1.

A company is a resident of PNG if it is either registered in PNG, it carries on a business in PNG and has its central management and control in PNG or it carries on a business in PNG and its voting power is controlled by shareholders resident in PNG (Section 4(1) of the *Income Tax Assessment Act* 1959 (ITA)).

A company's taxable income is its assessable income less any allowable deductions (Section 4(1) ITA). Broadly, a company's assessable income is its gross income excluding any exempt income. The assessable income of a company which is a PNG resident includes income from all sources (within or outside of PNG), while the assessable income of a company which is not a PNG resident only includes PNG source income (Section 46 ITA).

A company's income tax liability is calculated by applying the relevant corporate tax rate (30 per cent or 48 per cent) to the company's taxable income (gross income less allowable tax deductions) and allowing for any credits.

Allowable deductions include expenses, other than capital expenditure, incurred in carrying on a business (Section 68 ITA). The cost of certain (depreciable) capital assets is deductible but the cost must be spread over the effective life of the asset (Division 3 of Part 111 ITA).

Business losses can be carried for up to 20 years but they cannot be carried back (Section 101 ITA) and the transfer of losses between group companies is not permitted.

The tax law contains a number of concessions available to companies. These concessions include enhanced/accelerated depreciation, rate reductions and in some cases tax exemptions. They can apply to a particular sector, range of activities or, in some cases, to a particular company or project. These concessions which reduce the tax which would otherwise be payable (or alter the timing of tax payments), are designed to provide incentives for particular industries or projects.

Dividends received by a PNG resident company are subject to a rebate on the portion of tax paid on the dividend, so that they are only subject to tax at the company level (Section 216 ITA)

To reduce the potential for double taxation on foreign source income, tax paid in the source country on such income is credited against any PNG tax payable in that income (Section 219 ITA).

Double tax agreements with a number of other countries also operate to relieve double taxation. Currently PNG has active double tax agreements with nine countries being Australia, Canada, China, Fiji, Korea, Malaysia, Singapore, New Zealand and the United Kingdom.

The law contains a number of integrity provisions to guard against the avoidance of PNG income tax. These provisions include deemed dividend rules (Section 144 ITA) transfer pricing rules (Division 15A ITA), thin capitalisation rules (Section 68AF) and general anti avoidance rules (Section 361 ITA).

Companies are required to withhold and remit tax on dividends, interest, royalties, management fees payments and foreign contractor payments. The relevant rates are contained in Table 1.

Table 1: Summary of PNG's withholding rates

	Standard	**Treaty**	**Mining**	**Petroleum**
Dividends paid by resident companies	17	10-15	10	0
Interest	15	10	15	15
Royalties paid to non-residents: - other than				

associates	10	10	10	10
- associates	30	15	30	30
Management fees to non-residents	17	0-10-15	17	17
Foreign contractors	12	0-12	12	12

The tax year for companies is generally the calendar year (i.e. January – December) though an application can be made for a substituted accounting period. PNG does not permit the filing of consolidated returns for groups of companies. PNG operates a provisional tax collection system, under which companies are required to make payments of estimated tax liability based on corporate tax in the prior year (adjusted for inflation) on 30 April, 31 July and 31 October each year.

CHAPTER 3: CORPORATE TAX RATES& WITHHOLDING TAXES

Overview

Under the Committee's terms of reference, a specific objective of the Review is to 'improve the competitiveness and efficiency of the tax system to encourage investment, savings, employment and economic development'.

Given that CIT is a major instrument for taxing non-resident investors, as a capital importing country it is important that PNG's CIT settings remain competitive within the region to promote investment and growth. Imposing high levels of taxation on 'mobile tax bases' may simply cause them to move overseas. Similarly, the existence of a CIT and the rate at which the tax is imposed can influence both:

- investment decisions, that is whether an investor invests in a jurisdiction or in a particular project within the jurisdiction – and therefore impact on economic activity in the jurisdiction; and

- profit shifting considerations whereby a multinational investor will consider how to minimise tax costs through decisions related to;

    - the business structure by which an investment is made and the financing (debt or equity) of that structure – which can impact on the amount of tax revenues received from any such investments in a particular jurisdiction; and

    - where to locate certain mobile functions, assets and risks.

For investment decisions, it is the average rather than the statutory (i.e. 30 per cent) rate of tax that is significant. The average rate takes into account not only the statutory or 'headline' rate but also other tax factors such as the presence of allowances and concessions. In PNG the average rate may be significantly lower than the statutory rate given the presence of incentives available to certain sectors of the economy.

The statutory rate is still important. Notably, it affects incentives to shift profits internationally. Once a business starts to earn income, multinational enterprises have the option through transfer pricing, thin capitalization and other devises, to locate the profit of their business. By shifting profits from jurisdictions like PNG to a jurisdiction elsewhere which has a lower tax rate, the after tax return of the multinational group can be maximized and conversely it's corporate tax is minimized.

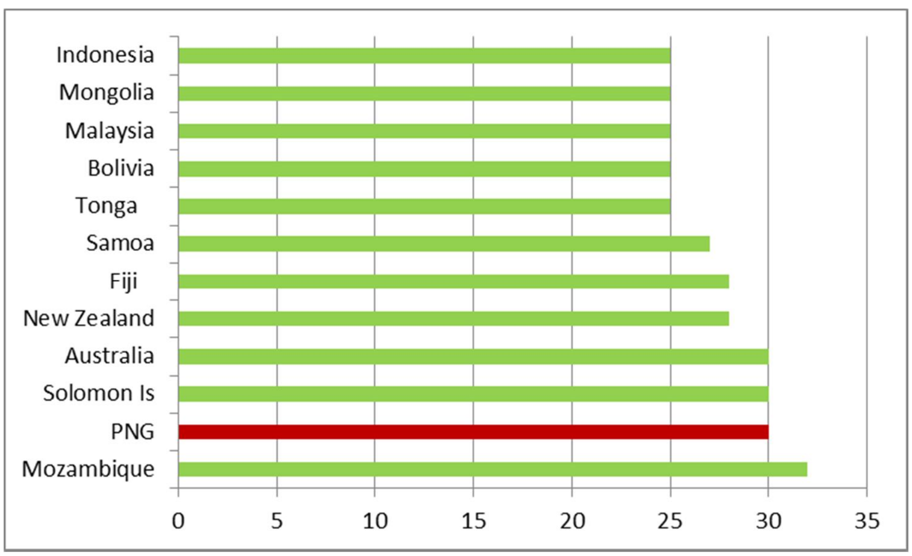
The statutory rate (resident companies)

As noted above, PNG has a statutory corporate tax rate of 30% for resident companies. As dividends paid by resident companies are subject to a withholding tax of 17% the effective tax rate on the distributed profits of profits of a resident company is 41.9%.

Given the need for PNG's corporate taxation system to remain competitive it is worth reflecting on how PNG's rates compare to other countries.

Figure 4 below shows PNG's statutory rate relative to a number of other regional and resource-rich countries.

Figure 4: 2013 Corporate income tax rates (in per cent)



PNG's company tax rate of 30 per cent is comparable to other countries in the region —although it is at the high end of the range. For example; Australia's statutory corporate tax rate is 30 per cent while New Zealand's is 28 per cent with both rates being higher than the OECD average which is around 25 per cent. As both countries have imputation systems the effective tax rate on distributed profits is, for resident shareholders, the shareholders marginal tax rate while for non-resident investors it is the corporate tax rate.

The regional emerging market economies of Indonesia and Malaysia have statutory corporate rates of 25 per cent. As Indonesia imposes withholding tax on dividends at 10 per cent for residents and at 20 per cent for a non-resident, the effective tax rate on distributed profits is, for resident shareholders, 32.5 per cent while for non-resident investors it is 40 per cent. As Malaysia does not impose tax on dividends the effective corporate tax rates for both residents and non-residents is 25 per cent.

Many Pacific island countries have lower statutory tax rates - Tonga, Samoa and Fiji have rates of 20, 27 and 28 per cent respectively. The Solomon Islands' rate is 30 per cent.

These comparisons with other countries suggests that there may be some pressure for PNG to lower its statutory corporate tax rate over time, especially if rates in other countries continue to decline. However, there does not appear to be a compelling need to reduce the rate in the short term. Indeed, the absence of a comprehensive resource rent tax in PNG (see Issues Paper 1) could mean that the relatively higher company tax is justified on the basis that the company tax base may be capturing some resource rents.

In addition, the results of a recent business survey into the key areas of reform sought by PNG business highlighted that reductions in the company tax rate is lower in the order of priorities than addressing law and order, corruption, and the need for more infrastructure[2]. It is also worth noting that, whilst the Review has received a range of submission recommending measures to improve the corporate tax regime, a reduction in the corporate rate has generally not been sought.

Question 3.1- are PNG's current corporate tax rates appropriate? Are they competitive? Is there a need to consider some change in the medium to long term?

[2] Institute of National Affairs & Asian Development Bank, *The Challenges of Doing Business in Papua New Guinea – An Analytical Summary of the 2012 Business Environment Survey*, May 2014.

Implementing a corporate tax rate change

If PNG were to reduce the tax rate applying to companies it would need to determine the best means of doing so. The most obvious means would be to reduce the statutory rate. However, this is not the only way.

Another option would be to reduce the tax on distributed profits through a reduction in the dividend withholding tax rate (a discussion on withholding rates more broadly is included below). However this would leave the effective rate of tax on a company's retained earnings unchanged and reduce any incentive in the current system for companies to retain earnings solely for tax purposes. Conversely if the reduction was implemented through a reduction in the company tax rate, the effective rate on both retained and distributed earnings would be reduced. In addition, the current incentive to retain earnings would be increased.

Another approach to implementing a reduction in effective rates of corporate rates would be through an imputation system. Under an imputation system dividends are included in a shareholders assessable income and a credit is allowed for any taxed paid by the company. An imputation system effectively taxes a shareholder on the same basis as if he or she had made the investment directly into the income earning activities of the company. An imputation system for taxing dividends, addresses the tax bias towards investing into a country through debt arrangements rather than through equity arrangement such as shares.

The 2000 Taxation Review did consider the merits of introducing an imputation system in PNG. However, it recommended against it given the complexity that it would entail and the potential for unforeseen consequences and possible revenue leakage. The current Tax Review Committee similarly sees little case to move towards an imputation system and notes that no submissions received to date have argued for this.[3]

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[3]Interestingly, Malaysia's single tier system for the taxation of corporate profits replaced an imputation system as it was considered that the imputation system was not able to accommodate increasingly sophisticated business transactions; the high compliance costs of maintaining the franking account; and contained the payment of dividends in cases where a company might have distributable profit and but could not frank the dividend because of insufficient credits. See:
http://www.hasil.gov.my/printext.php?kump=5&skum=1&posi=2&unit=5000&sequ=15&lgv=1

Question 3.2 – if PNG were to seek to change the effective corporate tax rate in the future, would this be best achieved through altering the statutory rate?

