OIL SEARCH LIMITED

Corporate and International Taxation

Oil Search Submission to Tax Review Committee

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This paper contains the response from Oil Search Limited to the Papua New Guinea Taxation Review Issues Paper No.2: Corporate and International Taxation

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Section 1: Introduction

The taxation of corporate entities and their international operations has become an issue of global importance in recent years. The actions of demonstrators in London who were protesting against the low rates of tax paid by multinational companies operating in the UK such as Starbucks and Google was the first signs of a public outcry which led to a realisation that international tax minimisation was an issue that needed to be tackled head on by legislators and regulators. This movement spawned a new acronym for tax experts around the world, BEPS, otherwise known as Base Erosion and Profit Shifting.

BEPS is now the subject of a substantial OECD exercise looking at whether or not the current international tax rules allow for the allocation of taxable profits to locations different from those where the actual business activity takes place, and what could be done to change this if they do. Further, it has also been a topic of significant discussion amongst leaders of the G20, with Australia's Treasurer Joe Hockey at the forefront of an international crackdown on aggressive structures such as the now infamous Double Dutch/Irish sandwich used by the aforementioned Google and Starbucks, but also such other household names including Apple, Microsoft, Facebook, IBM and GE.

Ultimately, the aim of BEPS and all preceding and future tax reform agendas is to ensure that entities pay their fair share of tax. A number of the issues flagged as part of the BEPS project seem to have influenced the issues raised in the Tax Review Committee's *Issues Paper No.2: Corporate and International Taxation,* including transfer pricing, controlled foreign company provisions, thin capitalisation and debt/equity rules. However, Papua New Guinea ("PNG") must be conscious of the status of its economy and its ability to implement and enforce its tax laws as part of the consideration of any particular reform package.

PNG already features a relatively robust system of provisions which ensure that foreign multinationals operating in PNG cannot strip profits out of the PNG tax net with related party charges without incurring a PNG tax cost. However, tax laws have evolved in recent times at the international level and to a degree PNG's tax laws require some limited revision to modernise them. Oil Search strongly endorses the focus on these issues by the Tax Review Committee with the hope that the Committee sets a platform whereby international competitors operate on a level playing field with PNG based companies and where PNG companies can compete in international markets without being disadvantaged by PNG's international tax system.

In relation to the domestic taxation issues raised by the Committee, we see the proposed reforms as a positive step toward ensuring that appropriate amounts of tax are paid by all industries operating in PNG, whether it is natural resources, agriculture, manufacturing or fishing. By ensuring that each industry makes a fair contribution by way of tax payments, this will allow the Government to utilise a greater proportion of the revenue towards domestic resource mobilisation, i.e. building the infrastructure to allow the PNG economy to flourish. It is only through this increased economic growth that the Vision 2050 development goals will be met.

This Oil Search submission addresses the issues contained in the Tax Review Committee's *Issues Paper No.2: Corporate and International Taxation* and has also raised several other policy issues not considered in the Paper. As PNG's largest listed company and long term contributor to the country's development, we have a strong commitment to working with all levels of Government and with the communities in which we operate to ensure the future prosperity of PNG. We look forward to working with the Tax Review Committee and exchanging views on potential reforms as part of developing a balanced taxation regime for PNG.

Section 2: Executive Summary

Oil Search considers the current tax review vital to providing the platform for the next phase of economic growth in PNG. Through the refinement of the tax system, the Government has the opportunity to incentivise further investment into PNG, whilst at the same time ensuring that PNG gets its fair share of tax revenue from activities undertaken in-country.

This submission contains detailed explanations of our views on these matters and on other tax and policy questions raised in the Issues Paper. We are keen to work with the Committee and the Secretariat in developing a common understanding of these issues and their consequential impacts.

In the short term, we consider the following should be the key areas of focus for tax reform within PNG:

- The adoption of a self-assessment taxation system;
- The reduction of the non-resident corporate tax rate to 41.9%;
- The introduction of a tax loss transfer system for wholly owned corporate groups;
- Simplification of the depreciation system; and
- The introduction of foreign dividend account rules.

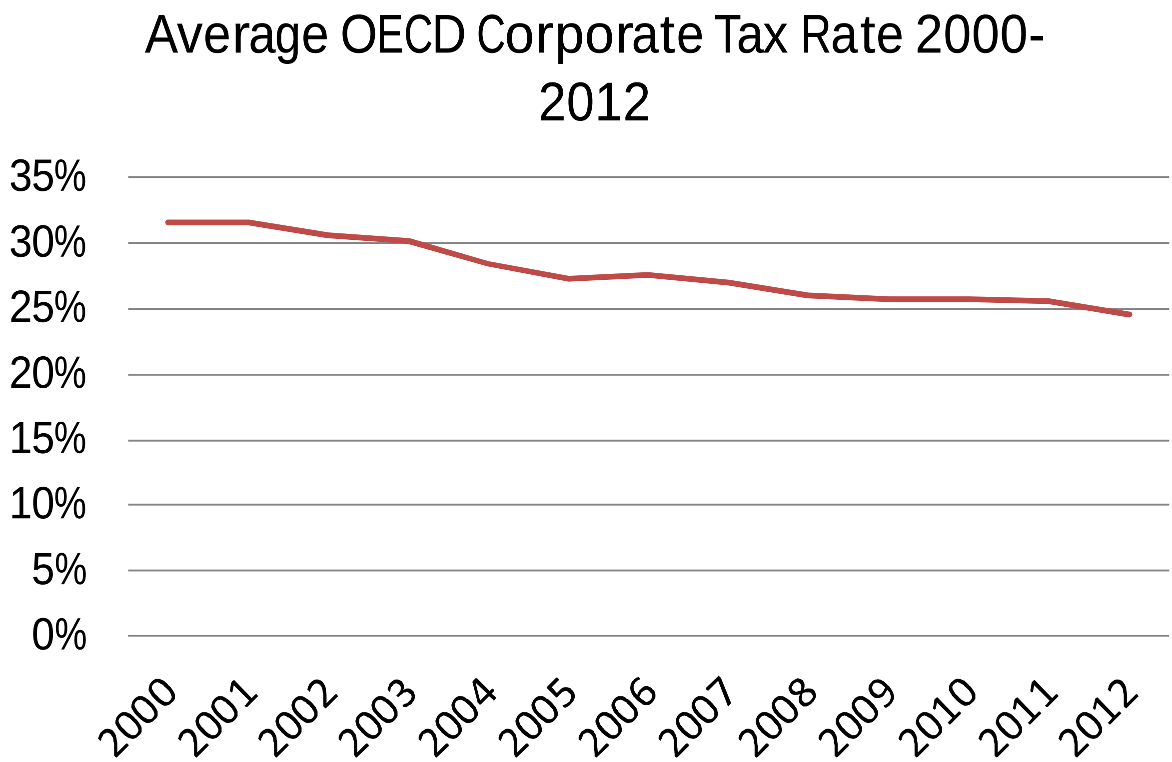
Whilst there are other measures that Oil Search supports in the short term, the above issues represent the building blocks for the continued growth of the PNG economy. It is acknowledged that the introduction of a tax loss transfer system would result in a potential cost to the revenue. However, in theory, the cost should be outweighed by the introduction of other measures countenanced by the Committee and the growth in revenues attributable to the increased economic activity in PNG.

In the medium to longer term, PNG will need to consider whether its budgetary position will allow for some other fundamental structural changes in the tax law, including a reduction in the corporate tax rate, a reduction in the dividend withholding tax rate, the introduction of a new transfer pricing regime, the introduction of a controlled foreign company regime and the introduction of provisions governing share buy-backs for PNG resident companies.

PNG needs to ensure that its tax system reflects both the state of its economy in the development cycle and also what its internal tax administration can effectively administer and enforce. The biggest challenge to the PNG tax revenue is the lack of resources within the Internal Revenue Commission ("IRC") and we strongly urge the Committee to continue its holistic approach to this tax review by looking not only at the provisions that raise tax, but also at the bodies that administer the tax and ultimately how the benefits of taxation are conferred on PNG citizens.

