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29 August 2014

Submission: Issues Paper No.2 – Corporate & International Taxation

Dear Sir / Madam

We write in response to the request for submissions on the Issues Paper No.2 – Corporate & International Taxation (the Issues Paper) released by the Taxation Review Committee on 31 July 2014. PwC is pleased to present its submission on the matters raised in the Issues Paper.

PwC has conducted a simple survey of businesses on tax reform in PNG and we have attached the results of the survey to this submission. We received 107 responses to our survey.

The results of the survey do not necessarily represent the views of PwC. In the interests of simplicity our survey has not explored all the matters raised in the Issues Paper, and given the limitations of the survey the results should not be viewed as a comprehensive summary of taxpayer views. The results are provided nevertheless for your information and interest.

PwC supports tax reform in PNG and the work of the Tax Review Committee. Please contact us if there are any matters you would like to discuss.

Yours sincerely

Jason Ellis

Jason Ellis
Partner

Introduction

PwC believes the PNG Income Tax Act is generally sufficiently robust to facilitate collection of a fair level of income tax in PNG and prevent tax avoidance. In our view perceived and actual tax collection shortfalls in PNG are largely the result of poor levels of compliance by taxpayers and enforcement by the Revenue Authorities.

We note that a key part of the Tax Review Committees work is the efficiency reviews being conducted of the Internal Revenue Commission and Customs, and PwC agrees with the point made in the Overview section of the Paper that improved compliance enforcement is a key factor in the Tax Review being successful.

The paper notes that of 42,522 registered companies in PNG only about 2,000 are corporate income tax payers. We note it is likely there is substantial non-compliance with other taxes, and not only corporate income taxes.

Nevertheless, we do believe there are some key technical and reform matters that should be addressed by the Committee. Many of these have been raised in our submission dated 15 May 2014, and in some cases have been noted by the Tax Review Committee in the Paper. In our view some of the key matters are:

- Introduction of a self-assessment regime for income taxes
- Alignment of the resident and non-resident corporate tax rates
- Reform of the management fee withholding tax
- Clarification of the meaning of "interest" and "dividend" for tax purposes to prevent duplication of withholding taxes
- Introduction of a foreign dividend account rules
- Introduction of tax loss transfer rules

We have discussed these matters and the other matters raised in your paper below.

While not raised specifially in the Paper we take this opportnity to raise the issue of penalties. Recent compliance enforcement, and implementation of the SIGTAS system at the Internal Revenue Commission, has resulted in penalties being issued for late payment of taxes due under the *Income Tax Act*. The Act includes provision for a 20% late payment penalty that is, technically, imposed for any late payment of tax – even 1 day late. In our view this punitive measure should be limited to gernuinely recalciltrant taxpayers, where collection activity is required by the IRC, and other late payments should be subject only to time value penalties (ie late payment interest).

As the penalty regime is contaned in the Act, statutory amendment would be required to change the incidence of imposition of the flat 20% penalty. In our view this would be helpful in encouraging a greater number of taxpayers to become compliant without the fear of an overly punitive penalty applying to a voluntary dislcosure.

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?

As a matter of principle PwC believes it is important that PNG's effective tax rate is globally competitive. As noted in the Issues Paper the PNG corporate tax rate is high compared to other jurisdictions and we note there has been a recent trend, both globally and in the region, to reduce corporate tax rates. For instance both New Zealand and Fiji have recently reduced their corporate tax rates. As there is a growing trend for jurisdictions to reduce corporate tax rates it will become increasingly important for PNG to do the same.

However, we appreciate that in practice a reduction in the company tax rate will need to be offset by an increase in other taxes, or broadening of the tax base, to compensate and ensure there is not a decline in revenue collected. Accordingly, the reduction of the company tax rate cannot be considered in isolation, and the larger issue needs to be addressed before we offer a formal view.

We note that respondents to our survey generally took the view that the PNG corporate income tax rate is high compared to other jurisdictions, but that they would not be prepared to pay for a reduction in the corporate tax rate through an increase in other taxes.

In our view a reduction in the corporate tax rate, while desirable in the medium to longer term, is not a short term priority for PNG. In the short term we would prefer to see a reduction in the dividend withholding tax rate.

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?

In our experience the 17% dividend withholding tax is significant disincentive to taxpayers distributing profits from PNG companies.