As corporate tax receipts make up a significant proportion of PNG's annual revenue collections any change will potentially require significant changes to the tax mix. This issue is not considered as part of this Paper, instead it will be better assessed as part of the final draft report in which a broader whole-of-tax system perspective will be examined.

Non-resident corporate tax rate

As mentioned above, the non-resident corporate tax rate is 48%. Having a different resident and non-resident corporate tax rate is not uncommon. It is an attempt to align the tax outcomes for companies operating in PNG either through a branch (i.e. as a non-resident company) or a subsidiary (i.e. as a resident company)[4].

The higher rate recognises that, for investment into a country through a subsidiary, the subsidiary will be taxed at both the subsidiary level (in PNG's case at 30%) and remaining profits then distributed to the offshore parent company will again be subject to dividend withholding tax (at the basic rate of 17% or lower depending on whether the company is in the mining & petroleum sector or subject to a double tax agreement).

A number of submissions to the Review have stated that the 48% rate appears to be a remnant of a time when the corporate tax rate was higher, at 35%. If the rationale for the different rates remains, it is argued, then the rate should be around 42%[5]. Other submissions have gone further and argued that having different rates at all is not justified and the distinction should be removed as has been done in other jurisdictions such as China.

Certainly the impact of the higher tax rate on inbound investments is uneven and, when taken together with the absence of a capital gains tax in PNG, is likely to be influencing the structure of such investments.

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[4] There are other systems of achieving this. For example in Indonesia this is achieved through a special tax on the branch structure (though this can significantly increase complexity)

[5] That is, a basic 30% rate and then 17% on the remaining income (i.e. 17% of 70% = 11.9%), which is 41.9%.

As illustrated in Table 2 below, the effective tax rates can vary significantly.

Table 2: Effective Tax Rates on Foreign Investment

Investment	Comment	Effective Tax Rate
Invests directly (e.g. through a local branch)	All profits are taxed, but there is no dividend to be paid to a parent company, because the branch is treated as a division of the foreign company.	48%
Sets up PNG subsidiary. Pays profits as dividends	Profits taxed at 30% and dividends paid after the 30% tax. Rate on dividends varies but standard rate is 17%.	41.9%
Sets up PNG subsidiary. Accumulates profits which are taken as a capital gain on sale of the business	Profits taxed at 30%, no tax payable on the capital gains	30%

Another argument against the higher non-resident corporate rate is that, at least for those companies that are resident in a jurisdiction that has a non-discrimination clause in a double tax agreement with PNG, the higher rate may not actually apply. As noted above, a higher rate may also increase incentives for multinationals to engage in profit shifting.

On the other hand, there may be sound policy reasons for retaining a higher rate and providing an incentive for investment to be undertaken through resident companies in PNG. From a tax perspective applying anti-profit shifting rules to branch-headquarter transactions is more complex than applying those rules to a subsidiary-parent relationship. This is because payments for intra-group services may be less detectable in the divisional accounting used by branches. However, if the policy goal is to encourage the establishment of resident companies, this may be better achieved directly through investment regulation.

Question 3.3 – does the higher non-resident corporate tax rate influence investment structures in PNG? Does it act as a deterrent to some foreign investment?

Question 3.4 - what are stakeholders views on lowering the non-resident corporate tax rate? Should it be reduced to 42%? Are there arguments to support maintaining it at the current, higher rate?

Withholding taxes

Withholding taxes are calculated by reference to the amount of the payment made. In PNG this applies to dividends, interest, royalties, management fees and foreign contractor payments[6]. As shown in Table 1 above, whilst PNG has standard rates for these withholding taxes they can vary, both under treaties and across sectors.

Broadly, withholding taxes play an important role in corporate tax collections. As they are relatively easy to administer, and given the challenges in administering tax integrity frameworks such as transfer pricing rules, relatively high withholding taxes can ensure some source country taxation on hard-to-tax subsidiary-parent transactions or transactions with foreign residents more broadly. The case for this was also made in Issues Paper 1.

In PNG, dividend and interest withholding taxes play a relatively important role in revenue collections, contributing K232m and K50m to revenue in 2013 respectively. Foreign Contractor Withholding Tax Payments have also increased significantly over time. However, the absence of a capital gains tax in PNG likely means that dividend withholding tax receipts are lower than they otherwise would be. This is because, in the absence of a CGT, there is an incentive to retain profits within a company and extract them upon the sale of the company/business.

The rates applying in PNG are not inconsistent with similar rates applying in the region. In addition, most OECD countries have rates applying between 10-30%. As noted above, however, if a decision is made to lower the effective

[6] Royalty withholding taxes are also considered in Issues Paper 1

corporate tax rate more broadly, one option would be to achieve this through reducing the rate applying to distributed profits – that is, by reducing the dividend withholding rate. Indeed, reducing the standard dividend withholding tax rate to 10% in line with the applicable rate in the mining sector was a recommendation of the 2000 Review. This was also proposed in one submission to the Review.

> *At a time of global capital mobility, the high dividend withholding tax rate should not create [an] unattractive and uncompetitive environment. Such barriers are potentially dangerous for a growing and developing economy trying to bring in much needed foreign investments.*[7]

As well as the impact on non-resident investors, changes to the dividend withholding tax rates would also affect resident investors. As a result of changes made in 2006, the dividend withholding tax is now a final tax for all investors, meaning resident Papua New Guineans pay a flat 17% on dividends received (and do not need to declare this income). A reduction in dividend withholding rates may encourage investment by Papua New Guineans into companies and, for private companies, it may reduce incentives for businesses to distribute profits from the business other than through dividends (for example, through 'employing' family in the business).

From an international competitiveness perspective, responses to the questions above will highlight whether or not stakeholders consider that PNG needs to change its corporate, and withholding tax systems in order to continue to attract international capital. However, the Committee is interested in obtaining broader views on other bases for reducing withholding taxes.

One option may be for PNG to consider aligning its withholding tax rates. There are no doubt historical reasons why PNG has ended up with such a variety of rates but aligning some/all of the rates may form a useful part of a broader simplification/harmonization effort. In addition, the current disparity between the dividend and interest withholding tax rates may be contributing to a preference for debt financing, at the same time as other aspects of PNG's tax system are trying to limit these preferences.

Question 3.5 - in addition to international competitiveness arguments, are there any other reasons that PNG should consider reducing its withholding tax rates?

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[7] See JAJ & Associates submission dated 30 April 2014, available from www.taxreview.gov.pg

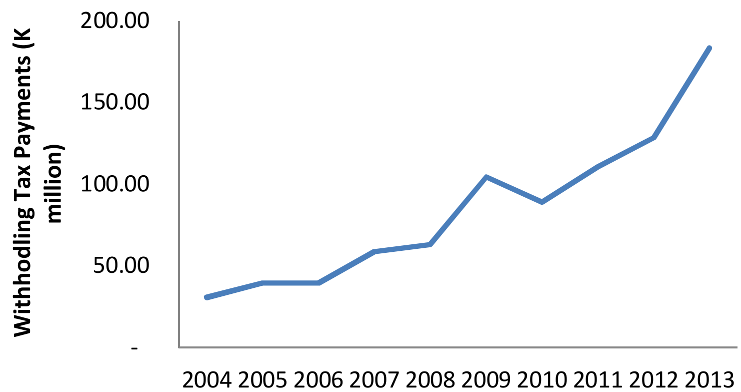
Foreign Contractor's Withholding Tax

Under Division 14A of the ITA, payments to non-residents engaged temporarily in PNG under contract are subject to a withholding tax. The withholding tax applies in relation to certain contractors working in the construction sector or certain professional service providers. The tax is levied on 25% of the gross value of the contract which is taxed at the non-resident rate of 48%. This gives an effective rate of 12%.

A non-resident contractor, with the express approval of the Commissioner General, may lodge an annual income tax return and be assessed on an actual net profit or loss basis (in this sense the withholding tax can be considered to be non-final). If approved, special deductibility rules may apply.

The withholding tax has become an increasingly important tax instrument over time. This is demonstrated in Figure 4 below.

Figure 4: Foreign Contractor Withholding Tax Payments over time (K, Million)



Source: IRC data

Such withholding taxes are not uncommon. They can be an effective mechanism to capture tax on source income earned by non-residents working in a country for a short period of time. The rates applying in other countries do vary, in part due to the design of the particular regime (notably, whether it is final or not).

As the rate is linked to the non-resident corporate tax rate, submissions to the Review have argued that any reduction in that rate should flow onto the foreign contractor rate. If this were the case then a reduction in the non-resident corporate tax rate to 42% would reduce the effective foreign contractor's withholding tax rate to 10.5%.

However there does not appear to be any compelling reason to retain the link between the non-resident corporate tax rate (and a portion of the gross value of the contract) and the withholding tax rate. Such a link appears to be unusual when compared to similar regimes overseas and is certainly unique to PNG's own withholding tax system. The key driver behind setting the rate should arguably be ensuring that it effectively balances its dual policy goal – of both collecting a fair portion of PNG sourced income in a manner that simplifies arrangements for both the IRC and taxpayers.

The Review understands that a significant portion of foreign contractors have the withholding tax applied as compared to applying to be assessed on an actual profits basis. This may suggest that the current rate gives an effective tax rate lower than would apply on assessment and/or that there are significant compliance cost savings associated with using the regime (though this will largely be dependent on the nature of the work).The Review has also had concerns raised by some businesses about what they see as a relatively low rate of foreign contractor withholding tax acting as a disincentive for foreign workers to be engaged in PNG as employees. This may suggest that, rather than lowing the rate, there may be a case for an increase. However, any such increase would need to factor in any flow-on costs for business.

Question 3.6(a) – if the non-resident corporate rate was reduced, is there any reason that the foreign contractor withholding tax rate should continue to be determined on its current basis (a portion of the gross value of the contract, taxed at the non-resident corporate rate)?

Question 3.6(b) –if not, are there any other reasons why the rate should be reduced? Increased?

Another issue raised in the course of the Review on the foreign contractor withholding tax, albeit unrelated to the rate itself, is the Commissioner-General's discretion to allow a foreign contractor to be assessed on an actual profit/loss basis. One submission has argued that, given the IRC's indication that it will generally exercise this discretion in favour of the taxpayer, the discretion should be removed and the provision should operate as a matter of law. That is, if a taxpayer applies in the income year before the contract commences, they should be able (as a matter of law) to be taxed on an actual profits basis. Under such a system, a withholding tax could continue to apply in relation to the payment to the foreign contractor, with the amount withheld creditable against the assessed amount.

Question 3.7 – should the Commissioner-General's discretion to allow a foreign contractor to be assessed on an actual profits basis be replaced with a provision that operates as a matter of law (i.e. upon application) without the need for the Commissioner-General to exercise her discretion?

Removing discretions in the law, where possible, would be necessary in any move towards a self-assessment system. This is explored further below in Chapter 4.

Management Fee Withholding Tax

The Committee is aware that there have been ongoing concerns about the scope of the Management Fee Withholding Tax. The Tax is payable on gross payments remitted overseas in respect of management fees (see Division 14C ITA).