Section 3: Corporate Tax Rates and Withholding Taxes

The Consultation Paper identifies the challenge faced by all nations that are competing for inbound investment dollars; namely, what is the tax rate that attracts sufficient levels of foreign investment but still results in an equitable sharing of the economic profits between the investor and the State? History shows us that the average corporate tax rate across developed nations is reducing, with Government's increasingly preferring the use of consumption and personal taxes to derive revenue. For example, the table below highlights the movement in the OECD average corporate tax rate from 2000-2012 with the average rate decreasing by more than six percentage points over that time.



Corporate Tax Rate

As the Committee's paper correctly identities at Figure 4, the PNG corporate tax rate is at the high end of the range compared to its Pacific counterparts. Further, the table fails to highlight the reduction in the Australian corporate tax rate to 28.5% or the reduction in the Fijian rate to 20%. PNG has the highest corporate tax rate in South Pacific, before even examining the effect of the 17% dividend withholding tax which increases the effective tax rate to 41.9%. In comparison to similar regional economies this is an obvious disincentive to investment in PNG and magnifies the potential motivation for foreign multinationals to utilise cross-border related party transactions to minimise their PNG tax liability.

In reality, foreign multinationals, in particular Australian multinationals due to the operation of the imputation system, will always look to minimise their foreign taxes and would rather pay tax in their home jurisdiction, all other things being equal. Thus, even if the corporate tax rate in PNG was reduced, it would be unlikely to limit foreign multinationals using cross-border transactions to limit their PNG tax liability. Hence, transfer pricing by foreign multinationals should not be used as a justification for changing the corporate tax rate. The corporate tax rate should only be reduced because it will drive economic growth within PNG via the attraction of investment capital. The cost associated with a reduction of the corporate tax rate needs to be counter-balanced against the economic growth that a reduction would create. If little additional foreign investment is forecast from a corporate tax rate cut, it may be that economic growth would be maximised in providing tax cuts in other areas, such as personal income taxes.

To the extent that a reduction in the effective corporate tax rate was in consideration, we would recommend that this be implemented by way of a reduction in the dividend withholding tax rate as opposed to a reduction in the headline corporate tax rate. A reduction in the dividend withholding rate is preferred due to the fact that it encourages companies to distribute earnings back to shareholders who can then reinvest them or consume them as they see fit. The Government should not be encouraging companies to retain cash as this leads to capital inefficiency and increases the risk of shareholders exiting companies tax-free given there is currently no capital gains tax regime.

Non-resident Corporate Tax Rate

When corporate taxpayers are evaluating investment decisions, they will predominantly look at the post-tax cashflows generated by the company. These post-tax cashflows are not evaluated at the level of the operating company; rather they are evaluated on the post-tax cashflows on a fully repatriated basis. For non-resident entities, the current system of tax rates makes it unlikely that those entities would subject themselves to the non-resident tax rate. Most foreign companies who have operations in PNG will either set up a PNG based subsidiary (thereby cutting their effective tax rate to 41.9%) or they will be subjected to FCWT at the rate of 12%. Depending on the profit margin of the entity and also the treatment of foreign branch profits in their home jurisdiction, the FCWT route is often the most attractive. Hence, it would be surprising if there was a significant amount on non-residents actually paying tax at the 48% rate.

The concept of keeping the non-resident corporate tax rate at 48% to try and ‘force’ non-residents to set up PNG based companies is illogical given the operation of the FCWT. Further, where non-resident taxpayers are only participating in the PNG market for a short period of time (e.g. work on a one-off project) and where their profit margins are slim, the FCWT and the non-resident tax rate can be equally unpalatable. In that scenario the tax law is effectively forcing a company to set up a PNG subsidiary or walk away from the project.

We recommend that the non-resident corporate tax rate be amended to 41.9%, in line with the effective tax rate on repatriated earnings by a PNG resident company. This levels the playing field for all market participants and given the comments above, is unlikely to be a material drain on tax revenues.

Imputation System

The Committee’s paper discusses the potential merits of introducing an imputation system into PNG. Given one of the tenets of the review is to ensure that the PNG tax laws are as clear and simple as possible for the public to understand, the introduction of an imputation system would seem to be an inconsistent approach. Depending on the scope of the imputation system, it could also lead to distortions in the manner in which people invest in shares (see for example the refund of excess credits available to Australian superannuation funds). Hence, Oil Search does not recommend the introduction of an imputation system in PNG.

Withholding Taxes

As discussed above, we support any proposed reduction in the corporate tax rate to be effected by way of a reduction in dividend withholding tax. This would encourage better capital management by PNG corporates, give PNG a more internationally competitive withholding regime and potentially incentivise additional investment in PNG companies by PNG residents, assuming that any dividends received by PNG resident individuals continue to be exempt from any further personal taxation.

Further, provided that there is not a significant loss in tax revenue, we would support a harmonisation of withholding tax rates as part of the overall theme of simplification. In that context, a rate of either 10% or 15% would be in line with international comparatives and would arguably remove some of the tax planning that foreign multinationals investing in PNG might currently undertake. For example, if they are seeking to minimise their PNG taxable profits, they would be indifferent as to whether a deductible expense was in the form of a royalty, a management fee or interest. However, given dividend withholding tax is only applied against post-tax profits, there is a case for maintaining a lower rate of dividend withholding than for the aforementioned other three withholdings. In that scenario, the appropriate standard dividend withholding rate might be 10%, whereas interest, royalties and management fees could be subject to a 15% withholding rate before any treaty relief is applied.

Finally, we would also recommend that the PNG tax law be amended such that any dividend paid between PNG resident entities within a wholly owned corporate group is exempt from dividend withholding tax. It is inappropriate to impose dividend withholding tax when there has been no change in the parties who are beneficially entitled to the underlying profit (i.e. the shareholders of the parent entity).

Foreign Contractor Withholding Tax

In a developing country such as PNG, one of the most significant risks for a government is being able to effectively tax non-residents operating in-country. Often this failure to capture a share of tax is attributable to the lack of effective tax systems, in particular in the area of enforcement, and also the lack of formal bilateral relationships with other countries. To that end, Oil Search supports the continued operation of the Foreign Contractor Withholding Tax ("FCWT") regime.

Having the FCWT set as a deemed 25% profit at the non-resident corporate tax rate makes intuitive sense by virtue of the fact that it is essentially a foreign branch profits tax and as such allows for a simple and effective way of rationalising, communicating and explaining the rate and its calculation to foreign contractors. Without the benefit of a detailed analysis, it would seem that an assumed 25% profit margin is fair and equitable tax charge for non-residents operating in the country.

Whilst FCWT is notionally a tax on the foreign contractor, in reality it is often the local PNG company employing the contractor that incurs the cost of FCWT. This happens through inflated contractor prices to recover the existing 12% FCWT rate or by the payer being contractually obliged to gross up the supplier's invoices so that the payer bears the cost of the FCWT and not the foreign supplier. As such, an increase in the FCWT rate may be a deterrent for local PNG business to hire foreign suppliers to do work in PNG which may result in local businesses limiting their investment and exploration activities in PNG. Unfortunately, the PNG economy is not sufficiently developed that the skills that these foreign contractors bring to a project can be easily replaced with local labour. Hence the Government needs to find the delicate balance between the collection of an appropriate amount of tax from foreign contractors without potentially damaging the economy.

With regard to the potential allowance of a foreign contractor to be assessed on an actual profits basis as a matter of law, the critical question is whether creating such a right potentially creates revenue risk for the Government. A non-resident taxpayer could invoke the right to be taxed on an actual profits basis, but then never lodge a tax return for assessment. Hence, it would create risk to allow this right without still maintaining a withholding tax on payments made to the non-resident to ensure compliance.