We also noted in our general submission to the Committee dated 15 May 2014 that the application of dividend withholding tax to payment of dividends by one PNG resident company to another PNG resident company is an impediment to business in PNG, and discourages the distribution of dividends within corporate groups. This view is reinforced by the results of our survey.

Section 189B of the Act imposes dividend withholding tax on dividends paid by a resident company. Where the net dividend is paid to a resident company, that company is required to record the gross amount of the dividend in an account entitled "undistributed dividend account" and is required to record the amount of dividend withholding tax in an account entitled "Refundable Dividend (Withholding) Tax Account".

Section 216 of the Act provides that a resident company is entitled to a rebate in its assessment of the amount obtained by applying to that part of its taxable income that represents dividends the average rate of tax payable by the company. The consequence of the Section 216 dividend rebate is that dividends are effectively received tax free by a resident company.

In the context of dividends received by resident companies, the combined effect of the obligation to withhold tax on dividends paid to resident companies and the dividend rebate is that dividend withholding tax represents the payment of the tax due by the ultimate shareholder and is not a tax liability of the resident company shareholder. This means the imposition of dividend withholding tax on dividends paid to resident companies is an impediment to the operation of company groups and has the potential to reduce the amount which would otherwise be available for future investment or available for repayment of debt.

Under the current law intragroup dividends are subject to dividend withholding tax but not subject to tax in the hands of the holding companies. The requirement to pay dividend withholding tax in these circumstances reduces the ability of the holding companies to reduce debt or reinvest profits. In other words, the payment of dividend withholding tax on dividends paid between resident companies is an impediment to business. It is considered this impediment should be removed by exempting from dividend withholding tax dividends paid to resident companies.

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?

Yes, the high non-resident tax rate is an impediment to foreign investment in PNG. In our view the rate should at least be reduced to the equivalent effective tax rate applying to PNG companies (ie the combined company tax rate and dividend withholding tax rate). There is no obvious policy reason for encouraging investment through a PNG incorporated company rather than a branch of an overseas company. The existing transfer pricing rules apply equally to a branch of a foreign company and a PNG incorporated subsidiary undertaking international related party transactions.

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?

No. There should not be a difference in the tax rate applying to resident and non-resident companies.

In our experience the key disincentives for foreign investors to use a PNG company are:

1. A liquidator must obtain tax clearance from the IRC before the Registrar of Companies will de-register a PNG company. In our experience this can take many years – we have applications for tax clearance that have been outstanding for more than 4 years. While taxation clearance is also required to de-register a non-resident company, and also time consuming, this does not involve the ongoing cost of a formal liquidation.

2. The annual compliance costs – in particular the requirement for a foreign owned PNG company to be audited – are higher for a PNG company than a branch of a foreign company

Accordingly, investors are reluctant to use a PNG subsidiary because of the higher annual compliance cost and the high cost of exit.

If there is a desire to encourage foreign investors to use PNG companies to invest in PNG this should be facilitated by provision of a simple and efficient regulatory system in PNG, not by applying a tax penalty to the use of foreign companies.

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

PwC believes it is important that the management fee withholding tax is reformed and we have discussed this below at 3.8.

We also note that if, as proposed at section 6 of the Issues Paper, PNG's tax treaty network is not extended, it may be worthwhile considering a reduction in dividend withholding tax and interest withholding tax rates to bring these in line with the standard rates used in treaties (globally, not just the PNG treaties) – eg a reduction of the rate imposed by domestic law to 10%. This would reduce the incentive for "treaty shopping" and provide a simpler platform whereby the same withholding tax rates apply in all cases.

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)?

In our view the mechanism for calculation of foreign contractor withholding tax should be retained. Otherwise, PNG would potentially have 3 different tax rates:

- One for resident companies (then with a dividend withholding tax)
- One for non-resident companies
- One for foreign contractors.

If there is a view that the foreign contractor tax does not collect sufficient revenue then this should be addressed by varying the deemed profit margin that is applied, not by applying a different tax rate.

The current mechanism for calculation of foreign contractor tax is well understood. However, one point which needs to be made clear is that foreign contractor withholding tax applies to companies and not individuals undertaking working in PNG. The extended definition of salary or wages means there is a presumption that payments to individuals are subject to salary or wages tax. Given the compliance costs operating in PNG including the need to obtain a work permit and employment visa it is unlikely foreign workers can be engaged as foreign contractors through interposed entities rather than employees.