As a result of changes made to the definition of "Management Fee" in the 2005 Budget it now extends to:

> *a payment of any kind to any person, other than to an employee of the person making the payment and other than in the way of royalty, in consideration for any services of a technical or managerial nature and includes payments for consultancy services, to the extent the Commissioner is satisfied those consultancy services are of a managerial nature* (section 4(1) ITA)

Of particular concern to some in Industry is the inclusion of 'technical fees' in the definition. This, it has been argued, has resulted in the withholding tax extending beyond its original policy intent.

Given these ongoing concerns, the Committee considers it worth reflecting on the policy intent of the framework and to seek further feedback from Industry on these issues.

As identified above, withholding taxes play an important role in the ability of a country to assert its source taxing rights, particularly given challenges in effectively administering complex integrity frameworks such as transfer pricing. This is equally true of the Management Fee Withholding Tax (2004).

First enacted in 1989, the Management Fee Withholding Tax was introduced as a means of curbing transfer pricing practices. Notably, the regime was introduced in response to the practice of certain businesses inflating 'management fee' payments to offshore related entities as a means of transferring profits to a lower taxing jurisdiction. In doing so, the PNG resident entity would also be eligible to deduct the relevant fee.

The changes made in 2005 extended this definition to include 'technical fees'. The Review understands that this was in response to concerns that fees were being re-characterised as such as a means of circumventing the existing withholding tax. However, the underlying policy intent, to assert source taxing rights in instances where there was a risk of transfer pricing activity between related entities, remained.

As the law currently stands, the regime only applies to "taxable management fees" as defined by sections 68AD and 155M. These sections have the effect of limiting the deductions available from the payment of such fees to associated entities (that is, these provisions do not apply and therefore the withholding tax does not apply in relation to payments that the Commissioner General is satisfied are not made to an associated). These provisions therefore act as an additional integrity measure, protecting against the transfer pricing between related entities.

Management fee and technical fee withholding taxes (these are not always combined as in PNG) are a feature of other tax regimes around the world (Singapore is one example). The Review understands that a similar policy rationale underlies such regimes.

Question 3.8 – do stakeholders agree with the policy rationale underlying a management fee withholding tax? Having regard to this, do stakeholders have ongoing concerns regarding how the withholding tax has been implemented in PNG?

CHAPTER 4: ASSESSMENT AND COLLECTION OF CORPORATE INCOME TAX

PNG's tax law supports a typical administrative assessment system of assessing tax liabilities where the tax authority (the IRC) examine tax returns lodged by taxpayers to calculate the amount of tax payable, and then notifies the taxpayers of the tax liability.

This system contrasts to a self-assessment system under which a taxpayers' returns are accepted at face value in the first instance and the Revenue Authority may subsequently verify the accuracy of the information in the return within a prescribed period after that initial assessment. A tax liability arises upon lodgement of the return, with payment of tax made thereafter within a specified time period.

After being first adopted by Canada and the United States in the early part of the 20th Century and by Japan in 1947, now over half of OECD member countries have adopted self-assessment for company income taxation[8]. Self-assessment systems have also been adopted, in whole or in part, by many developing countries including Sri Lanka, Pakistan, Bangladesh, Indonesia, Kenya, Zambia, Lesotho, Liberia, Malawi, Rwanda, Tanzania, and Zambia.

The move to self-assessment recognizes a number of limitations with an administrative assessment system including:

- they are resource intensive
- resource limitations mean that checks by the tax administration are often ineffective in detecting unreported income
- taxpayer education and assistance programs are often not well developed
- penaltiestend to be lower, and are often inconsistently applied or are open to negotiation
- less tax is collected overall because of insufficient focus on the highest revenue risks
- high level of disputes, often with each step in the dispute resolution

[8]International Monetary Fund, 2014, 'Managing Income Tax Compliance Through Self-Assessment', Working Paper WP 14/41, March 2014 available from: http://www.imf.org/external/pubs/ft/wp/2014/wp1441.pdf

process presenting an opportunity for taxpayers and tax officials to negotiate the tax liability.[9]

A self-assessment system is a recognition of the underlying reality that the tax authority will never be in a position to accurately determine the tax liability of each taxpayer. Rather, it is the taxpayer themselves, with assistance and guidance from the tax authority, that is in a better position to determine its own tax liabilities. Under a self-assessment system the role of the tax authority becomes that of an educator in helping the taxpayer to understand their obligations and, secondly, that of an auditor and enforcer to ensure returns are being lodged and in accordance with the law.

Whilst some countries have moved towards a universal self-assessment system (i.e. applying across all tax areas) other countries have introduced such a system on a limited basis (for example, for large taxpayers or in relation to CIT).

In PNG, there appears to be a strong case for moving towards such a system for the larger corporate taxpayers at least (the case is less clear for personal income tax, which is supported by a strong final withholding tax system in any event). Arguably, for larger corporates, especially those with professional tax advisers, the requirement for a notice of assessment to be issued before a liability to tax arisesdoes not appear to provide any benefits such as reducing compliance cost or providing certainty for the taxpayer, or increasing tax system integrity.

The 2000 Tax Review recommended the introduction of a self-assessment system for large taxpayers. Indeed, the Review understands that the IRC, through its administrative practices, has already begun to give effect to a partial self-assessment system (such as through expediting the assessment of certain larger corporate taxpayers).

Nonetheless, there is a broader policy question as to whether PNG's income tax laws should begin to give effect to a move towards self-assessment, at least initially for larger corporate taxpayers. In addition to changes in the law to ensure that a liability arises upon lodgment, the introduction of such a system is ordinarily accompanied by changes to interest, penalty and record keeping provisions in the law and often a private rulings system to provide certainty to

[9]IMF, 2014, p 11.

taxpayers. Discretions in the law, under which a taxpayer's liability is dependent upon the exercise of the Commissioner-General's discretion, may also need to be examined. Other conditions, which based on past experience have been seen to be a condition for the successful implementation of a self-assessment system (extracted from a recent IMF report), is at Attachment A.

Question 4.1(a) – should PNG consider moving towards a self-assessment system? Is it appropriate for this to be limited to larger corporate taxpayers in the first instance?

Question 4.1(b) – how much of a priority is this for PNG?

Chapter 5: Integrity Frameworks

Overview

As in other countries, PNG has frameworks in place to guard against the avoidance of PNG taxation including through non-compliance, payments made to associated persons, aggressive tax planning and international profit shifting. This is appropriate - as with many other developing countries, PNG has a proportionally high reliance on corporate tax receipts and erosion of those receipts through non-compliance or aggressive tax practices can have a significant impact on the country's revenue base.

PNG has a number of tax integrity frameworks also found in other jurisdictions. These include:

- deemed dividend rules (section 144 ITA), which are designed to prevent the avoidance of dividend withholding tax through distributing profits through payments other than dividend payments
- transfer pricing and thin capitalisation rules which are designed to address arrangements used to avoid PNG tax by shifting profits out of PNG to lower tax jurisdictions
- a general anti-avoidance rule (section 361 ITA), a broad provision which cancels the tax benefit from any arrangement which has the purpose of effect of avoiding tax

One of the overarching challenges with these frameworks is in effectively administering them. Typically there are issues in building the specialist expertise needed to implement the rules, practical challenges in obtaining information to identify high risk taxpayers and challenges in building arrangements to efficiently resolve disputes. Beyond the need to further build administrative capacity, the discussion below identifies some potential areas of reform.

Transfer Pricing

PNG's transfer pricing rules are contained in Division 15 of the ITA. The application of these rules (along with the thin capitalization rules) to the Mining and Petroleum sector was discussed in Issues Paper 1. However, whilst certainly relevant to that sector, they have broader application to multinational companies operating in other sectors in PNG and are therefore also considered as part of this paper.

Broadly, PNG's transfer pricing rules operate to address international profit shifting, by requiring that income and expenses from international transactions between related parties are determined on an arm's length basis.The application of the "arm's length" principle should result in prices being charged or paid for the supply or acquisition of goods and services, or assets of a capital nature, that would have been charged or paid between unrelated entities for comparable products under comparable circumstances.

Issues Paper No. 1 highlighted the urgent need for the IRC to undertake audits and risk assessments of mining and petroleum sector. This would extend to transfer pricing issues and the need goes beyond the mining and petroleum sector. Given that, since the release of that paper, the IRC has become a statutory authority, it may now be better placed to seek international expertise to assist it in this work (at least in the short term).

PNG's transfer pricing rules are based on Australia's transfer pricing provisions as they existed prior to amendments in 2012 and 2013. The reason for the amendments were that there were significant deficiencies in the repealed Australian legislation highlighted in a 2011 court case[10]. The problems included that the law was found to be transaction based, not allowing the court to look at the totality of arrangements existing between the related parties. The case also highlighted that the legislation differed in some respects from the transfer pricing rules contained in treaties, another undesirable inconsistency. The case also highlighted that the court did not need to have regard to international guidance material, the driver of international consistency in transfer pricing regimes around the world. The is an unprecedented level of international focus on increased collaboration between tax authorities in combating transfer pricing. The potential of these collaborations will be maximized where rules are internationally consistent.

Given the risk of similar deficiencies being found in the PNG Transfer Pricing rules, there appears to be a strong case for making similar updates to PNG's

[10]*F C of T vs SNF* : [2011] FCAFC 74

laws. The OECD has published simplified draft transfer pricing legislation for developing countries which could provide a useful model[11].

Question 5.1 – do stakeholders agree that there is a need to update PNG's Transfer Pricing Rules? How much of a priority should this be?

Thin Capitalisation

Thin capitalization refers to the practice of funding a branch or subsidiary with excessive amounts of debt rather than equity capital.

Overall the amount of debt that a businesses or entity can hold will be limited by commercial considerations including for example the need to manage solvency risks. However, in the case of a multinational company the financial position of the whole (multinational) group can be managed on a group basis, rather than at the subsidiary (local) level allowing the group to allocate debt to the various companies as it sees fit. In these situations, multinational groups are able to set up local subsidiaries with minimal capital and high levels of debt.

This allows the subsidiary to claim significant interest deductions and by in effect shifting the profit offshore allows the multinational group to minimise its worldwide tax. However, this reduces PNG tax paid on the income earned and activity undertaken in PNG. It may also have the effect of providing a competitive advantage for the multinational over domestic PNG companies.

The recently introduced thin capitalisation rules (section 68AF ITA) aim to ensure that PNG receives a fair share of tax from entities operating in PNG by disallowing interested deductions to the extent that the amount of debt held by a company exceeds 200 per cent of the company's equity (i.e. a gearing ratio of 2:1).

The thin capitalisation rules apply broadly. However they do not apply to the mining and petroleum industries (which are subject to separate rule that allow debt of 300 per cent of equity) nor to the finance sector (which includes banks or financial institution licensed under the Banks and Financial Institutions Act 2000) which are not subject to any limit.

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[11] *OECD Transfer Pricing legislation – A Suggested Approach*, June 2011

The Committee is currently considering submissions made in response to the suggestion that consideration be given to lowering the thin capitalization ratio applying to the mining and petroleum industry.