Foreign suppliers from countries with a DTA with PNG that has a non-discrimination clause would be taxed at the rate of 30% of actual profits if they were on the assessment basis. This potentially could lead to a lower effective tax rate than FCWT (deemed 25% profit at the 48% non-resident rate) and as such these suppliers would be more inclined to opt for the assessment basis. Ultimately, the only entities who would ever seek to be assessed on an actual profits basis are those who envision making a tax saving. Hence, the introduction of this right to be assessed on an actual profits basis will only lead to a reduction in revenue unless other rates of tax are changed at the same time. If taxpayers are making a higher profit margin they will seek to have FCWT applied as a final tax, especially if they can obtain a gross-up from the local PNG company who has engaged them and/or if they can obtain a tax credit in their home country for any FCWT imposed or if their PNG branch profits are exempt from tax in their home jurisdiction.

Given the substantial budget deficits of recent times, it is recommended that the current system of requiring the Commissioner-General to exercise her discretion be retained for the short to medium term to avoid any potential revenue shortfalls that may occur as a result of non-resident taxpayers' failure to lodge tax returns and pay the tax due.

Management Fee Withholding Tax

The policy that stands behind a management fee withholding tax is still sound. It is a useful mechanism to stop non-resident taxpayers artificially creating deductions in PNG and moving the income to either their home jurisdiction or a low taxed jurisdiction. However, the management fee withholding tax as it currently operates appears to be limited in its effectiveness.

As it currently stands, there is significant confusion around the scope of management fee withholding tax. This is due to the broad and inclusive definition of what a management fee is per the Income Tax Act. In particular there is significant confusion about when management fee withholding tax applies since the expanded definition of management fees was introduced to include *'services of a technical or managerial nature and includes payments for consultancy services'*.

Whilst the Committee has not included revenue data on management fee withholding tax in the consultation paper, it is noted that FCWT collections have been steadily trending upward as the economic growth of PNG has trended upward. Whilst Oil Search is not in possession of the collection data, it would be surprising if the management fee withholding tax collections were comparable to the FCWT collections. To the extent that this tax has not raised significant revenue, this will likely be attributable to the confusion as to when it applies and the fact that the withholding tax is not imposed on entities resident in a country with which PNG has a double tax agreement. Hence, the query is whether this tax is worth the effort it takes for the IRC to administer it.

Whilst PNG is still in the development phase of its approach to transfer pricing, management fee withholding should be retained, but there needs to be a tightening of the definition so that any ambiguity is removed. In the longer term, once the IRC has a dedicated transfer pricing audit team up and running, this withholding tax should be repealed.

Responses to Tax Committee's Questions

Consultation Questions	Responses
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?	PNG's corporate tax rate is higher than many of the neighbouring jurisdictions, but any reduction in the rate should only be part of a medium to long term strategy when the PNG budgetary position allows it.
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?	No, it would be preferable to achieve the reduction in the effective tax rate by a reduction in the dividend withholding tax 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?	Whilst the non-resident tax rate influences investment structures, it is unlikely to materially deter foreign investment given the relative ease of setting up a new PNG resident subsidiary.
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?	Yes the rate should be reduced to 41.9% to non-resident taxpayers are not penalised for not wanting to maintain a local PNG subsidiary.
Question 3.5 - in addition to international competitiveness arguments, are there any other reasons for PNG to consider reducing its withholding tax rates?	Reducing the dividend withholding tax rates will encourage PNG corporates to actively manage their capital and distribute profits back to shareholders which can then be reinvested in the PNG economy.
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)?	The FCWT rate should continue to be linked to the non-resident rate. This makes the FCWT rate transparent and easy to understand for non-resident contractors operating in PNG.
Question 3.6(b) – if not, are there any other reasons why the rate should be reduced? Increased?	No. The rate should continue to be determined by the rate a non-resident would otherwise pay if they submitted a tax return.

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?	No. The risk of non-resident companies making that application and never filing a return is too great and PNG does not have the resources to undertake international enforcements. The current practice where the payer is required to seek the approval of the Commissioner-General should be retained.
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?	There are significant concerns around the scope of the management fee withholding tax. Greater clarity is required to make this an effective tax, but the underlying policy behind the tax remains sound.

Section 4: Assessment and Collection of Corporate Income Tax

The Committee's consultation paper correctly points out the shortcomings of an administrative assessment system. However, it understates the current problems in PNG.

As it stands, the final payment of tax is only due 30 days after a taxpayer receives an assessment. In the recent past, it has at times taken years for lodged returns to be assessed. This is an adverse outcome for the State because it delays the State getting monies it is otherwise entitled to. From the perspective of the taxpayer it creates even more issues. The first issue is that a taxpayer needs to maintain sufficient liquidity so that if the returns are assessed, it has available cash to meet those demands. This creates undue pressure on the Treasury functions of large corporates as it increases the amount of working capital it needs to maintain. The second issue is that the audit period for an amended assessment only begins to run from the time the assessment is issued. The longer the time from the end of an income year to the start of an audit, the greater the risk that a taxpayer will not be able to locate requested supporting information due to records being misplaced or a loss of corporate memory from staff leaving the organisation. It is best practice from an audit perspective to examine any issues as soon as practicable after lodgement of a return as it makes the job of all parties easier.

By adopting a self-assessment regime, the IRC could refocus its efforts on targeting and auditing particular issues. An example of this approach can be seen in the practices of the Australian Taxation Office which each year publishes its Compliance Program that specifically highlights the types of taxpayers and types of transactions that it will be targeting in the year. From there, it is these issues that form the backbone of its risk review questionnaires that periodically go out to corporates. Depending on the responses received by the Australian Taxation Office, it is only then that a matter might move into a full audit. The adoption of a self-assessment regime supports this risk based approach.

Responses to Tax Committee's Questions

Consultation Questions	Responses
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?	Yes. We recommend that a self-assessment system be adopted for all taxpayers, but would support a phased approach if the Government and IRC thought this would ensure a smoother transition.
Question 4.1(b) – how much of a priority is this for PNG?	This should be a high priority as it will lead to a substantially more efficient and effective IRC as they will able to concentrate more of their efforts on education and enforcement than in the current model.

Section 5: Integrity Frameworks

Transfer Pricing

PNG's transfer pricing laws are fundamentally sound and do not require drastic changes. However, the current global environment and the focus on BEPS has meant that there has been a significant international movement to create a global transfer pricing model that ensures that appropriate taxes are being paid by multinational corporates. Hence, the question for PNG is not so much whether there is a significant deficiency in the current law, but rather whether PNG wants to form part of this global movement and align the standards to those espoused by the OECD.

The main driver for bringing PNG in line with international standards is that it would allow adjustments between jurisdictions to be undertaken more easily as the taxpayer should get a compensating adjustment on either side of the transaction given the systems should be aligned. Further, by having a global set of rules, PNG can leverage the guidance and jurisprudence around the world as part of interpreting whether taxpayers have met the required standards.

Given the influx of foreign investment dollars into PNG, transfer pricing should be a high priority. However, before the Committee considers potential reforms to the provisions, the question is whether the transfer pricing expertise exists within the IRC to enable thorough reviews of taxpayers' cross-border related party transactions under the existing laws, let alone a new set of transfer pricing provisions. Further, the international debate on transfer pricing would seem to still have a long way to go before a truly global set of principles is agreed and implemented. For example we note that the G20 Development Working Group has so far only published Part 1 of its report into the impact of BEPS in low income countries and after Part 2 is released in September 2014, we would expect that there would still be further periods of consultation. Hence, it would appear that PNG has some time to build up its skill set in relation to transfer pricing and potentially influence the debate through participation in various international fora.

Oil Search fully supports the eventual reform of PNG's transfer pricing regime. However we would caution against implementing an expanded regime without the internal capability to administer it and without having undertaken significant diligence around what type of regime is optimal for a developing country like PNG. Hence, we would recommend transfer pricing reform be a medium term goal of this review process.

Thin Capitalisation

In most jurisdictions, thin capitalisation regimes are used by Governments to stop foreign investors leveraging their projects with related party debt at high interest costs so that they leave as little taxable income in the country of operation as possible. Oil Search supports the utilisation of thin capitalisation measures to limit this type of aggressive tax planning.