It is also important that the foreign contractor tax is understood to be an income tax on company profits, and that the withholding is simply a collection process. In some cases this may be important for taxpayers in their home jurisdiction in classification of the PNG source income and relief for the tax deducted. Accordingly, we believe that the non-resident income tax rate should be used in the calculation of the foreign contractor withholding tax liability.

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

As noted above, the foreign contractor tax should be administered as a tax on company profits. Accordingly, there is no basis for the rate to be 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?

Yes, we agree that this should be a matter of law rather than discretion.

We note that the IRC, in its recent Taxation Circular, TC 2013/4, dealing with the administration of the foreign contractor withholding tax system, has advised that permission to lodge an annual tax return will be granted to taxpayers as a matter of course. This being the case there would appear no reason this approach cannot be reflected in the law to provide greater certainty to taxpayers.

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?

We do not agree with the management fee withholding tax. As noted in the paper the withholding tax, together with the section 68AD, effectively operates as an anti-avoidance provision to prevent the shifting of profits out of PNG.

However, PNG tax law contains general transfer pricing rules that can be applied to ensure that profit shifting – via management fees or otherwise – does not take place. There is no the need for a specific anti avoidance measure.

The problems with the current system are:

- It results in PNG collecting tax from non-residents on non-PNG source income. This is contrary to the underlying principle of PNG tax law (ie that non-residents should be taxed only on PNG source income).
- The withholding tax is not limited to payments to associates. Payments to unrelated parties – where there is no profit shifting intention – are also subject to management fee withholding tax (and, again, the non-resident is taxed on non-PNG source income)
- In many cases the non-resident is not able to obtain relief from the PNG tax in their home jurisdiction (ie a foreign tax credit) because the income is not foreign source income (ie it has home jurisdiction source, not a PNG source).
- WHT applies to the deductible part of the management fee, but not the amount that is non-deductible under section 68AD.

The intention of section 68AD is to capture payments that might be called "dividend substitution arrangements" – ie profits remitted through inflated management fees, rather than by dividend. This being the case the withholding tax should apply to the non-deductible, dividend substitution, portion of the payment only, and not to the deductible portion. Importantly, as a dividend substitution arrangement the withholding tax should apply only to payments to associates.

In our view both section 68AD and the management fee withholding tax should be repealed and enforcement dealt with under the transfer pricing rules. However, if these provisions are retained they should operate as follows:

1. Withholding tax should apply only to payments to related parties.
2. Withholding tax should apply only to the non-deductible amount in excess of the section 68AD limit.

Most importantly, in our view, there is no policy basis for imposing management fee withholding tax on payments to unrelated parties. This results in imposition of tax on the non-PNG source income of a non-resident of PNG, and applies in cases where there is no tax avoidance (ie profit shifting) motive.

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?

PwC supports the introduction of a self-assessment regime for companies in PNG for the following reasons:

- In our view the IRC resources currently dedicated to the assessment of tax returns can be more effectively and efficiently deployed in compliance enforcement and audit activities.
- The current assessment system is not working – in many cases assessments take years to issue, which creates uncertainty for taxpayers and defers the collection of revenue by the IRC.
- There should be no cost to the revenue from adoption of a self-assessment system. The IRC will still have the ability to review assessments and make amendments via a tax audit process.
- Self-assessment is compatible with the move toward greater levels of electronic lodgement.
- Self-assessment regimes are in place in many other jurisdictions.

While we acknowledge that self-assessment will in some cases result in tax being payable by companies at an earlier time than is currently the case (ie payment on lodgement, rather than waiting for an assessment to issue from the IRC), we believe the increased certainty that comes with a set date for payment of tax will be welcomed by most taxpayers.

In our view there is no particular reason to limit – even initially – self assessment to large corporates. The simplicity and certainty of a self-assessment system would be welcomed by SMEs, and is consistent with encouraging SMEs into the tax system and providing a simpler process for them to participate. Having separate systems for large and other corporates will only add complexity to the regime.

We note that the responses to our survey where overwhelmingly supportive of a self-assessment regime.

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

In our view the introduction of a self-assessment regime should be a priority for PNG. This is fundamentally important to improving efficiency at the IRC and ensuring that resources are directed to productive compliance enforcement activities.