In addition to this possible area of reform, the fact that PNG's thin capitalization rules do not extend to the finance sector may be another area in which changes to PNG's existing rules could be considered. Notably, there is no reason why thin capitalization rules should not apply to the finance sector. However, it is common to apply more generous debt to equity limits – for example, in Australia financial entities can access a thin capitalisation safe harbour gearing ratio of up to 20:1.

Question 5.2 – do stakeholders agree that thin capitalization rules should extend to the finance sector with provision of a higher gearing ratio? What ratio might be appropriate in the PNG context?

Substance over form approach

Related to the introduction of the new thin capitalization rules, the Tax Review has been specifically requested to examine whether the substance over form approach in defining 'interest' (and indeed 'debt' and 'equity' more broadly) is appropriate for PNG.

As a consequence of the introduction of the general thin capitalization rules, definitions of 'debt', 'equity' and 'interest' were inserted into section 4 of the ITA (that is, they apply across the tax law, not just in relation to the thin capitalization provisions). The definitions took a substance over form approach - meaning, for tax purposes, a financing instrument is treated not by its legal form (for example, whether it is a share or not) but by its underlying economic substance. An example would be a preference share - a share that usually requires the regular payment of a set dividend amount. Although formally a 'share', the regular & set payments have the characteristic of interest and would be considered to be so in a substance over form approach.

As noted above, whether something is debt or equity is important from a tax purposes, both for the purposes of thin capitalisation and in determining whether a particular payment is deductible.

From a thin capitalisation perspective, a substance over form approach appears justified. Over time, international finance arrangements have increasingly made us of hybrid instruments (that is, instruments that have both a characteristic of debt and equity) there are countless international examples of these instruments being used to minimize or eliminate the imposition of tax on income in any jurisdiction. To avoid these instruments being used to facilitate excessive profit shifting through debt loading into a jurisdiction , an effective thin capitalisation is needed to look through the legal form of an arrangement to determine the actual level of debt financing for an operation.

It is arguable whether the same approach is needed across other areas of PNG's income tax laws. Whilst consistency would be preferred, an important consideration in PNG's context is the need to retain simple laws where ever possible. Beyond thin capitalization considerations hybrid instruments are frequently result in ‘double deductions’. Rules to counter the effectiveness of using hybrid instruments as tax planning tools is to be one of the first deliverables of the G20/OECD BEPS project. Implementation of these rules would counter cross border arbitrage but while ever there are both substance and legal form approaches to debt and equity the opportunity will remain for purely domestic arbitrage opportunities to occur. These considerations need to be balanced against arguments that a move away from a simple legal form approach (in which a share by name is treated as a share regardless of its economic substance) could create a level of complexity and uncertainty that may be unnecessary.

The Committee is seeking a broader view from stakeholders on the analysis above, in particular whether or not the broader application of the definitions of interest, equity and debt may unnecessarily contribute to the complexity of PNG's income tax laws.

Question 5.3 – does the current approach to the definition of 'interest', 'debt' and 'equity' create any issues beyond the thin capitalisation rules?

Other integrity rules

In addition to the existing integrity frameworks there is a question as to what other, if any, frameworks PNG could consider implementing to further strengthen the integrity of its corporate tax regime. As noted above, however, one of the key challenges facing PNG is effectively administering its existing frameworks and any consideration of introducing any newregime needs to be considered in that context.

A number of integrity frameworks applied in other jurisdictions are discussed below and feedback is sought from stakeholders as to their appropriateness in a PNG context.

Question 5.4 – is there a need for PNG to consider introducing any new integrity frameworks to better protect its corporate tax base? What are stakeholders' views on the frameworks described below?

Controlled Foreign Company rules

Controlled foreign company (CFC) rules, as with transfer pricing and thin capitalization, can be used to discourage the shifting of profits to low tax jurisdictions.

Whilst CFC rules differ from country to country, broadly speaking CFC rules are used to prevent a resident deferring the payment of tax through holding income offshore in a company controlled by the resident. Generally, such rules would require that the resident 'control' the foreign company, that the company is located in a 'low tax' jurisdiction (or a jurisdiction on a specific 'black list') and that the foreign company derives certain types of income (usually passive income so as not to disadvantage resident businesses making active investments in other countries). If caught by the regime then the 'tainted income' becomes taxable to the resident taxpayer.

Given their nature, CFC rules usually benefit those countries with strong outbound investment. In this way, they are arguably more relevant for developed rather than developing countries. Indeed, perhaps reflecting this, the Organisation for Economic Cooperation and Development (OECD), as part of its G20 endorsed Base Erosion and Profit Shifting (BEPS) Project, is examining ways of strengthening CFC rules.

At the same time, if PNG were to seek to position itself as a regional centre for companies, then CFC rules may become an important part of the broader tax integrity framework in the country.

Transactions with 'secrecy' jurisdictions

A number of countries around the world have implemented a range of other measure to address the concerns around transactions with so-called 'secrecy' jurisdictions, a term often used interchangeable with 'tax havens'. Whilst the definition of such jurisdictions varies, they are generally low or no tax jurisdictions with a regulatory environment that seeks to protect the anonymity of that taxpayers or enterprises using the jurisdiction as a means of minimising their overall tax burden.

Countries have implemented unilateral measures in their domestic law, predominantly aimed at addressing the reluctance of such jurisdictions to share information which might assist in identifying tax avoidance or evasion. Such measures include denying deductions for payments made to parties in that jurisdiction or imposing withholding taxes on certain 'risky' payments to those jurisdictions unless the genuine nature of those payments/deductions can be established.

Given that such measures are often implemented where another jurisdiction is unwilling to share information or to enter into an exchange of information agreement, such a regime for PNG may be best considered along with broader efforts to expand its exchange of information networks discussed in Chapter 6 below.[12]

Earning Stripping Rules

In recent times, a number of countries (including the US and Japan) have introduced earning stripping rules aimed at restricting deductions for interest payments exceeding some specified proportion of a company's income. Such rules are used to complement other related frameworks, such as thin capitalisation rules.

In a recent publication by the IMF, the IMF indicated that 'such measures are relatively easy to apply, and can be especially attractive for developing countries in protecting their tax base from base erosion[13].'

Minimum Tax

Another way that countries have sought to support the CIT base is through a minimum tax. Such a tax seeks to protectrevenue by charging tax on

[12] It is also worth noting that PNG already has in place an integrity mechanism to guard against the transfer of funds offshore to certain jurisdictions. The taxation certificate regime, found in sections 354A onwards requires a clearance certificate to be obtained from the Commissioner General where a large transfer of funds is proposed to certain listed jurisdictions.

[13] See International Monetary Fund, 2014, 'Spillovers in International Corporate Taxation', *IMF Policy Paper*, 9 May 2014.

something such as turnover, book earnings or assets that is less prone to manipulation than 'taxable income'. Over 30 countries have implemented such minimum tax regimes though they vary from country to country. Whilst they can add a significant level of complexity to a tax regime, they 'have proved both useful and practicable in protecting domestic tax bases, and might also be addressed to combating aggressive international tax planning in relation to inward investment.'[14]

Other options arising from the current International Focus on Base Erosion and Profit Shifting

There has been significant recent focus by the world's leading economies through the G20 group of countries to the challenges of base erosion and profit shifting (BEPS). Notably, countries have come to recognise that international tax principles first established in the 1920's have failed to keep up with changing, modern business practices. As well, there is increasing concern about the ability of multinational enterprises to take advantage of differences in domestic taxation rules to generate low or even no tax outcomes.

To address this, the G20 has committed to an OECD-led 15 point Action Plan to address BEPS. The Action Plan is broad and includes examining measures related to transfer pricing, CFC rules and interest deductions between related parties[15].

As a G20/OECD Project, the Action Plan is focussed around those areas that are of particular concern to developed countries (including the rise of the digital economy). Indeed, BEPS issues are likely to manifest quite differently in a country like PNG as compared to the world's leading economies. Nonetheless, for practical reasons, many aspects of PNG's corporate and international tax system are based on concepts and principles that apply broadly throughout the world and the significance of international investment to PNG's economy mean that many BEPS issues are still relevant to PNG.

In recognition of this, the Project has included some consideration of developing country issues and the G20's Development Working Group has

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14 See International Monetary Fund, 2014, 'Spillovers in International Corporate Taxation', *IMF Policy Paper*, 9 May 2014.

15 See OECD, 2013, *Action Plan on Base Erosion and Profit Shifting*, available at http://www.oecd.org/ctp/BEPSActionPlan.pdf

been asked to prepare a report to the G20 on BEPS issues confronting low income countries by the end of this year.

Outputs from each of the Action Items are expected to be completed over the next 18 months, with the first outputs due by the end of 2014. This paper does not consider each of those Action Item but notes only that, whilst many may not result in changes to the international tax system that could be of direct meaningful benefit to PNG (and other developing countries), some Action Items may be worth following.

Action Item 13, for example, which calls for a reexamination of transfer pricing documentation, is one area where a number of commentators have highlighted as potentially useful to developing countries. In particular, calls for the development of a standard template for 'country by country' reporting by MNEs (under which MNEs are required to report certain information on a country by country basis) could be of significant assistance to a country like PNG in more effectively administering its transfer pricing rules.

Action Item 15 also calls for the development of a multilateral instrument to assist countries in more readily amending their existing network of bilateral treaties to ensure that they better guard against BEPS (for example, better prevent treaty abuse). As discussed below in Chapter 6, if a decision is taken to review PNG's existing Treaties and subsequently amend them, doing so through a multilateral treaty arrangement may make such a process easier and quicker.

More generally, the international dialogue now under way on how developing countries can better address BEPS and related issues may help to inform both administrative and policy approaches in PNG going forward. Chapter 6 below includes a discussion on the benefits that PNG may have in greater engagement on international fora.

CHAPTER 6: INTERNATIONAL TAX AGREEMENTS

Overview

Double Tax Agreements (DTAs) are designed to eliminate the double taxation of investment across borders and in doing so facilitate investment. They seek to do this by allocating the taxing rights between 'source'and 'residence' countries (i.e. the country where the investment is going to and where it is coming from). Another common feature of DTAs is that they provide for cooperation between tax authorities, particularly in the area of exchanging information.

There has been a significant increase in the number of DTAs over the last 20 years, including those entered into by developing countries.

PNG has negotiated tax treaties with 12 other jurisdictions. However, 4 of those treaties are pending ratification (at the time of release of this Issues Paper the Review understands that that the agreement with New Zealand is close to ratification) and consequently are not yet in force. Treaties, currently in force are:

- Australia
- Canada
- China
- Fiji
- Malaysia
- Singapore
- Korea
- United Kingdom

Negotiating new double tax agreements

A policy issue confronting PNG is one regarding the approach it should take in negotiating new DTAs.

A number of submissions to the Review have argued for the need for PNG to negotiate more DTAs, highlighting both the advantages of increasing inward investment and for assisting those PNG entities investing offshore (notably, in connection with the Superannuation industry). Certainly, as noted above, DTAs can play an important role in providing certainty to investors and providing a more appealing investment environment.