In relation to the finance sector, there would not appear to be any compelling reason to exclude financial institutions from the thin capitalisation limits, but given the leverage position inherent in their balance sheets, a higher permissible debt to equity ratio must be allowed. Without a high permissible debt to equity ratio, it may leave PNG based banking institutions vulnerable in terms of regional competitiveness. Further, it could result in PNG being an unattractive place for global banks to operate as they simply cannot build the scale and leverage they require due to the limitations that a thin capitalisation regime will impose. Finally, before making a recommendation supporting a thin capitalisation limit for financial institutions, we strongly recommend that the Committee consider whether the implementation of such a regime is of merit where there are already other controls imposed by the Bank of Papua New Guinea which de facto impose a limit on the amount of debt that a financial institution can take on (e.g. capital adequacy ratios). However, we acknowledge that the controls imposed by the Bank of Papua New Guinea may not apply to all of the financial institutions that this law change may be seeking to regulate.

As part of its broader review of the corporate tax regime, we would also encourage the Committee to consider the introduction of an arm's length test which would allow taxpayers to exceed the 2:1 debt to equity ratio where it is funded with debt from an unrelated third party financial institution. If a taxpayer can obtain debt from non-related parties at a ratio of more than 2:1, they should be entitled to do so as it clearly signals a very strong and very profitable business that will benefit all stakeholders. If an arm's length debt test was introduced, the Government will need to ensure that it has appropriate anti-avoidance rules to deal with the potential that taxpayers may seek to enter into back-to-back financing arrangements through financial institutions to avoid thin cap limits.

Debt/Equity Tests

As the current debt and equity tests stand, tax and accounting outcomes for a particular instrument are always aligned. This alignment prevents taxpayers from accessing cross-border tax arbitrage opportunities given the majority of developed countries also adopt substance over form approaches with reference to the designation of debt and equity instruments. If PNG reverted to a form over substance approach, inbound financing from foreign based multinationals could take the form of a profit-linked debt instrument so that a debt deduction could be taken in PNG (subject to the thin capitalisation rules) with equity treatment for the holder who would likely get a foreign dividend tax exemption. In that scenario, PNG would be disadvantaged as the debt deduction would not have been available under the existing regime, thereby increasing the taxable income of the entity.

Whilst we understand the Committee's stated desire to keep the tax system as simple as possible, which would lend itself to a form over substance approach, we query whether there is likely to be any significant impact for ordinary citizens of PNG. Typically the types of hybrid mismatches that the consultation paper refers to are structures only considered by sophisticated taxpayers who would easily comprehend the nuances of the current debt and equity tests. We consider that it would be highly unlikely that any of the instruments held by ordinary PNG citizens would have a different legal form from the underlying substance. Hence, we consider that the debt and equity tests are one area where PNG should, relatively speaking, retain the more complex provisions.

We note that as part of the introduction of the revised debt/equity rules, the impact of the change was not reflected in all of the affected parts of the tax law. For example the definition of a dividend is based on the form of the arrangement-i.e. a distribution made on a share. This creates a dividend withholding tax issue on what would otherwise be a debt interest. The Committee should recommend to the Government that all of the provisions in the Income Tax Act that rely on the concepts of debt and equity are aligned to ensure no instances of double or non-taxation.

Other Integrity Rules

Controlled Foreign Company Rules

Controlled Foreign Company ("CFC") rules are appropriate for jurisdictions with large outbound investment flows, in particular where high net wealth individuals are investing in passive assets and keeping profits offshore and outside of the tax net of their home jurisdiction. Typically CFC provisions do not affect multinationals that have physical operations in a foreign jurisdiction as this income is considered "active" and is typically exempt from attribution under CFC rules.

Given the profile of countries that typically would employ a CFC regime as described above, the merits of the introduction of a CFC regime in PNG should only be considered in light of how much passive foreign investment is occurring on behalf of PNG resident individuals and companies. If the vast majority are companies conducting active businesses, then we would suggest that the introduction of CFC rules is perhaps a lower end priority as the prospect of raising a material amount of taxes probably does not justify the significant investment that will be required to implement a CFC regime. The introduction of a CFC regime should be a medium to long term goal for PNG as PNG moves into the phase of being a net investment capital exporter.

To the extent that a CFC regime was introduced in the short term, careful drafting of the provisions will be required to ensure that the profits of active underlying businesses are not subject to attribution. This will require the CFC provisions to have appropriate tracing rules as well as carve-outs for distributions of underlying active profits up the ownership chain.

Transactions with Secrecy Jurisdictions

Whilst it is not clear what jurisdictions the Committee is referring to in the context of secrecy jurisdictions, many of these jurisdictions probably have long histories of being used in international finance and trade and are attractive due to their stable and well understood regulatory regimes, as opposed to being a mechanism to avoid taxes. Further, some service providers, including banks and insurers, extensively utilise these jurisdictions and the underlying customer may have little or no choice about the counterparty's country of residence. Given that any contract with these types of entities typically includes a gross-up clause for any amount withheld, it would seem unjust to financially penalise PNG taxpayers for dealing with these types of counterparties.

If the IRC is concerned about companies artificially re-directing profits that would otherwise be taxed in PNG into these secrecy jurisdictions, we think that this is best controlled by exercise of a number of provisions that are already in place in PNG, namely the thin capitalisation provisions, the various withholding taxes and the cap on deductible management fees. Further, we would encourage PNG to build more of an international profile in tax matters by broadening its network of bilateral/multilateral exchange of information agreements.

Earnings Stripping Rules

The introduction of Earnings Stripping rules is unnecessary in the PNG context. These rules which are based on the US system, largely replace the operation of a robust US thin capitalisation regime. Whilst Japan has recently introduced Earnings Stripping Rules, Japan has a more concessional thin capitalisation regime for corporates than in PNG as it provides for a 3:1 gearing ratio and it is generally only applicable to related party debt. The PNG thin capitalisation provisions allow a 2:1 debt to equity ratio and it applies to all debt of the taxpayer.

Earnings Stripping provisions seek to control the amount of deductible debt that can offset earnings, but this is already appropriately controlled in PNG through the thin capitalisation provisions. Hence these provisions are not required and would merely complicate the tax laws applicable to corporate taxpayers as the introduction of such laws would also require a series of new anti-overlap provisions to ensure that taxpayers would not be subject to an interest deduction limitation under both the thin capitalisation and earnings stripping regimes.

When considering the potential introduction of Earnings Stripping provisions, the Committee must keep in mind the nature of the PNG economy. It has been traditionally focussed on resources which are subject to enormous volatility (see gold price movements as an example). Having an earnings-linked interest deduction limitation is simply not appropriate for an economy where, due to the nature of its exports, earnings are volatile. Further support for this contention can be seen in the PNG Treasury's recently released mid-year economic outlook where the growth forecast for 2014 was cut from 6.2% to 5.4%, chiefly attributable to resource price volatility.

Minimum Tax

The introduction of a Minimum Tax in an economy such as PNG's creates a risk that the IRC would inadvertently threaten the financial survival of some small to medium businesses which operate on small margins. Further, if the IRC is already struggling to obtain compliance from these types of entities, collection of a minimum tax would also appear to be a challenging prospect. In addition, it would add complexity to the tax system for these small to medium businesses which the Committee is seeking to avoid.

In reality, the only entities that could realistically be subject to a Minimum Tax would be larger corporates. However, these entities typically already pay tax in advance of assessment via the Advance Payment of Tax rules. Hence, it is unclear what types of taxpayers a Minimum tax is intended to capture from a policy perspective.

To the extent that a Minimum Tax was implemented, clearly it would need to be creditable against tax payable, either within the same legal entity or another member of the same wholly owned group to ensure that the Minimum Tax does not result in an inappropriate increase in the effective tax rate for taxpayers within large corporate groups.