In conjunction with the introduction of a self-assessment regime we recommend that the lodgement program and timetable be reviewed and possibly be incorporated into the law (or regulations) rather than the current practice of Gazettal. In our view the current lodgement program prescribed by the IRC is not realistic. Some of the issues we have identified with the current lodgement program are:

- The current program is based on lodgement percentage milestones, commencing on 30 April each year. We note that the Companies Act requires companies to prepare financial statements or accounts within 5 months of year end. For a December balancing company, this means the accounts must be completed by 31 May. It is not clear to us why income tax returns are required to be completed and lodged before financial statements are prepared. In practice it is not possible to prepare a tax return in advance of the final accounts, so the 30 April and 31 May lodgement milestones are impossible to meet.

- PwC supports a 'staggered' lodgement timetable to avoid having all returns due at the same time. However, in our view the current arbitrary milestone percentage approach is not workable. For example, tax agents are required to have 30% of taxable returns lodged by 30 April - putting aside the practical difficulty with a 30 April lodgement date (as described above), there is no basis for selection of the 30% to be lodged. Tax agents have to convince an arbitrarily selected 30% of their clients to lodge earlier than other clients, and somehow explain to these clients why they have been selected. Clients are, unsurprisingly, resistant to lodging early and all will work toward a 30 June lodgement date.

  The arbitrary milestones also encourage taxpayers to 'shop around' for a tax agent that can - for whatever reason - facilitate a later lodgement date for them.

  PwC believes that lodgement dates should be determined by an objective distinction between taxpayers - for example, taxpayers could be classified as 'small', 'medium', or 'large' taxpayers (eg based on tax payable, or turnover, or some other measure), and lodgement dates assigned accordingly. Alternatively, taxpayers could be classified by industry - there is already a different lodgement date for resource companies to all other companies.

- Finally, PwC would like clarity on the lodgement date for taxpayers with substituted accounting periods (ie other than 31 December). The tax agent lodgement program prescribes that lodgement dates are set by reference to the balance date, but this has not historically been enforced by the IRC which has simply identified tax returns by the 'year of tax'. Early balancing companies have been able to lodge by 30 June each year, even though this is more than 6 months from year end, without penalty. Late balancing companies have had to request formal extensions to confirm that they can lodge up to 6 months after year end to prevent returns being treated as late when lodged after 30 June.

- There should be no gross up or deemed income imposed by the IRC when companies request a substituted accounting period. In our experience substituted accounting periods are usually requested to align the companies PNG balance date with its overseas parent. Due to the possibility of the IRC imposing a gross up, many companies balance dates in PNG are not aligned to their foreign parent resulting in additional compliance costs and can result in delays in finalising their PNG income tax returns.

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?

PwC agrees that technical amendment to the transfer pricing (and other) provisions to ensure the integrity of the rules is important. However, at this stage we note that the existing transfer pricing rules are not enforced by the IRC. We are not aware of a risk review yet being undertaken by the IRC. Accordingly, we believe the priority should be establishing a process for enforcement of the existing rules before determining whether these rules are sufficient.

We also note that Base Erosion and Profit Shifting (BEPS) is a developing issues globally, and in our view legislative response, particularly from a developing nation, should be deferred until the BEPS issues are fully understood and developed. In many cases BEPS is focused on the new economy (digital business etc) and how tax system should tackle tax this. In our view this is not yet an issue for a developing nation such as PNG.

We are not aware of sophisticated transfer pricing, profit shifting, and anti-avoidance strategies being employed by PNG taxpayers and the existing rules should be adequate at this stage. The key issue is capacity building and compliance enforcement of the existing rules

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?

PwC does not believe it is necessary to extend the thin capitalisation rules to the financial sector.

Licensed financial institution are already subject to minimum capital requirements prescribed by the Bank of PNG, and we do not believe there is any basis for applying any stricter gearing requirements for tax purposes that are already prescribed by the Bank of PNG.

The Prudential Standard issued and enforced by the Bank of PNG imposes 3 capital adequacy requirements:

- Leverage (equity) Capital Ratio.

  The Leverage Capital Ratio is calculated as tier 1 capital divided by total assets, less: goodwill and other intangible assets, future income tax benefits, losses carried forward and encumbered assets, all of which are also excluded from Tier 1 capital.

  The minimum Leverage Capital Ratio is 6.0%

- Tier 1 Risk-Based Capital Ratio.

  The Tier 1 Risk-Based Capital Ratio is calculated as tier 1 capital divided by total risk-weighted assets.