However, whilst DTAsare effective in preventing double taxation, there are increasing concerns that they can also be used to give the unintended outcome of not taxing income in any jurisdiction – usually referred to as double 'non-taxation'. This is a growing concern of countries around the world and is being examined as part of the broader focus on BEPS by the OECD/G20. In particular efforts to develop rules for inclusion both in treaties and in domestic law to prevent treaty abuse should be closely followed in PNG[16].

In addition, whilst the primary purpose of a DTA is to relieve double taxation there is some question as to whether they are necessary for this purpose. Certainly PNG and investment partner countries provide 'juridical' double tax relief under their domestic laws(in PNG see section 219 ITA).

Similarly, in PNG's context, the value that the certainty that DTAs purport to provide in encouraging investment may be limited given the extensive use of fiscal stability clauses in natural resource agreements.More broadly, some commentators have questioned whether there is indeed any evidence to suggest that DTAs increase inbound investment to low income countries[17].

Finally, negotiating tax treaties can require significant resources. Given the tax administration challenges facing PNG, there is a very real question as to whether the negotiation of new tax treaties is a good use of existing resources.In addition, from a policy perspective, PNG may be better off focussing on ways to improve the quality and certainty of the tax system as a whole.

Question 6.1–given the many and variety of challenges facing PNG's tax system, should negotiation of new DTAs be a priority?

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[16] This is being considered as part of Action Item 6 and is scheduled to be completed by September 2014.

[17]One study concluded tax treaties may increase inbound investment to middle income - but not low income - developing countries: Neumayer, Eric, 2007, 'Do double taxation treaties increase foreign direct investment to developing countries? *Journal of Development Studies*, 43 (8). pp. 1501-1519.

Reviewing existing treaties

A related issue is whether or not PNG's existing DTA's continue to serve PNG's national interest. Given some of the concerns expressed above, there may be a very real question as to whether or not this is the case. This is an issue faced by a number of developing countries and is particularly so for resource rich countries. In Mongolia, for example, consideration was given to cancelling their entire network of DTAs because of concerns that mining companies were abusing the network through setting up intermediate companies in jurisdictions in order to take advantage of more favourable treatment accorded by a relevant treaty. This may also be an issue in PNG where withholding taxes can vary from treaty to treaty.

An outright abrogation of treaties is not, of course suggested and would not be looked on favorably by foreign investors. In addition to having the right policy settings, a predictable and stable tax regime is an important aspect of encouraging foreign investment. However, as a matter of good public policy, PNG should consider reviewing its existing treaty network on a regular basis to identify whether they remain in the country's best interest.

As a part of this process, PNG should follow international developments on preferred treaty practice, particularly given that its treaties, as with other countries, are based on international models produced by the UN and the OECD. As identified above, the current work being undertaken by the OECD/G20 should be followed closely by PNG, particularly given that two-thirds of PNG's bilateral treaty partners are currently engaged in that work. Given aspects of this will be concluded by the end of this year, the Committee will be in a position to identify any possible areas of reform as a consequence of that work.

In addition, it should be acknowledged that there may be broader political, non-economic motivations that may lead a country to sign a DTA. In that context, a review of the existing treaty network against the country's national interest could help inform the negotiation of any subsequent treaty.

Question 6.2 – do stakeholders agree that PNG needs to regularly review its treaty network to ensure that it continues to serve the country's interests?

Greater collaboration with other tax authorities

One of the benefits of DTAs is that they can facilitate greater collaboration between tax authorities, especially through providing the legal basis for exchanging taxpayer information. In a globalized economy, where taxpayers are increasingly operating across borders, collaboration is vital and can assist tax authorities to address offshore tax evasion.

DTAs are not the only basis upon which such collaboration can occur. These benefits could be obtained more efficiently by signing the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. If PNG were to sign this multilateral agreement, it would enable PNG to develop a network of information exchange with around 50 major countries, including all major trading and investment partners. The main advantage with the multilateral treaty is that it involves a once-only investment in ratifying the treaty.

An amendment to PNG's tax secrecy provisions may be required in order to facilitate the disclosure of information under the Multilateral Convention.

Question 6.3 - given the resource cost of entering into double tax agreements should PNG consider joining the Multilateral Convention on Mutual Administrative Assistance in Tax Matters?

Irrespective of whether PNG chooses to use bilateral or multilateral agreements some capacity to administer international tax arrangements needs to be developed.

PNG could consider increasing its engagement in international tax forums to further develop its networks for multilateral tax cooperation. The Global Forum on Transparency and Exchange of Information in Tax Matters is the largest such organization with over 121 members, including a number of developing countries. Any commitment by PNG regarding information exchange relationships with other jurisdictions could be complemented by engagement with the Global Forum which can provide support to countries with limited administrative capacity.

Question 6.4 – should PNG pursue enhanced international engagement with other tax authorities including, for example, through membership of appropriate international tax forums?

CHAPTER 7: DEPRECIATION

Overview

Expenses of a capital nature are not ordinarily immediately deductible (that is, deductible in the year in which an asset is purchased). This is because expenditure on capital items results in the creation of an asset. However for assets the value of which declines over time, tax systems generally allow a proportion of the value of an asset to be deducted annually over a period of time.

The rate at which an asset is depreciated generally follows the effective life of an asset – essentially the length of time the piece of equipment or asset can be used and still be cost effective. By basing depreciation on effective life, the tax system is trying not to distort decision making – that is, encouraging taxpayers to favour some assets over others because of the tax outcomes involved.

PNG's depreciation regime is set out in sections 73 to 84 of the ITA. Under this law, the Commissioner General has the power to prescribe the effective life of depreciable assets which are set out in the Schedule of Rates produced by the IRC. Assets can be depreciated using either the prime cost method (that is, the same deduction is available in each year) or the diminishing value method (the amount of the deduction decreases each successive year).

In addition to the standard regime, PNG has a number of depreciation based incentives.Notably the Income Tax Act also allows further accelerated depreciation (that is, an even greater proportion of the value of an asset to be deducted in the first year of use) for a certain class of assets. This class of assets is contained in section 73 of the Income Tax Act and are summarised in the table below:

Asset	Rate
A broad range of new capital assets/articles with an effective life of over 5 years relating to various sectors of the economy (e.g. manufacturing, transport, construction and real estate) – ss. 73(3) of the Income Tax Act.	An extra **20%** of the value of the asset can be depreciated in its first year of use.

New capital assets/articles used in the tourism industry	An extra **55%** of the value of the asset can be depreciated in its first year of use.
Expenditure on improving or extending fuel conservation plant or equipment.	An extra **20%** of the value of the expenditure can be depreciated in the year it is incurred.
Expenditure on converting an oil-fired plant to a non-oil fired plant.	An extra **30%** of the expenditure onthe conversion can be depreciated in the year it is incurred.
New non-oil fired plant	An extra **30%** of the value of the asset can be depreciated in its first year of use.
New industrial plant (that is, new plant or equipment used in manufacturing)	In any year, the taxpayer can elect to deduct the remaining depreciable value of the plant (so long as it does not exceed the taxpayer's income having accounted for all other deductions).
Property used in agricultural production	**100%** of the value of this can be deducted in its first year of use (that is, it can be immediately deducted)
Property used for fishing by residents engaged in commercial fishing	**100%** of the value of this can be deducted in its first year of use (that is, it can be immediately deducted)
Boats/ships and ancillary equipment used as dive boats by an accredited scuba diving/snorkelling operator	**100%** of the value of this can be deducted in its first year of use (that is, it can be immediately deducted)

The 2000 Review

The 2000 Tax Review Report also considered PNG's depreciation regime at the time, focusing on ways of simplifying it and thereby reducing compliance costs for taxpayers and the revenue administrator. The recommendations in that Report included:

- Allowing purchases of assets with a value of less than K1,000 to be immediately deductible;
- Allowing assets valued between K1,000 and K100,000 with the same depreciation rate to be pooled together and depreciated, effectively, as a single asset

This immediate expensing (for capital items under K1000) is available for mining, gas and petroleum projects (section 155I ITA). Limited pooling arrangements are also available for that sector (see subsection 155E ITA).

However such measures have not been made available more broadly.

Improving PNG's Depreciation Regime

A number of submissions received by the Review to date have again highlighted the depreciation regime as an area in need of reform.

Updating depreciation schedules

One area of concern raised in submissions is that the effective life schedules used to calculate the depreciation of assets are rarely updated. This can create challenges for businesses where the creation of new, or updating of existing technology can render the schedules incomplete or inaccurate. As an example of this the current schedule, whilst specifying the effective life of a radiogram (a piece of furniture that combines a radio and a record player that lost its popularity in the 1960s), the schedule does not list the effective life of a mobile phone.

A clear response to such concerns would be for a process to be instigated to bring the existing schedule up to date. As the schedule of depreciation rates is determined by the Commissioner-General of Taxation this would be a matter for the IRC, in consultation with Industry.Given the limited resources of the

IRC, there is however a question as to whether or not this should be a short term priority.

As part of this updating process, consideration could be given to simplifying the existing regime. Assets, for example, could be classified into three or four broad categories (e.g. grouping assets that last a long time such as buildings at one end, and assets with a short term life such as computers at the other end) with a single depreciation rate applying to each category.

Furthermore and more broadlyconsideration could be given to addressingsome of the challenges associated with updating the schedule on a regular basis and in a more systematic way. One submission to the Review, for example, suggested that, for companies audited by a chartered accountant, they could be given an option of utilising depreciation amounts as determined for accounting purposes. In aligning the accounting and tax treatment this, it is argued, would also reduce complexity for businesses.

A further option would be to put further impetus on businesses themselves to determine the effective life of assets themselves. The Review understands that currently, businesses can write to the Commissioner-General to argue for a change in the effective life in the schedule but a further step would be to allow taxpayers to make an assessment themselves of the effective life. Such an approach is, for example, used in Australia where businesses are able to make such a determination based on a range of criteria specified in the legislation.

This includes:

- how the taxpayer expects to use the asset;
- what rate of wear and tear the taxpayer expects from that use assuming the asset is maintained in reasonably good order and condition;
- how long the asset could, in these circumstances, be used to produce income;
- any proposal to scrap or abandon the asset that would otherwise cut short its use for income producing purposes; and
- any other relevant information such as manufacturer's specifications, independent engineering information and the taxpayer's particular experience with similar assets.

In making this self-assessment, the taxpayers would be expected to advise the IRC of the basis of their determination. Doing this would enable the IRC to identify whether or not any broader changes to the effective life schedule should be made.

One of the clear disadvantages of such an approach is that by giving such a discretion to the taxpayer, it may be open to abuse. Whilst specific anti-avoidance provisions could be included (allowing the Commissioner-General to require the use of the statutory effective life if the determination by the taxpayer is unreasonable, supported by penalties in more seriouscases) another option would be to limit such an approach to 'low risk' companies. For example, such a regime could form part of the broader self-assessment for larger companies discussed in Chapter 4.

Question 7.1(a) -what priority should be given to updating the depreciation schedule?