Base Erosion and Profit Shifting

Whilst there has been a strong international response in relation to BEPS and the low effective tax rates for many large corporates, especially those who predominantly derive income from the digital economy, the fault does not necessarily lie with tax haven entities that are typically intermediate holding companies. Rather it is the failure of the international tax rules of the jurisdiction of the parent entity in not attributing this underlying income. Hence the focus of BEPS should be on deriving an agreed set of international tax attribution rules, and less on the source issues which can only lead to a loss of tax revenue for developing countries whose income is typically derived from primary production and not high-tech industries.

For PNG, BEPS is probably of little practical impact given that PNG has a reasonably robust set of transfer pricing and other provisions designed to prevent artificial profit shifting. We consider that the most appropriate course of action for PNG is to watch this debate develop, in particular PNG should consider in detail the Stage 2 report from the G20's Development Working Group. At the appropriate time, PNG should seek to leverage any best practice guidance published by the G20 or the OECD, including in relation to the thin capitalisation and transfer pricing regimes.

Responses to Tax Committee's Questions

Consultation Questions	Responses
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?	Transfer pricing is an important issue for PNG given it is an importer of investment capital. However, reform needs to be supported by an IRC capable of enforcing any new laws and hence we would recommend that reform should be a medium term priority.
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?	Yes the rules could be extended to the Finance sector provided they can access a higher gearing ratio and that the rules do not duplicate restrictions already put in place by the Bank of PNG. Oil Search is not in a position to comment on what the appropriate debt to equity ratio might be for a financial institution.
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?	The current definitions protect the PNG revenue from foreign multinationals using hybrid instruments to obtain a tax arbitrage and on balance do not cause any issues for PNG corporate taxpayers.
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?	The integrity provisions discussed would add unnecessary complexity to the PNG tax law for little economic benefit as this stage of the PNG economic growth cycle. The introduction of these types of provisions should be revisited once PNG moves away from its current status as a developing economy that is still reliant on foreign capital investment.

Section 6: International Tax Agreements

New Double Tax Agreements

The negotiation of new Double Tax Agreements by PNG is a great idea in theory given it will usually eliminate circumstances of double or no taxation and hence provide certainty to taxpayers. However, in today's complex tax systems, typically the only material outcome of a new Double Tax Agreement is to reduce the rates of withholding that would otherwise apply under the domestic law. In practice, large economies who are often the most significant trading partners of developing nations, give priority in treaty negotiations to other developed nations where the inbound and outbound capital flows are the highest. Hence, negotiating a treaty with an economy such as PNG is often very low on the priority list for a large developed economy. Given that scenario, it is hard to discern what benefit PNG may derive from undertaking a program to increase the number of agreements to which it is party or in renegotiating existing agreements. Further, if the only economic impact from a new Double Tax Agreement is a lowering of the withholding rates that PNG imposes on payments to the other jurisdiction, then the negotiation may end up being a cost to the revenue for PNG. Oil Search's view is that the negotiation of Double Tax Agreements should be a low priority for the PNG Government.

Reviewing Existing Treaties

The comments made above in relation to the negotiation of new treaties, generally apply to the review of existing treaties as well. The only caveat is that if the IRC becomes aware of foreign investors treaty shopping in relation to their inbound investment structures, for example utilising Singapore and its territorial tax system, then the introduction of an appropriate Limitation of Benefits article to existing treaties is recommended.

Greater Collaboration with Other Tax Authorities

Given the above comments around the practical difficulties in negotiating Double Tax Agreements, it follows that other forms of international co-operation must be found. Becoming a signatory to the Convention on Mutual Administrative Assistance in Tax Matters is an excellent idea and comes at a relatively small financial and administrative cost. Given the lack of outbound capital flows from PNG, it is likely that requests for information under the Convention would come from PNG, as opposed to PNG being requested for information. Hence there is little risk of PNG being overwhelmed with information requests and the Convention becoming an administrative burden on the IRC and Treasury.

Further, as part of Oil Search's continuing support of corporate transparency programs such as the Extractive Industries Transparency Initiative ("EITI"), we would also support PNG becoming part of the Global Forum on Transparency and Exchange of Information in Tax Matters.

Responses to Tax Committee's Questions

Consultation Questions	Responses
Question 6.1– given the many and variety of challenges facing PNG's tax	No, negotiation of new DTA's should be a lower level priority for PNG at this time.

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?	A periodic review of PNG's DTAs is recommended, particularly in relation to DTAs which could be subject to abuse due to the absence of a limitation of benefits article in the DTA.
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?	Yes, the Convention would be a cost effective way of creating an information exchange network.
Question 6.4 – should PNG pursue enhanced international engagement with other tax authorities including, for example, through membership of appropriate international tax forums?	PNG should continue to build on its relationships with the tax authorities in its major trading partners and also international tax forums, but should be wary of the obligations that membership of such bodies may bring, especially given PNG's circumstances as a developing nation.

Section 7: Depreciation

Improving PNG's Depreciation Regime

Updating Depreciation Schedules

The fact that PNG's depreciation schedules have become outdated is largely a function of the lack of available resources within the IRC. Hence whilst best practice would be to maintain the Commissioner's schedule of effective lives, including periodic updates, there is a question as to whether such an approach is practical. In contrast, the approach at the other end of spectrum would be to allow taxpayers or their representatives to self-assess the effective life of their assets. Maintaining an up to date schedule of effective lives is a time consuming undertaking for the IRC. However, the IRC could potentially leverage published schedules used in other jurisdictions. Conversely, requiring taxpayers to self-assess creates too large a risk to the revenue and arguably makes the tax law more difficult to apply for average PNG taxpayers.

The middle ground is to have a simplified system which contains several different categories of assets. One jurisdiction that uses such a system is the US, but that system is still overly complex in terms of being usable in a PNG context. A better option would be to model the depreciation system on that which applies to Mining and Petroleum which has two asset classes-short life and long life, each with separate depreciation rates. The adoption of a similar approach for all other assets would greatly simplify tax calculations for corporate taxpayers.

In terms of calculating where the threshold for the short life and long life assets might be, the Committee should give consideration to providing incentives for small businesses to acquire capital assets. By creating such an incentive, it will hopefully drive economic growth in the small business sector. For example, a small business might be defined as one with an annual turnover (per lodged tax returns) of less than 1 million kina. Small business taxpayers could then have an accelerated depreciation profile for their assets, perhaps 150% of what large taxpayers may receive. This idea is outlined in further detail in the table below.

Tax Payer	Turnover threshold	Short Life (<10 years)	Long life (>10 years)
Small Business	<K1 million	37.5% straight line	15% straight line
Large Business	>K1 million	25% straight line	10% straight line

The other alternative is that small business taxpayers could access even higher rates of depreciation, but utilising a diminishing value approach. An even more aggressive approach to driving growth in the small business sector would be to offer a bonus deduction on capital asset purchased by small businesses. For example, if a small business purchased an asset worth more than K50,000 then it would be entitled to depreciate 150% of the acquisition cost at the agreed rates. This obviously would come at a cost to the revenue and would need to be policed by appropriate auditing activities by the IRC, but could provide a fillip for the PNG economy over a defined period.

Low Value Assets

The introduction of a low-value pool for assets costing less than K10,000 and immediate expensing of asset acquisitions of less than K1,000 would significantly reduce the tax compliance burden for small businesses. Whilst it would come at a cost to the revenue in the immediate term, ultimately it should encourage spending on capital assets by small to medium businesses and be a driver for economic growth. The Committee should keep in mind that the rate at which the low-value pool is depreciated can be set to minimise the financial impact. For example, the low-value pool depreciation rate could be set as low as 30% and could be calculated on a diminishing value basis.

Reducing the compliance burden associated with low-value assets would be a benefit for all taxpayers, but priority should be given to small businesses in terms of these proposed changes if there is a significant concern regarding the funding cost. One potential course of action is to introduce the provisions for small businesses first with the regime expanded to all businesses after 12-24 months.

Blackhole Expenses

Large corporate groups will typically only have limited transactions in the ultimate parent entity, especially where the parent entity is listed. This is because the parent entity prefers not to have active businesses in that entity which could become a dividend blocker, i.e. losses from the business in the parent entity block the ability for profits from underlying businesses to be distributed to shareholders. Hence the parent entity would typically only incur business development costs that do not relate to an existing operating asset and stewardship costs. In this scenario, it is the business development costs that are arguably non-deductible in PNG due to the fact that the costs are too remote from the production of assessable income.