  The minimum Tier 1 Risk-Based Capital Ratio is 8.0%

- Total Risk-Based Capital Ratio.

  The Total Risk-Based Capital Ratio is calculated as total capital divided by total risk-weighted assets.

  The minimum Total Risk-Based Capital Ratio is 12%.

Australia and New Zealand have recently increased the minimum capital requirements that apply for banks under the thin capitalisation rules in those countries from 4% to 6% of risk weighted assets. The prescribed minimum requirements of the Bank of PNG are higher than the thin capitalisation requirements in Australia and New Zealand.

If the thin capitalisation rules are extended to financial institutions we believe the gearing ratio applicable should be at least 15:1 – noting that Australia has recently reduced the ratio for non-deposit taking financial institutions from 20:1 to 15:1.

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?

Yes. The current definitions of 'debt' and 'equity', and 'interest' and 'dividend' in the Income Tax Act make it possible for a return on an instrument to fall within the definition of both interest and dividend. This creates the following issues:

- Uncertainty about the classification and therefore whether the return will, subject to thin capitalisation rules, be tax deductible;
- The possibility that, technically, both interest and dividend withholding tax can apply to the same return.

In our view it is important that this uncertainty is addressed. We have set out some further detail on this below.

Background

In the 2012 National Budget the *Income Tax Act* was amended to include thin capitalisation rules for all companies. In conjunction with these amendments, definitions of "debt", "equity" and "interest" were included in Section 4 of the Act and these definitions have effect from 1 January 2013. In particular, the definition of interest extends the meaning of interest beyond its ordinary meaning to include, amongst other things, an amount:

- that is in the nature of interest; or
- that represents the time value of money in relation to the cost of a debt; or
- to the extent that it could reasonably be regarded as having been converted into a form that is in substitution for interest; or
- of a discount in relation to a security to the extent that the discount could reasonably be regarded as representing the time value of money; or
- to the extent it could reasonably be regarded as having been received in exchange for interest in connection with a washing arrangement; or
- which would be classified as interest or in the nature of interest if it were disclosed in financial statements prepared in accordance with the standards published by the International Accounting Standards Committee.

On the other hand the existing definition of dividend includes within the meaning of dividend:

- Any distribution made by a company to any of its shareholders.
- Any amount credited by a company to any of its shareholders as shareholders.

The existence of these two definitions in the Act creates a dilemma where a company is making a payment which can be characterised as interest and as a dividend for income tax purposes. An example of this situation is where a company issues redeemable preference shares and the dividend return is based on a fixed rate on a cumulative basis.

Where preference shares are issued with a cumulative fixed rate of return and are redeemable at the option of the holder, the preference shares have some of the characteristics of debt but remain at law shares. However, in order to categorise a financial instrument as debt or equity for taxation purposes, it is necessary to consider the classification of the financial instrument for accounting purposes.

The International Accounting Standard (IAS) 32 deals with the classification of financial instruments into financial assets, financial liabilities and equity instruments. In discussing the classification as liability or equity IAS 32 includes the following general statement:

"The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument."

For the purposes of IAS 32 a *"financial instrument is an equity instrument only if (a) the instrument includes no contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer and (b) if the instrument will or may be settled in the issuer's own equity instruments, it is either:*

- *a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or*
- *a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments."*

If the preference shares have a fixed rate of return and are redeemable at the option of the holder, then there appears to be a contractual obligation to deliver cash and, therefore, it seems likely the preference shares would be recognised as a liability for accounting purposes. In other words, applying a substance over form approach it is likely that preference shares with a cumulative fixed rate of return would be classified as debt for accounting purposes.

In summary, if preference shares are characterised as debt under the accounting standards, then under the definition of debt in the Act, the preference shares would also be classified as debt for income tax purposes. In addition, the amount payable on the preference shares would be classified as interest for accounting purposes and would also be classified as interest for income tax purposes in accordance with the definition of interest in Section 4 of the Act.

On the other hand a preference shareholder will be entered in the share register of the issuing company, as a shareholder in the company and the preference share will be a share under the *Companies Act 1997* ("the Companies Act"). A shareholder is defined in the Act as a "member" or "stockholder", and although these terms are not defined in the Act, it would seem reasonable to conclude a preference shareholder who is a shareholder for the purposes of the Companies Act would also be a shareholder for the purposes of the Act. Accordingly, it is considered that the holders of preference shares will be shareholders for the purposes of the definition of dividend.