Question 7.1(b)–as part of efforts to update the effective life tables, should consideration be given to further simplifying the tables?

Question 7.1(c)–what do stakeholders think about other options to further streamline the depreciation regime in PNG (for example, allowing the use of accounting depreciation rates or allowing self-assessment for low-risk companies)?

Low value assets

As noted above, the ITA provides for the immediate expensing of assets valued under K1,000 for the mining, petroleum and gas sectors. Consideration could be given to extending this treatment across all sectors.

Whilst such an approach means that assets may not be depreciated in line with their effective life (potentially distorting investment decisions), such a move could be justified as a means of simplifying the affairs of taxpayers and ensuring consistency across the income tax laws. Whilst such a measure does not, in the long-run, change the ultimate tax liability of an entity, in bringing forward deductions it can have revenue implications in the short to medium term.

The Committee has also received a number of submissions arguing not only for an extension of the immediate write off to all sectors but an increase in that threshold. Thresholds of K5000 and K10000 have been recommended. Whilst undoubtedly further simplifying the affairs of taxpayers, such higher thresholds are significantly more concessional in nature, effectively providing accelerated depreciation for a much broader range of assets.

Question 7.2 –how valuable, in terms of simplification, to a business would be enabling the immediate expensing of low value assets? What threshold would be appropriate?

One option would be to apply a higher threshold to smaller businesses only. This could be justified on the basis that small businesses face a proportionally higher cost in complying with tax obligations. More detailed consideration of small businesses taxation issues will be undertaken through an Issues Paper to be released later in the year.

Question 7.3 –do stakeholders agree that simplifying the tax system is of more importance for smaller businesses?

Blackhole expenses

One submission to the Review has suggested that PNG introduce clear 'blackhole' expense rules. The lack of clear rules on such expenses in PNG's income tax laws, it is argued, reduces certainty and means that both the IRC and tax practitioners default to using Australian Tax Office rulings.

Broadly 'blackhole' expenses are capital expenses that are not otherwise deductible or depreciable (i.e. under the general rules). Common examples of such expenditure would include the cost of establishing a business or the costs of converting a business structure. Blackhole rules exist to some extent already for the Mining and Petroleum sector. Section 155D provides for the deduction of certain expenditures that would not otherwise be deductible (for example, the building of community facilities).

Australia does have 'blackhole' rules which allow such expenditure to be depreciated over 5 years (i.e. 20% per year).

Question 7.4 – does PNG need 'blackhole' expense rules or are existing administrative arrangements effective?

Other measures to simplify the depreciation regime

As well as the general depreciation regime described above, the Income Tax Act contains a number of depreciation incentives, or concessions. Many of these depreciation incentives would have been applied in response to a Government priority existing at the time of implementation.

Although the Committee will be considering the advantages and disadvantages of tax incentives as part of another Issues Paper, as part of broader efforts to simplify the existing depreciation regime (for example, updating and simplifying the schedules and enabling certain value of assets to be immediately written off) and in order to mitigate the revenue impact of this broader simplification effort, consideration could be given to removing these sector-sector depreciation concessions. Certainly feedback from consultations undertaken by the Review has revealed a broad lack of awareness of the incentives available, suggesting that they may not be being accessed by eligible taxpayers. Arguably, an overall simpler regime may be more readily understood and be of greater benefit to a broader range of taxpayers.

Such a move may ultimately allow consideration to be given to increasing the threshold under which low value assets could be immediately expensed.

Question 7.5 –what value do the current depreciation concessions provide to taxpayers? Would stakeholders support removing such concessions in exchange for a broader simplification of the regime?

Question 7.6 – are there any other means of simplifying or improving PNG's depreciation regime?

CHAPTER 8: INCENTIVES TO ENCOURAGE TRAINING

Overview

There are two features of PNG's tax system that are designed to encourage businesses to expend money on the training/upskilling of their employees.

The first of these is a training levy, imposed by Division 14D of the Income Tax Act and first introduced in 1990. It is a tax of 2% of the gross payroll of a business with a payroll over K200,000.

The training levy applies only if a business has spent less than 2% of its payroll on training or upskilling its staff. However the definition of a "qualifying training expense" is broad and includes the salaries of apprentices, the salaries of staff at approved training courses and the expenses of training staff at approved training courses. The amount of the levy is reduced by the amount of expenditure on approved training, so that once 2% of payroll is reached, no levy is payable.

The IRC has a role in approving training course, the payment to which qualifies as a "training expense" for the purposes of the levy.

The revenue collected under the training levy is limited, amounting to K6.4 million in 2013 (or .09% of total revenue). However, it should be acknowledged that the underlying policy intent of the measure is not to raise revenue.

Whilst the training levy can be seen as a disincentive for businesses not to invest in training, the double deduction available for staff training expenses can be seen as the incentive. Under section 72A, a double deduction (that is 200% of the value of the expenditure) is available for expenditure on the salary and wages of registered apprentices, the salary and wages of employees attending a Government Training Institute or other prescribed place of tertiary education, the salary and wages of full time training staff and also for tourism staff training costs.

Areas for reform

A number of submissions to the Review have queried the ongoing merits of the training levy and have called for it to be repealed. Whilst it is argued that the levy may have had a role in a different economic time in PNG, it is no longer needed as an incentive to encourage the skilling up of staff. One submission argued:

> *In the modern economic and business environment…employers are separately driven to undertake…training, to both remain competitive in their industry and to retain valued staff.*[18]

Similarly, submissions have also argued that the requirements of the levy are readily met by organisations or, in other cases, are simply ignored with limited enforcement action taken against them. Given the doubt as to whether the levy is achieving any, let alone its intended, policy outcome, it is argued that the administrative burden imposed on both taxpayers and the IRC should be dispensed with, with the removal of the levy.

Using tax incentives to encourage expenditure on training and education is not unique to PNG. Similar to PNG a number of countries have used tax instruments to this end (a combination of additional tax deductions and training levies). A recent report by the Canadian Policy Research Networks considered the effectiveness of various methods of encouraging employer-sponsored training (both tax and non-tax).

With respect to training levies, the report noted they do exist or have existed in various jurisdictions including Singapore, Malaysia, France, South Korea, Quebec (Canada) and Australia. The Australian levy (known more broadly as the Training Guarantee Scheme) was introduced at a similar time to the PNG scheme in the early 1990s but was soon repealed, thanks largely to the resistance of Australian small businesses[19]. The effect of the repeal of the regime was subsequently contested, some arguing that it reduced training and others suggesting it made little difference.

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[18] Deloitte, *Submission to the Tax Review*, 14 May 2014 (available at www.taxreview.gov.pg)

[19] Brisbois R., Pollack N. and Saunders R., 2009, 'Lessons from Other Countries Regarding Incentives for Employer-Sponsored Training', *Canadian Policy Research Networks Research Report*, March 2009, p. 19.

The Canadian report summarises a number of other papers that have examined the value of training levies. Those papers highlight a number of problems with the levy including:

- that the training would have been undertaken anyway, in the absence of the levy
- that it served only to highlight the cost of training, rather than to persuade firms that expenditure on training was a good investment
- firms may be reluctant to spend beyond the minimum required by the levy
- it does not influence the distribution of training between better and less-educated workers
- it had little impact on small and medium enterprises
- they may encourage inefficient and inappropriate training
- it may be of little benefit unless it coincides with adequate control of the quality of training (a broader issue for national skills investment)

The report ultimately notes that detailed evaluation of the effectiveness of training levies is rare.

In PNG, the level of informality in the small business sector probably suggests that many SME's that would otherwise exceed the K200,000 threshold in payroll and would otherwise be liable for the levy (and be able to claim the deduction) may, as a practical matter, be unaffected by both features of PNG's tax system. This may leave the training levy (and indeed the double deduction – which is only of value to entities engaged in the tax system) to apply to predominantly larger firms who may have an inherent commercial incentive to undertake training of their staff.

Overall, there is enough doubt over the success of similar regimes in other countries for PNG to reflect on whether both the levy and double deduction are effective in achieving their original policy intent. Certainly, since the levy was first introduced in 1990 the economic and business landscape of the country has changed. The training and up-skilling of employees has arguably become a more accepted practice of business in PNG, who have increasingly recognised the benefits of having a more skilled and effective workforce (that is, there are inherent commercial incentives for training staff).

If, for example, for some larger firms training would be undertaken anyway absent these provisions then the training levy and double deduction are simply imposing an administrative and revenue cost for little outcome.

In addition, if the value of the double deduction for staff training is that it provides an incentive for local firms to hire PNG workers over foreign workers, such a policy outcome may be better achieved directly through the immigration system.

Question 8.1 - what are stakeholder's views on the ongoing value of both the training levy and the double deduction for education? Should either/both features of the system be removed/retained?

One submission to the Review has argued for the expansion of the training levy and education double deduction provision to encourage companies to donate funds to training providers more generally (rather than focussing on the training their own employees).[20]This would be encouraged by allowing such expenditure to be subject to the double deduction provision and to count towards training levy calculations.

Such a measure would go beyond the original policy intent of the provisions and would see the tax system being used to fund broader training/education programs. Whilst encouraging greater spending on education should clearly be lauded, it is questionable whether the tax system is the best means of achieving this. Inevitably the need to introduce new rules and definitions into the law increases complexity, and the additional resources required to administer such regimes diverts scarce resources away from other activities. Moreover, such a program may be more readily and transparently funded by either the private sector (in order to train their own staff) or as part of a broader Government program involving direct funding rather than indirect funding through the taxation system.

[20] See RDL Management Consultant, *Submission to the Tax Review,* 7 March 2014 (available at www.taxreview.gov.pg).

CHAPTER 9: SECTOR SPECIFIC TAXATION ISSUES

Overview

The focus of this paper has been on the broad structure of PNG's corporate and international tax system. This is appropriate – to the extent possible, tax systems should apply consistently across different sectors as this helps to both remove economic distortions and simplify the system more broadly.

However, as was highlighted in Issues Paper 1 on the Mining and Petroleum taxation regime, given the unique characteristic of specific sectors of the economy, it may be appropriate to takea sector specific approach in considering some taxation issues.

Indeed, as with the Mining and Petroleum sector, in many ways PNG's existing tax system does take a sector by sector approach. This is achieved mainly through the grant of tax incentives either through the tax law or through specific agreements. 'Incentives' have the impact of either reducing the overall tax burden of a sector, part of a sector or, in some cases, a particular project or providing some other tax advantage (for example, accelerating the depreciation of assets as noted above). For example, a number of tax incentives are available for the tourism, agriculture and manufacturing sectors (in addition to the incentives available for the mining and petroleum sectors noted in Issues Paper 1).

The Review received a number of submissions and representations from individual companies or peak industry bodies many of which argue for either the retention of existing tax incentives available for certain sectors or the creation of new incentives. The Committee considers that these issues are best addressed as part of the broader tax incentives paper that will be released as part of the Review. However there are broader sector specific tax issues that are appropriately considered in this paper.