The introduction of blackhole deduction rules would clarify the deductibility of these types of costs along with other types of costs that corporate taxpayers may incur, including costs incurred in the establishment of new business structures or takeover defence costs. Oil Search supports the introduction of blackhole deduction rules.

Responses to Tax Committee's Questions

Consultation Questions	Responses
Question 7.1(a) -what priority should be given to updating the depreciation schedule?	The Committee should focus on a simplification of the regime which would render the updating of the schedule irrelevant.
Question 7.1(b)–as part of efforts to update the effective life tables, should consideration be given to further simplifying the tables?	Yes, the depreciation provisions should be simplified in line with the methodology adopted in respect of the taxation of the resources industry.
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).	See the comments above regarding simplification of the depreciation system.
Question 7.2 –how valuable, in terms of	The immediate expensing of items costing less

simplification, to a business would be enabling the immediate expensing of low value assets? What threshold would be appropriate?	than K1,000 would not only simplify the tax affairs of small business taxpayers, but would potentially also drive economic growth as people would be more likely to invest in their business as part of managing their tax position.
Question 7.3 –do stakeholders agree that simplifying the tax system is of more importance in relation to smaller businesses?	Simplification of the tax system is important to all taxpayers, but in terms of driving the future economic growth of PNG, then small businesses should be a higher priority than large taxpayers
Question 7.4 – does PNG need 'blackhole' expense rules or are existing administrative arrangements effective?	The existing provisions do not clearly provide deductions for certain types of expenditure. The codification of the treatment of these types of expenditure through the introduction of blackhole rules would provide certainty for taxpayers in relation to such issues.
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?	Oil Search is not in a position to comment on the value provided by the current depreciation concessions that are available to certain industries. Oil Search supports a level playing field for all market competitors, however understands that it is appropriate from time to time to introduce special concessions to encourage growth in particular sectors of the economy. The difficulty with sponsoring these types of concessions is that the industry becomes uneconomic without the concessions which results in other industries effectively underwriting loss-making businesses.
Question 7.6 – are there any other means of simplifying or improving PNG's depreciation regime?	As discussed above, consideration could be given to driving growth in the small business sector by providing for bonus deductions on top of the acquisition price for major capital acquisitions and/or providing for accelerated rates of depreciation for small businesses.

Section 8: Incentives to Encourage Training

One of the cornerstones of Vision 2050 is Human Capital Development. As part of the Human Capital Development stream, one of the stated goals was to improve PNG's position in the United Nations Human Development Index ("HDI") from 148 to inside the top 50. In the 4 years since the publication of Vision 2050, PNG has slid to 157 on the Index thereby indicating a fall in overall standards of well-being of PNG citizens in comparison to the gains being made in other parts of the world. In contrast to PNG, Malaysia is 62 on the Index, Fiji is 88 and Indonesia is 108. Whilst educational standards are only a part of the evaluation for the HDI, education is also the mechanism which enables countries to escape the poverty cycle. Hence, the focus on an education led evolution of PNG must not be lost.

Oil Search is supportive of the mechanisms currently in place to encourage taxpayers to invest in the education of their workforce. In the absence of a mechanism like the Training Levy and Double Deduction we would expect that the investment in training would dramatically fall within the PNG small to medium business sector as taxpayers seek to minimise their cost structures. We would expect that large taxpayers like Oil Search would continue to invest in training programs for their staff, regardless of whether the schemes existed.

Further, we do not consider the reporting requirements for the training levy to be particularly onerous and hence, in our view, the administration associated with the training levy is justified by the long term benefit for PNG. PNG's people policies should continue to focus on education and training with a longer term goal of negating the need for substantial quantities of foreign contractors in order to deliver large scale infrastructure projects.

Responses to Tax Committee's Questions

Consultation Questions	Responses
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?	Both the training levy and double deduction should be retained as they support the long term development of a skilled workforce for the growing PNG economy.

Section 9: Sector Specific Taxation Issues

As a general rule of commerce, the 'playing field' should be level for all participants in the market, i.e. no single party or industry should be favoured over another. However, in certain circumstances the granting of some form of tax incentive to an industry where the Government is seeking to stimulate growth is appropriate. For example, the double deduction for exploration that was granted to mining companies to stimulate mining investment was an appropriate action. Oil Search supports the provision of tax incentives in those circumstances.

Notwithstanding the fact that the granting of a tax incentive to a particular industry can be justified, the Government needs to be wary of continuing to fund industries which no longer generate net economic benefits for the country, i.e. the economic benefits generated by the industry are outweighed by the economic cost of supporting the industry which not only includes the financial support a Government provides but also the future environmental cost/loss of amenity that an industry can inflict.

In terms of the type of tax incentive that should be provided to a targeted industry, we support the use of accelerated depreciation or investment tax credits as better tools to encourage growth than a simple reduction in headline tax rates.

Export Taxes

In an ideal economy where all taxpayers willingly pay their share of the corporate tax burden, there would be no need for PNG to impose export taxes. However, where taxes have historically been difficult to collect, revenue authorities must use other mechanisms to collect taxes. In this context, Oil Search supports the Government utilising whatever is deemed to be the most efficient and effective mechanism to collect taxes due and payable. Notionally, appropriate transfer pricing regulation and legislative enforcement should be sufficient to deter taxpayers from seeking to avoid taxes, but in the PNG context the IRC is not currently equipped to be able to undertake such exercises. Hence, until the PNG economy and the infrastructure of the IRC matures, there would still seem to be a place for collection mechanisms such as export taxes and other similar types of withholding taxes.

Responses to Tax Committee's Questions

Consultation Questions	Responses
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?	As described above, where collections from a particular industry are difficult, we support the use of efficient collection mechanisms by the Government, including the use of export or other forms of withholding tax.
Question 9.2 - what are stakeholder's views on the current revenue arrangements applying to the fisheries sector? Is there a need to reconsider	Oil Search is not in a position to comment on the taxation arrangements applying to the fisheries sector.

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?	Oil Search is not in a position to comment on the relative merits of applying alternative taxation instruments to one industry in contrast to another within PNG.

Section 10: Other Issues

Foreign Dividend Account Rules

As PNG becomes a more developed economy, it follows that some PNG companies will experience such significant commercial success that they will be presented with opportunities to grow their business outside of PNG. These opportunities may arise in Pacific region, within Asia or potentially globally.

When PNG companies reach the size to expand internationally, it is inevitable that a substantial portion of their shareholder base will be non-resident. Due to the lack of liquidity in the POMSOX and the lack of available PNG investment capital, these companies will raise capital from non-resident investors and potentially have a secondary listing in another country. Capital raisings in a secondary market result in a large cross-section of investors, in particular, the largest shareholders will generally represent superannuation or pension funds which are investing on behalf of thousands of individuals and who are subject to concessional taxation.

As a general statement of principle, where a PNG resident company derives a profit within PNG, it should pay tax on that profit in PNG. Further, where a PNG resident derives a profit in respect of a foreign investment, that PNG resident should pay tax in PNG, but get a credit for any underlying tax in the foreign jurisdiction. But where a non-resident derives a profit which is attributable to a business located outside of PNG, PNG should not impose tax on the non-resident merely because the profit flowed through a PNG resident company. PNG currently provides a rebate for dividends received from foreign companies and so there is an appropriate outcome in the hands of the PNG company receiving the dividend. However, the flaw in the PNG system arises when those dividends are then distributed to its non-resident shareholders who are subject to a 17% dividend withholding tax.

PNG should introduce a set of foreign dividend account rules so that a PNG corporate entity can declare what portion of a dividend it is paying consists of foreign profits and that portion of the dividend should not be subject to PNG dividend withholding tax. This exemption will be particularly important to Sovereign investors, tax-exempt pension funds and charities for whom the withholding will be a straight cash leakage, but also Australian superannuation funds who would otherwise only be taxed at 15% on the receipt of the dividend.