It follows that the dividend paid on the preference shares will be characterised as a dividend for income tax purposes. Given this payment is also classified as interest it appears it is not possible for the Commissioner General to determine how such a payment should be characterised for income tax purposes in the hands of the payer or the payee in the absence of any clear legislative guidance.

In these circumstances, we expect the logical outcome would be symmetry in the taxation treatment of an amount which is both a dividend and interest for taxation purposes. However, this is not supported by the current law and it is possible for the situation to arise where the taxpayer paying the dividend is entitled to a deduction and the taxpayer receiving the dividend is not subject to dividend withholding tax and is not subject to income tax as a result of the dividend rebate.

The interest and dividend withholding tax provisions in the Income Tax Act do not operate exclusively of one another – because a payment is subject to interest withholding tax it is not specifically excluded from the dividend withholding tax provisions, and vice versa. Accordingly, if an return is both interest and dividend as defined in section 4 it will, technically, be subject to both interest and dividend withholding tax.

Suggestion

Prior to 1 January 2013 it was clear that a dividend paid was not an allowable deduction for income tax purposes on the basis that a dividend is a distribution of profits, rather an expense incurred in deriving those profits. There seems to us to be no benefit to the PNG revenue in a change in the law which potentially allows a deduction for dividends.

In addition, according to the explanatory memorandum which accompanied the Income Tax (2013Budget) (Amendment) Bill 2012 the relevant definitions were introduced *"to extend the thin capitalisation rules (interest deduction limitation) to all taxpayers, other than financial institutions"*. The pre-existing thin capitalisation rules applied only to resource projects and as these rules did not contain an extended definition of interest the anomaly discussed in this letter did not arise. In particular it is noted that under the thin capitalisation rules applicable to resource projects prior to 1 January 2013 a dividend would be treated as a dividend regardless of how it was treated for accounting purposes. Accordingly, it seems this issue is an unintended consequence of the 2013 Budget amendments.

Against this background, it is submitted that the simplest solution to the issue is to exclude from the definition of interest an amount which is a dividend for the purposes of the Companies Act. This will ensure that a dividend which is treated as interest for accounting purposes is not an allowable deduction for income tax purposes and the treatment in the hands of the shareholder follows the taxation treatment of dividends (including where applicable the deduction of dividend (withholding) tax and the allowance of the dividend rebate for resident company and authorised superannuation fund shareholders).

The alternative approach is for the interest definition to take priority over dividend (ie the definition of a dividend excludes any amount that is interest). In our view this is not the preferred approach – the situation before January 2013 was well understood and we are not aware of circumstances where the rules were used to obtain any tax arbitrage.

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 issues paper addresses the following:

- Controlled foreign company rules
- Transactions with secrecy jurisdictions
- Earnings stripping rules
- Minimum tax
- BEPS

PwC does not believe these are a priority for PNG at this stage. Addressing each in turn:

- CFC rules are by nature complicated and difficult to enforce. PNG is primarily an inbound investment economy, and we are not aware that strategies to avoid PNG taxes through CFCs are common. Accordingly, we do not believe the introduction of a CFC regime will be a significant revenue raiser for PNG and enforcement activity can be more productively directed elsewhere.

- PNG already has rules requiring tax clearance for remittance of funds outside of PNG, and additional requirements are in place in the tax clearance process for transactions with high risk jurisdictions. We agree in principle with greater sharing of information between jurisdictions but do not believe any additional unilateral measures are a priority for PNG at this stage.

- PwC believes that the existing thin capitalisation rules are adequate to prevent earnings stripping arrangements.

- PwC does not support a minimum tax. In our view this is likely to impose an additional tax burden on SMEs and start-up businesses.

- Our comments on BEPS are set out above. In our view the priority for PNG is enforcement of existing transfer pricing and anti-avoidance measures. PNG should continue to monitor BEPS developments with a view to legislative action in future once the issue are properly understood and a framework for compliance in PNG is in place.

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?

The IRC has limited senior resources which should be applied to resolving outstanding issues such as objections, requests for amendment, requests for confirmation of GST zero-rating for resource companies and requests for confirmation of charitable status, The IRC should be addressing these technical issues as a matter of priority. In addition, priority should be given to ensuring there is an efficient process for implementation of DTA's . The failure to implement the DTA with New Zealand on a timely basis after signature is an example of the failure of the existing procedures.