Use of Export Taxes

Another means by which the present PNG system takes a sector-specific approach is in addressing 'hard to tax' sectors. Such an approach, for example, has been taken in the forestry sector. Work undertaken as part of the 2000 Tax Review identified tax compliance concerns relating to that sector. It was noted, for example, that very little CIT had been paid by the leading logging companies that had been operating in PNG for some time. Notably, there were particular concerns around the use of transfer pricing as a means of limiting corporate tax payments.

In PNG, an export tax applies to the export of certain unprocessed logs. This tax is more readily enforceable than a CIT and, in PNG, its enforcement is supported by an independent monitoring company (SGS) that is responsible for monitoring export volumes. Whilst an export tax can be distortionary, given challenges in effectively collecting income taxes from the sector, it can play an important role in tax collections particularly in the face of significant compliance and enforcement challenges.

It is also worth noting that consideration is currently being given to the use of export taxes in the agricultural sector to encourage downstream processing as part of PNG's efforts to develop and grow its small and medium enterprises. This has been articulated in the Government's Draft SME Master Plan which calls for "the government [to] introduce export taxes for all Agriculture commodities that are currently being exported in their raw form to encourage downstream processing".

Whilst not a proposal of this Review, one submission to the Committee has raised concerns about such an approach. Representatives of the Palm Oil Industry have argued that such a move would reduce the competitiveness of an industry that already faces challenges competing with neighbouring palm oil producers of Indonesia and Malaysia. Another issue raised is that such an export tax could fall foul of Article 10 of the Interim Economic Partnership Agreement that PNG has signed with the European Commission.[21]Indeed, in

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[21]That Article provides that

Neither the EC Party nor the Pacific States may maintain or institute any duties, taxes or other fees and charges imposed on or in connection with the exportation of goods to the other Party, or any internal taxes, fees and charges on goods exported to the other Party that are in excess of those imposed on like products destined for internal sale, except:

(a) when these measures are necessary, in conjunction with domestic measures, for ensuring fiscal solvency of a Pacific State or for the protection of the environment; and

(b) in exceptional circumstances, where a Pacific State can justify specific protection to develop infant industries, that Pacific State may introduce temporary export taxes on alimited number of products destined for the EC market after mutual Agreement with the EC Party

recent years there has been some question as to the status of export taxes generally under current World Trade Organisation Rules although consensus now appears to be that they can be WTO compliant.[22]

The use of export taxes for wider economic purposes beyond raising revenue is not a new development. There may be a number of reasons, beyond raising revenue and even encouraging downstream processing, for utilising export taxes[23]. As suggested above, export taxation is part of a broader international trade debate currently underway that (as a generalization) sees developed countries reliant on the importation of raw materials pitted against many developing countries arguing for the continued use of export taxes as a legitimate economic policy tool.

It is not the intention of this Review to enter into this debate in detail other than in two respects. As a tax instrument, it needs to be recognized that export taxes can be distortionary and, depending on the rates that are set, can have significant impacts on the industry. The economic goal being pursued as part of the imposition of an export tax needs to be carefully weighed against this fact. Secondly, of more direct relevance to this Review, export taxes can (as is the case in PNG) play an important role as a revenue collection measure in sectors where traditional taxation instruments (including corporate income tax) are difficult to enforce, especially given limitations in tax administration.

Question 9.1 - what are stakeholder's views about the role of export taxes? Do you agree that they can and do have a role as a revenue collection instrument in sectors where taxation collection is particularly challenging?

Fisheries sector

Another significant sector in PNG where a different approach to revenue collection is required (and has been applied)is the fisheries sector.

As identified above, the fisheries sector is an important part of the PNG economy and has a potential that has yet to be fully realized[24]. Indeed, PNG's exclusive economic zonecontains some of the richest fishing grounds in the

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[22] See http://www.ictsd.org/bridges-news/bridges/news/wto-legal-status-and-evolving-practice-of-export-taxes

[23] For a history on the use of export taxes see www.twnside.org.sg/title2/par/Export_Taxes.doc

[24] National Fishers Authority website – www.fisheries.gov.pg

region. Of the various activities, tuna fisheries is the most significant and valuable. Estimates presented to the Review suggest that PNG contributes around 17% of the world's tuna catch with an estimated value of raw catch ofup to US$1.3 billion.

Whilst the sector is important to local markets and the subsistence economy, commercial fishing and exports (90% of catch) are significant. This largely involves foreign commercial fishing vessels operating in PNG waters as well as some processing activity onshore (canneries and loin plants).

For an industry long dominated by commercial foreign fishing vessels that often do not land on PNG's shores, there are challenges in putting in place appropriate revenue instruments to ensure sufficient return to PNG for its natural resource.

To date, a number of revenue arrangements have applied to the sector. At independence, PNG inherited a fisheries fiscal regime centredarounda baitfish royalty (at the time, 2.5% of the value of exports) and an export tax (5% of the value of tuna exports, excluding processed tuna). One of the challenges in administering such revenue arrangements is that they relied on the declared value of the catch which, given the nature of the industry, was difficult to confirm and open to abuse. Tax 'crime' in the fisheries sector remains a significant global issue today[25].

In response to integrity concerns (including transfer pricing), additional integrity measures were introduced and both the royalty and export taxes were increased. However, amidst concerns from industry about its viability a number of changes were made in 1995, including the removal of the export tax. Since then, the primary revenue instrument used in the fisheries sector have been the access fees charged under the Vessel Day Scheme –under which, broadly, a certain number of fishing days are prescribed and a fee paid for each day. The Review has been unable to confirm with the National Fisheries Authority (NFA) both the rate of the current fees or the receipts from access fees in recent years. However, in the 2014 Budget, it was projected that the NFA would pay dividends (for 2013) of around K50 million into consolidated revenue.

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[25] For a description of the issues see the Organisation of Economic Cooperation & Development, 2013, 'Evading the Net: Tax Crime in the Fisheries Sector', OECD

Given the nature of the industry (dominated by foreign fishing vessels that may never land on PNG soil), the sector contributes little to corporate income taxes. In 2013 the sector contributed just under K6 million, mostly from companies engaged in onshore processing.

Based on estimates of the value of the catch at the time and receipts from access fees, a 2010 study estimated that PNG was receiving around 5-6% of the value of tuna caught in its waters.[26] Since then efforts have been made to increase the benefits through the signing of "second-generation" access agreements – under which foreign fishing firms are provided favourable tuna fishing licenses (for example, without the need to pay access fees) in exchange for onshore investments in tuna processing plants[27].

The discussion above highlights that the fisheries sector in PNG is somewhat unique – notably, despite being an extremely valuable resource it sits largely outside the formal tax system. In addition, even the default revenue instrument (the access fees) are in some instances being waived in exchange for onshore investment.

Ultimately, how the taxation and revenue system interacts with the fisheries sector is part of a broader issue of ensuring that PNG maximizes its return from this valuable resource. Revenue instruments can also play a role in ensuring the sustainability of the sector (in terms of controlling effort). In recognition of these complexities, the Review is seeking further input from stakeholders to consider whether the tax system should again have a role in delivering some returns to PNG. For example, one submission to the Review has suggested that consideration be given to the reintroduction of an export tax on unprocessed tuna – this would provide both a revenue stream and could provide an incentive to encourage more downstream processing of the product.

The Review also understands that there may be some consideration being given to adopting an auction system for the award of fishing licenses. Auctions, if properly designed, can be an effective means of collecting rents

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[26]Havice, E., and Campling, L., 2010, 'Shifting Tides in the Western Central Pacific Ocean Tuna Fishery: The Political Economy of Regulation and Industry Responses', *Global Environmental Politics*, 10(1): 89-114.

[27]Havice, E.,and Reed, K., 2012, 'Fishing for Development? Tuna Resource Access and Industrial Change in Papua New Guinea', *Journal of Agrarian Change*, Vol 12 Nos. 2 & 3, pp 414.

from natural resources (this was considered in Issues Paper 1 in the context of Mining exploration licenses).

Question 9.2 - what are stakeholder's views on the current revenue arrangements applying to the fisheries sector? Is there a need to reconsider how the taxation system interacts with the fisheries sector? What impact would the reintroduction of an export tax on the fishing sector have?

Other Sectors

The Review is also interested in views on whether there are any other sectors of the economy where a different approach to taxation should be taken.

Question 9.3 - what other sectors of the economy consideration be given to using alternative taxation instruments?

CHAPTER 10 - OTHER ISSUES

Submissions to the Review have raised a range of other issues relevant to the corporate and international tax system. It is not possible for all such issues to be discussed in this Issues Paper and a number of issues remain under consideration by the Committee.

Nonetheless, this Chapter includes a discussion on some of the other issues raised to date. One of the key issues if such recommendations are adopted will be about the relative priority of any changes if a phased approach to tax reform is taken. Ultimately this may also be a question of the level of complexity that such reforms introduce into the tax system and how this measures against the wider need to assist efforts in tax administration.

Foreign dividends account rules

A number of submissions to the Review have suggested that PNG consider introducing foreign dividend account rules as a means of encouraging PNG as a regional headquarters for companies. One submission noted:

> *…PNG should be promoting itself as a Pacific headquarters jurisdiction. PNG is the largest economy in the Pacific and organisations with operations and investments throughout the Pacific Islands should be managed from PNG.*[28]

Broadly, such rules would operate to exempt from tax the dividends paid by a PNG resident company to a foreign shareholder where dividends are paid from income earned from the company's overseas activities. Similar regimes exist in other countries (such as Australia which has a 'conduit foreign income' regime).

From a policy perspective such a regime can be justified on the basis that, under broad international tax principles, PNG should not be taxing the foreign income of foreign residents (focusing rather on the PNG income of foreign residents or the worldwide income of its own residents). Plus if a foreign resident is taxed on their foreign income if they invest through PNG, this can act as a disincentive to establish companies in PNG.

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[28] See Bank of the South Pacific, *Submission to the Tax Review*, 9 May 2014 (available from www.taxreview.gov.pg/submissions

Any such regime in PNG would need to address integrity concerns, including any tax planning opportunities that may arise. Notably such a regime would need to be designed to ensure that PNG cannot be used as a conduit for foreign investors seeking to utilize PNG to generate no or low tax outcomes or be used by PNG residents structuring their arrangements offshore.

One option to address any integrity concerns would be to consider the implementation of such a framework, alongside broader efforts (explored in Chapter 6) to improve PNG's collaboration with other revenue authorities. The rule could also apply with a 'subject to tax' requirement, meaning that the exemption from dividend withholding tax would only apply where tax on the income has already been paid in the original jurisdiction (meaning that a taxpayer cannot use the regime to generate an outcome of double non-taxation).

Question 10.1 –do stakeholders support the introduction of foreign dividend account rules in PNG? How important is such a regime in the short term given PNG's economic development?

Question 10.2 –what integrity issues would PNG face if such a regime was introduced? How could these issues be addressed? Is there merit in considering the implementation of such a regime alongside broader efforts to increase PNG's collaboration with other revenue authorities?