In the absence of introducing appropriate foreign dividend account rules, there is a significant risk that multinational PNG resident companies could look to re-domicile into a jurisdiction that is friendlier in terms of the taxation of their shareholders, especially where their foreign operations become a material driver of corporate earnings. One only has to look at the public and political outcry that is currently occurring in relation to US corporate inversion transactions to see what can happen where corporates see significant tax advantages in moving their domicile.

We understand that the Committee is concerned about PNG being used as a conduit regime. However, we fail to see any economic downside in investors who choose to hold their Pacific region investments via PNG. Singapore and Hong Kong have thriving economies which have been based around their location as regional headquarters for global companies. Provided PNG has effective rules around domicile and residency and has appropriate limitation of benefit articles in their Double Tax Agreements, PNG should, from a purely economic perspective, be encouraging its use as a regional headquarters and adopting flow through taxation principles.

We acknowledge that the introduction of foreign dividend account rules is unlikely to be a high priority as part of the assessment of potential reforms to PNG's international tax regime. At the same time, the introduction of such rules is likely to come at little or no cost to the revenue in the short to medium term and the introduction of the rules now creates a set of fair and equitable rules for PNG's future which might also have the flow-on benefit of attracting investment into PNG as a Pacific region headquarters.

Corporate Transparency

As stated previously in this submission, Oil Search supports an equitable playing field for all market participants, no matter what industry they operate in. From a purely economic perspective, this ensures an efficient allocation of capital and resources. This principle of equity and fairness extends to transparency.

Oil Search Limited has taken a leading role in lobbying for the PNG government to adopt the EITI and each year publishes a corporate Transparency Report and a Sustainability Report which provides detailed information about our operations and payments made to various Government authorities. Hence, Oil Search would fully support any initiative of the PNG Government which sought to introduce transparency provisions on par with the standards set in the EITI. We would recommend that any such initiative should be limited to large taxpayers based in PNG (turnover >K$100m) so as to avoid the creation of an unnecessary compliance burden for small to medium enterprises.

Treatment of Losses

One of the major disincentives for taxpayers operating in PNG is the absence of tax grouping provisions or, alternatively, tax loss transfer provisions. At present, a taxpayer can conduct two or more mining or petroleum operations within a single legal entity, but due to the operation of the tax ringfences, cannot share tax profits and losses between the ringfences. This ability to share tax profits and losses between projects within an entity is commonplace in other resource rich countries including Australia, Russia, the US, Brazil and Canada. Similarly for non-resource corporate groups located in PNG, losses cannot be shared between related companies.

When it comes to large scale projects, there is typically a very substantial upfront capital cost to put the necessary infrastructure in place. This creates a large pool of depreciation deductions that are available once the project begins to produce income. As a result, it can often be several years before the project becomes tax payable. Due to inflation and the time value of money, the value of those tax deductions diminishes every year and this affects the overall rate of return on a project. If these losses/deductions could be used at an earlier stage (i.e. by offsetting taxable income in other companies that form part of the same taxpayer group) this will increase the overall net rate of return across the portfolio of projects. In the current environment where capital is internationally mobile, the difference in the rate of return could mean the difference between projects moving into execution or being delayed because the return does not meet the internal hurdle rate or the rate of return is less than a similar project in another country.

Tax grouping provisions will generally be of benefit where an entity is undertaking multiple projects in PNG. It follows that grouping provisions do not assist a single project investment; rather it acts as an encouragement for local and international companies to continue to invest in PNG. Given the broader economic benefits associated with increased foreign investment (see PNG LNG for example), this should be a high priority policy for the PNG Government. The Government may be concerned about the potential initial financial impact on the National Budget as a result of introducing grouping rules, but given the forecast increased tax and dividend cashflows arising from the PNG LNG Project, this is the optimal time to introduce such measures to ensure the continued growth of the PNG economy.

Tax grouping provisions would also address the hedging issue that often arises in large scale, limited recourse financed projects that feature a series of joint venture partners. Typically each joint venture partner will use a special purpose vehicle to participate in the project where the security over the shares can be pledged to the lenders. The covenants on the financing package typically prevent the joint venture partner special purpose vehicles from taking on any additional debt or other liabilities. This means that to the extent that a corporate group wants to hedge its exposure to the project, whether that be in relation to foreign exchange, commodity price or some other risk, that hedge cannot be in the entity that has the underlying physical exposure. This can create anomalies in a group whereby one group entity will make a hedging loss which it must carry forward and cannot offset it against the profit derived in the special purpose vehicle.

As the consultation paper correctly points out, the utilisation of a new company for a new project is effectively mandated by the financiers to the project. As described above, the financiers will lend on a limited recourse basis to the projects, but will require security over the shares in the company they are lending to. Corporate taxpayers who have other operations will not want to provide security over their other assets to lenders on the new project and hence it is necessary to ringfence the new project from the existing assets. Unfortunately, by virtue of this ringfencing, the taxpayer group will not be able to offset the profits of the existing business against the losses of the new project. The taxpayer in this situation should not be penalised and hence a tax loss transfer system is required.

The reforms in this area can be structured in different ways:

1. A tax consolidation system
   This would be based on the Australian concept where all subsidiary entities of the head company are effectively treated as divisions of the head entity and so all the profits and losses within the group are consolidated.
2. A tax loss transfer system
   Corporate taxpayers who are part of the same wholly owned group could simply transfer losses between one another to optimise the group's tax position.

In the PNG context, a tax consolidation is simply too complex and would add little value to the tax system. Further, certain senior officials within the Australian Taxation Office have questioned whether a move away from the tax loss transfer to a tax consolidation system was the right choice for Australia in retrospect. The Australian tax consolidation rules were introduced, in part, to address concerns around inter-entity loss multiplication within corporate groups. Given PNG does not have a capital gains tax system at present, the potential integrity issues associated with a loss transfer system would seem to be minimal. Hence, we are strongly in favour of a simplified tax loss transfer system.

Some difficulties will arise in a PNG tax loss transfer system due to the different rates of tax which apply to different types of entities. In particular, resource companies are subject to higher rates of tax than ordinary corporate taxpayers. Hence, the PNG system will need to consider whether it is the amount of the loss that can be transferred or the tax-effected amount of the loss that can be transferred where two related taxpayers have differing tax rates. Consideration will also need to be given to whether further amendments would be required in relation to the deduction of Allowable Capital Expenditure ("ACE") for resource companies as at present, a taxpayer's ACE deduction is capped at an amount which prevents the entity from creating a tax loss. The excess ACE which is not utilised by the taxpayer in a given year should be transferable to other related parties.

Oil Search would not be in favour of limiting the regime to future losses only as this could be manipulated by corporate groups by undertaking transactions which refresh the losses. Further, creating this limitation would add unnecessary complexity to the system which could confuse unsophisticated taxpayers.

Oil Search would be happy to work with the Committee on the assessment of the potential financial impacts of this change and also in relation to the architecture of a robust tax loss transfer system.

Carry-back of losses

Whilst there is economic justification for the introduction of a loss carry-back system, in the current PNG environment, introducing such a system is not recommended. As foreshadowed in the consultation paper, loss carry backs can be a significant risk to the revenue in the event of an economic downturn. Further, carrying back current year losses also adds significant complexity to the tax system.

We would recommend that the consideration of the potential for PNG to adopt a loss carry back system be deferred until such time as the PNG fiscal budget has grown sufficiently such that it could weather an economic downturn.

Capital Restructuring

Where PNG corporate taxpayers are undertaking capital management initiatives, there is currently uncertainty as to how a taxpayer must account for the buy-back. This is attributable to the lack of guidance on these issues in the PNG tax law. At present, the boards of the companies would seem to have a discretion as to whether they debit retained earnings or share capital when undertaking an on-market or off-market buy-back. Given that a return of capital would not attract dividend withholding tax, but the distribution of a dividend by a company would potentially attract dividend withholding tax, it follows that a company may prefer to debit retained earnings when undertaking a share buy-back program as it can ultimately leave a greater amount of cash in shareholders' hands.