Question 6.2 – do stakeholders 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?

Yes PwC agrees in principle there is a need to review on a regular basis its existing treaty network. However, as noted above the senior resources at the IRC should be applied in the first instance to deal with the enormous back log of outstanding issues noted above at 6.1.

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?

PwC agrees in principle consideration should be given to joining the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. However, again priority of senior IRC resources needs to be applied to outstanding issues. In addition, consideration should be given to whether there are other strategies which should be pursued to increase the existing tax base. PNG already has the ability to deal with international transfer pricing but does not have complex controlled foreign company or controlled foreign trust measures. Consequently, some information may be of little or no practical value.

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

PwC agrees in principle consideration should be given to enhanced international engagement with other tax authorities. However, again priority of senior IRC resources needs to be applied to outstanding issues. In addition, consideration should be given to whether there are other strategies which should be pursued to increase the existing tax base. PNG already has the ability to deal with international transfer pricing but does not have complex controlled foreign company or controlled foreign trust measures. Consequently, some information may be of little or no practical value.

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).

We believe that updating the effective life / depreciation tables is a priority for PNG. As noted in the Issues Paper these rules are considerably out of date and it is often difficult for taxpayers to identify the rate that should apply to a newly acquired asset.

PwC does not support the use of accounting depreciation rates for tax depreciation, for the following reasons:

- Tax depreciation is based on the effective life of an asset – this is not the same as the concept of useful life that is used for accounting purposes, and therefore fundamentally changes the basis of tax depreciation.
- The IRC would need some comfort that the accounting rates used by taxpayers are at least set in accordance with approved accounting standards. While this might be the case for taxpayers whose accounts are audited, there are many taxpayers who are not required to comply with accounting standards and could use whatever depreciation rates they choose. Taxpayers whose accounts are not audited or are privately owned may in practice use tax depreciation rates for accounting purposes.
- We believe the concessions – ie various levels of accelerated depreciation – in the existing tax depreciation rules are valued by taxpayers and therefore important to the levels of capital expenditure and investment in PNG. Accordingly, we would recommend that taxpayers have the option to elect to apply the accelerated depreciation rates, rather than accounting rates. It seems likely that accelerated depreciation would be chosen by many larger taxpayers and therefore it would primarily be smaller, unaudited taxpayers that apply their accounting depreciation.

In our view the use of accounting depreciation by unaudited taxpayers will reduce the amount of control and regulation of tax depreciation and potentially compromise revenue collection.

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?

In our view this is a valuable proposal. The requirement to maintain small assets on the tax depreciation register (perhaps indefinitely if diminishing value depreciation is applied) is a significant compliance cost for taxpayers. The cost to the revenue of allowing low value asset to be expensed is a timing cost only, and in our view unlikely to be significant.

In our view the K1,000 limit prescribed in Division 10 is no longer commercially practical and we suggest a higher threshold is appropriate. We would recommend this be at least K5,000.

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

PwC agrees that simplifying the tax system for small business is an important factor in encouraging compliance. However, in the case of the depreciation rules we believe that significant simplification can be achieved from:

- Updating the prescribed depreciation rates, and
- Allowing write off or pooling of low value assets

Simpler treatment of low value assets will in many cases cover a substantial amount of the capital expenditure of a small business, while still leaving the existing regulation, control (and concessions) in place for larger items.

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

We are not aware of significant costs that do not qualify for any tax relief, or that this is a current impediment to business in PNG. Nevertheless, PwC believes that tax relief of some form should always be available for expenditure by companies (except where there is a deliberate policy to make certain costs non-deductible) and expenditure should not be unintentionally non-deductible.

PwC supports the introduction of rules allowing for some tax relief – eg write off of otherwise non-deductible costs over a period of, say, 5 years – would be welcome to provide some certainty to taxpayers.

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?

No. In our view the depreciation concessions (ie accelerated depreciation) are an important factor in capital expenditure decisions and removal of the concessions would have the effect of reducing the level of capital investment in PNG.

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

If the cost to the revenue is prohibitive to the introduction of an immediate write-off for low value assets we would alternatively support a low value pooling mechanism. Under low value pooling all assets under a certain value would be aggregated and depreciated as a lump sum at a prescribed rate. If low value pooling is adopted instead of immediate expensing, we suggest a threshold for pooled assets of at least K10,000.