Corporate transparency

The Review has noted concerns from a range of stakeholders regarding the tax affairs of some companies. The concerns range from providing of tax incentives (such as tax holidays) for specific projects to companies not paying their 'fair share'. It is not appropriate for the Review to comment on individual cases, nor indeed is the IRC under the income tax law, permitted to discuss publicly the affairs of individual taxpayers (either individual or company) - see section 9 of the ITA.

However, what these concerns have reinforced is that perception about the fairness of the tax system matter, particularly in encouraging voluntary compliance. Whilst the success of a tax system depends in some part on effective compliance action by the revenue administrator, even more significant is voluntary compliance underpinned by taxpayer understandingthat they need to pay their 'fair share'. This is particularly important in PNG, where a relatively small proportion of individuals and businesses shoulder the majority of the revenue burden.

One means of addressing such issues, and to build more confidence in the system, is to make the system more open and transparent. This is already recognised in the extractives sector, where initiatives such as the Extractive Industry Transparency Initiative (EITI) have been developed as a means of building confidence in the sector, encouraging more open (and informed) public debate, as well as holding companies and Governments to account for the revenues paid and received.

PNG has committed to the EITI process, having recently been accepted as a candidate country. Consistent with this, PNG could consider extending its revenue transparency agenda to include other large companies in others sectors of the economy. In developing such a framework, the types of companies (i.e. the income threshold that would apply[29]) would need to be determined, along with the type of information to be published. Given the presence in PNG of a number of project or company specific tax incentives (that are not always apparent on the face of the law), consideration could be given to including such incentives as part of such a regime.

The introduction of such a framework (and indeed the introduction of EITI) would likely require amendments to PNG's tax secrecy provisions. However, whilst taxpayer confidentiality is an important part of maintaining confidence of any tax system, this is arguably more relevant to individuals and smaller businesses as compared to larger corporate entities.

Question 10.3 – should PNG introduce a broader corporate transparency regime, following on from commitments to implement EITI? What issues could this raise?

Treatment of losses

Transfer of losses/consolidation

A number of submissions have recommended that the Review consider reforms to improve the law as it related to groups of related companies.

[29] if the self-assessment system were introduced for 'large businesses', whatever threshold is used there could also apply to any corporate transparency measure.

PNG's income tax law does already provides for the amalgamation of companies (Division 7A, ITA) however this framework focusses on clarifying the tax treatment of a company or companies ceasing operation and effectively folding into another (amalgamated) company.

The tax law, it is argued, should go further and recognize that, whilst wholly-owned groups of companies are separate legal entities, they are part of the same economic entity.

In recognition of this, full 'consolidation' regimes have been implemented in some jurisdictions which in effect treat the group of companies as a single entity – meaning inter-company transactions are disregarded and the economic entity need only lodge a single tax return. However, such regimes are particularly complex and can result in unforeseen and undesirable interactions with other parts of the tax system. This may be why a recommendation of the 2000 Tax Review "to provide for grouping of companies which are wholly owned subsidiaries" may not have been implemented. None of the submissions to the Review has recommended the development of a full consolidation regime in PNG.

An alternative to a full consolidation regime is to permit the transfer of losses between wholly owned companies. This, it is argued:

- recognises that economic groups may choose to establish new businesses using separate companies for non-taxation reasons;
- would encourage the establishment of new businesses where this may not otherwise have occurred (if the early losses of one company can be utilised by a more profitable business in the group);
- reduces incentives to transfer losses within the group through other, artificial means.

On the other hand, introducing such a new regime would add complexity to the system[30]. It would also favour existing larger businesses (who are able to utilise losses elsewhere) over new entrants and smaller businesses. However,

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[30] The move to a full consolidation regime in Australia was in part a response to the complexity and integrity issues associated with existing grouping rules, including the transfer of loss provisions – see for example 'Chapter 25 – A Case for Consolidation' contained in Discussion Paper 2 – A Platform for Consultation, published in 1999 as part of the broader Review of Business Taxation (available at: http://www.rbt.treasury.gov.au/).

encouraging the growth of already established businesses may be a desirable policy outcome.

One of the most significant considerations in introducing such a regime would be the potential revenue implications, particularly in the short term. To inform consideration of this regime, the Review would be interested in engaging further with key businesses that may be looking to utilise such a regime to identify the likely revenue impact of such a measure.

Another alternative to limit any unknown or possible revenue implications would to be limit any such regime to losses accrued from enactment only (that is, not applying the regime retrospectively, to losses accrued to date).

Question 10.4– do stakeholders support the introduction of transfer of loss rules for members of wholly owned groups in PNG? How vital or useful is such a regime in the short term?

Question 10.5– what are the likely integrity issues if such a regime was introduced? How might these integrity issues be addressed?

Carry-back of losses

In PNG, if a loss cannot be offset against income in a given year, it can be carried forward for most businesses for a period of 20 years (this was changed from 7 years as a result of a recommendation of the 2000 Review). One submission to the Review has, however, argued that businesses be able to carry back losses – in effect, allowing them to claim back losses against tax paid in previous income years.

Such a measure was introduced in Australia and has subsequently been slated for repeal in large part due to the revenue considerations. Whilst there may be some sound economic reasons for considering such a measure, in terms of removing a tax bias against risk taking, such a regime may not be well-suited to PNG's economic circumstances. Certainly, an economic downturn in the country could significantly increase the revenue cost to the state at a time when revenue limitations would also likely be significant.

Capital restructuring

The Companies Act 1998 allows for a company to reduce its capital and buy-back its shares. One submission to the Review has noted that when similar rules were implemented in Australia, the taxation law was amended to clarify the tax treatment of such buy-backs. This is particularly important in distinguishing between buy backs initiated by publicly listed companies ('on-market' buy backs) and private companies ('off-market' buy backs).

The Committee is interested in obtaining any further views from stakeholders on this issue.

Question 10.6– what do stakeholders think about how the income tax law currently treats share buy-backs? Does the current system create uncertainty? How critical is the need to address this uncertainty in the short term?

Taxation of trusts

The Committee has received a number of submissions querying the current tax treatment of trusts. Under the existing law, trusts are treated like companies. That is, tax is payable at both the entity level (in this case the trustee level) and also at the beneficiary/shareholder level (see sections 130 & 131 of ITA). The trust is liable to tax at 30% (also the corporate tax rate) and the beneficiary must include trust income in their assessable income (which is taxed at their marginal rate).

One exception to this is property unit trusts. Whilst such trusts are liable to pay tax at 30% at the trust level, distributions from unit trusts are not included in the unit-holder's assessable income (see para 29(1)(o) ITA). Broadly a property unit trust is a collective investment vehicle used to invest in property in PNG. To ensure that it is truly a collective investment vehicle a range of criteria applies to ensure that the trust is widely held by a number of investors.

The Committee has received one submission calling for the loosening of the criteria of what defines a collective investment whilst another has called for the use of such trusts for other types of investment, such as interest bearing securities.

There is some merit in maintaining the existing treatment of trusts. Treating trusts like companies does mean that they are generally not used in PNG as a tax effective investment vehicle. The Review understands that this has been a conscious policy decision – encouraging the broader use of trusts could significantly increase the complexity of the overall tax system and increase tax planning opportunities.

Notwithstanding this, and given that the law already provides for the different treatment of unit trusts in certain circumstances, the Review is seeking further information and input from stakeholders about the merits (and any issues that may arise from) of expanding such provisions.

Question 10.7– is there a need for the Review to reconsider expanding the current unit trust provisions in the law? What kind of issues could arise if this was done?

ABBREVIATIONS

BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
CIT	Corporate Income Tax
DTA	Double Taxation Agreement
DWT	Dividend Withholding Tax
IRC	Internal Revenue Commission
ITA	Income Tax Act
MNE	Multinational Enterprise
OECD	Organisation for Economic Cooperation and Development
PIT	Personal Income Tax

ATTACHMENT A CONDITIONS FOR A SUCCESSFUL SELF-ASSESSMENT SYSTEM

Clear and simple tax laws. In order for taxpayers to calculate their own tax liabilities, they must first understand the tax law and how it applies to their situation. Simple laws and regulations facilitate self-assessment, while minimizing taxpayer effort and compliance costs. This can be achieved by rewriting the tax law to reduce the volume of information and in clear language that helps ensure that taxpayers know and understand their rights and obligations under the tax laws. Simplified and harmonized administrative procedures can also help lower cost of compliance. Simplified rules (including record keeping requirements) should be in place for small taxpayers. A rulings regime that is binding can also help clarify the law and ensure consistency of application of the law by both taxpayers and tax officials should also be enacted in law.

Good service to taxpayers. Self-assessment demands that tax administrations adopt a service-oriented attitude toward taxpayers, ensuring that taxpayers have the information and support they need to meet their tax obligations. Taxpayers must receive clear information describing their obligations, the taxes applicable, and when and where they are payable. They need to be informed about changes to the laws and they should have easy access to information and tax forms. Modern tax administrations provide taxpayers with a range of advice and information through enquiry centers, web sites, public seminars, and so on.

Simple filing and payment procedures. Tax forms must be simple, with clear instructions on how to complete them. Filing of returns and payment of taxes should be through means convenient to taxpayers. Modern innovations in this area should also be exploited to improve the business environment and reduce the cost of compliance. Examples of new practices in this area include e-filing or other means (e.g., drop-off boxes in the tax administration or a commercial bank), and e-payment (internet and mobile banking).

Effective collection enforcement. Prompt detection of taxpayers failing to file tax returns and/or pay the tax due is critical to improve tax compliance. This begins with having a cleansed and updated taxpayer register. Collection enforcement must be prompt and expeditious, since international experience has consistently shown that the older the debt, the more difficult it is to collect.

Selective risk-based audit. Taxpayers must know that if they fail to comply with the tax laws, they face a reasonable risk of being detected. Self-assessment systems therefore rely heavily on a strong audit program focused on higher-risk taxpayers. The tax office must have sufficient resources to audit a reasonable percentage of taxpayers each year, using a variety of audit techniques, to effectively increase the risk of detection of noncompliance.

Fairly applied interest and penalties. Interest and penalties serve to remind taxpayers of the need to take reasonable care in preparing their tax returns and managing their tax affairs. Interest and penalties must be neither too lenient nor unrealistically harsh, and must be applied consistently throughout the country and between taxpayer groups. It is important to draw a distinction between interest and penalties: while penalties are imposed as sanctions for violations of the law, interest is intended to compensate for the time the taxpayer has used the government's money.

Fair and timely dispute resolution. While a tax administration must have effective powers to detect and sanction non-compliance, it is also important that taxpayers have access to an appeal process to protect their rights. When taxpayers disagree with the results of an audit, they must have access to processes for the resolution of any dispute with the tax office. The processes should be simple, neutral, and transparent, and typically include: (1) an independent administrative appeals process within the tax administration; (2) a special tribunal when the taxpayer is dissatisfied with the outcome of the administrative appeals process—the tribunal should include qualified professionals, typically considered as judicial appointments at the level of the lower courts of law; and (3) a judicial process to resolve matters of law and assure procedural fairness.