The Australian experience in relation to the taxation of buy-backs should not be used as a point of reference due to three critical differences between the PNG and Australian tax systems.

1. The ability to attach franking credits to the dividend component of an off-market buy-back price;

2. The fact that franking credits are refundable to certain classes of entities, in particular superannuation funds; and
3. The absence of a capital gains tax in PNG.

The other significant factor to take into account in considering the introduction of share buy-back rules is the significant lack of liquidity in the POMSOX. Hence, it is not clear why capital management is a focus area for this review. It would seem that the only material issue that the Committee could be concerned about is PNG corporates with a foreign listing undertaking capital management activities on that foreign exchange. This would seem to only capture a handful of corporates once oil and gas entities are removed from the equation (no dividend withholding tax is applied on their dividends so no arbitrage opportunity arises based on how they treat the buy-back). Of the remaining dual listed corporates, Oil Search is not aware of any of them having undertaken capital management programs in recent times. Hence, we would suggest that any reform to this area of the law should be low priority.

To the extent that the Committee was still concerned around the way buy-backs are being undertaken, any new provisions should be limited to setting out how companies should account for the buy-backs. In this regard, we would recommend that the committee consider the 'slice' approach which would debit share capital and retained earnings proportionately if a buy-back was undertaken.

The consideration of the tax implications of PNG resident individuals participating in buy-backs may be considered separately in the Committee's paper on personal taxation in PNG. For simplicity, we would assume that the disposal of a share as part of a buy-back arrangement should continue to be treated as a non-taxable capital gain to an individual, regardless of whether a component of the buy-back price may have otherwise constituted a dividend.

Taxation of Trusts

Oil Search supports the continued treatment of trusts as companies. Introducing flow-through taxation of trusts, as is a feature in numerous common law countries, would add significant complexity for the IRC in terms of auditing the affairs of taxpayers. Allowing for the flow-through taxation of trusts could lead to an increase in tax minimisation schemes and could potentially harm the PNG tax revenue.

Capitalisation of Interest in Development Costs

Whilst not an issue that the Committee has sought input on, Oil Search would like to take the opportunity to highlight the treatment of interest expenses in PNG. The quarantining and capitalisation of interest expenses incurred in connection with the construction of acquisition a capital asset for tax purposes is unique to PNG. In Australia for example, the test in relation to the deductibility of an expense is whether the amount is on revenue account and immediately deductible or is on capital account and hence should be capitalised and depreciated. Interest would rarely if ever be seen to be capital in nature as the question would be whether the borrowed funds were used by the taxpayer for the purposes of deriving assessable income, not whether the funds were borrowed in connection with construction or acquisition of an asset that will be used to generate assessable income. We recommend that Section 68(5) of the Income Tax Act be amended to specifically exclude interest expense.

Research and Development

Effective from 1 January 2014, the Research and Development ("R&D") tax concession was removed. We understand that the principle reason for this change was not because the PNG Government thought that providing an additional R&D deduction was bad policy, but simply because it didn't have the technical resources to effectively administer the regime. This development was a significant disappointment to the corporate taxpayers in PNG and we would encourage the Committee to not forget about R&D as part its deliberations. Investing in R&D creates value for taxpayers and PNG alike. Further, by providing for the additional deduction it increases investment by corporates in sectors that will lead to increased numbers of PNG citizens in highly skilled jobs. This should have a trickle-down effect of increasing the quality and number of university graduates coming out of PNG's universities. We look forward to the Committee's future paper on tax incentives where we expect that this issue will be considered in greater detail.

Responses to Tax Committee's Questions

Consultation Questions	Responses
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?	PNG should introduce foreign dividend account rules as part of creating an international tax regime that is ready for the next stage of PNG's evolution, that is, where PNG becomes an exporter of investment capital.
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?	Whilst it is acknowledged that the introduction of these rules may make PNG attractive as a conduit regime, given PNG's limited treaty network, this is unlikely to be a material risk. However, this should not limit PNG's efforts to become more involved at the global level in combatting tax avoidance.
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?	Yes PNG should adopt of set of principles on par with the EITI for large taxpayers. Whilst some privacy concerns may exist, we would expect that this could be adequately managed.
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?	PNG should introduce loss transfer rules as soon as possible. The introduction of those rules will be a spur for additional domestic and foreign investment in PNG.
Question 10.5– what are the likely integrity issues if such a regime was introduced? How might these integrity issues be addressed?	Whilst there is a notional risk that taxpayers may undertake loss trafficking, the loss utilisation tests on a change in ownership that already exist in PNG should be sufficient to combat this issue.
Question 10.6 – what do stakeholders think about how the income tax law currently treats share buy-backs? Does the	Whilst the current absence of rules around the treatment of share buy-backs does create some uncertainty, this is unlikely to be a high priority

current system create uncertainty? How critical is the need to address this uncertainty in the short term?	issue 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?	In the interests of maintaining a simplified tax system, PNG should refrain from adopting the flow through taxation of trusts. Changing the taxation of trust would create complexity, particularly for the IRC and could potentially come at a revenue cost.

Section 11: Conclusion

The stated aim of the Tax Review Committee is to ensure that PNG's tax system is relevant, efficient and effective. In this respect, the reform of the tax system can be a catalyst for economic growth in the PNG economy and the raising of living standards for all PNG citizens. For a long time PNG has relied on its resources industry to drive the economy, but this tax review provides an opportunity to lay the foundation for growth across a number of different sectors. This will smooth the inherent volatility in tax revenues, which are currently highly dependent on commodity prices, as PNG becomes more of a broad based economy.

The challenge of corporate tax reform in PNG in reality is made up of two distinct considerations. Firstly, does PNG have tax laws which capture an appropriate amount of revenue for the State? The consultation paper drafted by the Committee examines a number of potential areas of reform, and whilst Oil Search does recommend several changes, the existing system is far from dysfunctional. The second consideration as part of the tax reform process is whether the revenue authorities are equipped, in terms of headcount and technical skills, to implement and enforce those laws. Through no fault of its own, at present the IRC is suffering from being understaffed and a lack of senior administrators who have the requisite skills to administer the tax law in an efficient and effective manner. We are aware that the Committee is undertaking a diagnostic of the performance of the IRC and we strongly encourage that undertaking and look forward to the recommendations which emerge from that piece of work. However, we are also of the belief that reform of the underlying tax system can assist the IRC in delivering increased levels of performance. To that end, we strongly recommend the implementation of a self-assessment system.

It is critical for PNG that the revenue is protected from tax avoidance, whether in the form of non-compliance by PNG resident companies and individuals, or multinational enterprises artificially shifting profits offshore through related party dealings. The Committee's consultation paper on corporate and international tax reform focuses on a number of measures designed to prevent these potential revenue leakages. We support the retention of the existing mechanisms, but we caution the Committee from over-complicating the system with a substantial set of new provisions, especially where the introduction of the new rules is predicated on perceived risks to the revenue as opposed to real ones. Whilst the introduction of controlled foreign company provisions or remodelling the transfer pricing provisions may be consistent with current international tax trends, the Committee needs to consider in detail the cost/benefit analysis of introducing such provisions.

In our view, the Committee should be focussed on those reforms which simplify the tax system for corporates and those which encourage further investment in the PNG economy. In particular we strongly recommend:

- The introduction of a tax loss transfer system for wholly owned corporate groups;
- Reduction in the non-resident corporate tax rate to 41.9%;
- Simplification of the depreciation system; and

- The introduction of foreign dividend account rules.

As highlighted in our previous submission in response to the consultation paper no.1, Oil Search sees itself as more than just a taxpayer in PNG. We consider ourselves an important development partner with our nation. Our responsibility does not end at payment of the tax cheque. It is our corporate priority to partner with the State in delivering meaningful projects across the nation for sustained long term development in the furtherance of the State's development goals. This includes working with the State in relation to the tax reform agenda and we would welcome the opportunity to further contribute to the process.

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