The Committee may also consider the introduction – even if only temporarily – of an investment allowance or similar mechanism whereby an additional deduction or tax credit is allowed for qualifying capital expenditure on new assets.

The investment allowance was reintroduced in Australia in 2008 (through to 2012), in response to the global financial crisis, to encourage capital expenditure by business. In our view a similar scheme may be worthwhile in PNG at a time when business activity is declining following the completion of construction of the PNG LNG project. A stimulus for additional expenditure would also act to compensate for the removal of the R&D tax concession, but could be much simpler to administer than the R&D concession.

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?

PwC agrees that the training levy does not operate as an incentive to train staff. In the majority of cases this incentive to train staff is inherent in the business and the training activity will be undertaken by the employer regardless of whether the training levy is imposed.

Given the compliance burden on business of the training levy, and the fact that limited revenue is collected because of the qualifying training expenditure incurred, we agree that the training levy should be repealed.

If the training levy is not repealed we would suggest that some amendments be made to improve the fairness of the levy and reflect its policy intent. Training levy is imposed on total payroll, including PNG citizen and non-citizen staff, but only expenditure incurred in training citizen staff can be qualifying training expenditure. Accordingly, examples of scenarios where inequitable outcomes can arise include:

- where citizen and non-citizen staff are employed by separate entities. Because there is no grouping permitted for training levy the expenditure on training the citizen employees cannot be offset against the training levy liability of the company that employs on non-citizens.

- where citizen employees are engaged through labour hire companies, and the taxpayer therefore does not have any citizen employees of its own, and therefore no qualifying training expenditure. This is particularly the case for resource projects where a large amount of the local workforce is engaged through landowner companies. The taxpayer will still incur expenditure on training the people, but they are not their own employees.

In our view the rules should reflect the policy intent of encouraging training of citizens and where expenditure is incurred for this purpose it should be qualifying training expenditure that can be offset against the training levy liability.

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?

PWC agrees there may be a role for export taxes as a means of revenue collection where revenue collection is particularly challenging. The paper notes in the 2000 Taxation Review in relation to logging *"there were particular concerns around the use of transfer pricing as a means of limiting corporate tax payments."* PWC makes no comment on whether or not this concern was and remains valid. However, the fact that this is being raised in the 2014 Taxation Review suggests the IRC has not taken the lead and focussed on auditing these sectors and addressing the issue using the existing provisions available to the Commissioner General.

On balance it is considered the IRC should increase its resources to enable it to enforce compliance with PNG's transfer pricing provisions rather than simply introduce new taxes and apply the same level of enforcement. The latter would presumably result in a similar lack of compliance.

We also feel strongly that export taxes should not be used as a policy lever to encourage (or compel) the establishment of otherwise unsustainable industry in PNG – eg where an export tax is imposed on unrefined materials to encourage business to use a preferred refiner in PNG to refine their product to avoid export taxes. This strategy has been employed in other jurisdictions with, we understand, disastrous consequences for the applicable industries in those jurisdictions. Such a strategy in PNG is likely to have similarly adverse impacts on investment in PNG.

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?

PwC supports the introduction of foreign dividend account rules. Our full reasoning and analysis is set out in our submission dated 15 May 2014.

In summary, under the current law non-residents who invest in PNG companies will be subject to PNG dividend (withholding) tax on the dividend income from those investments either when the income is derived or when it is distributed to the non-residents. This will be the case whether the underlying income is derived in or outside PNG. However, if the non-residents derived the foreign dividend income directly, or through an interposed foreign entity, the dividend income would not be subject to PNG tax because foreign residents are taxed only on their PNG source income.

It is submitted by eliminating this tax disincentive, the proposed measure will improve PNG as an investment location for foreign investors without impacting existing Government revenues. It is considered the reforms will encourage the use of PNG as regional headquarters as PNG's existing major companies expand their investments beyond PNG and will also improve PNG's attractiveness as a base for our multinational companies. It is considered if these measures are not introduced PNG's multinational companies will look to alternate means of dealing with the issues which could mean the loss of the PNG identity of some multinational groups.

However, this measure does not, nor is it intended to, remove any PNG tax paid by the PNG entity on the income from the foreign investments. Nor does it refund any of that entity-level tax when the income is distributed to foreign investors. To do either of these things would mean giving foreign-owned PNG companies an unfair advantage over PNG-owned companies when it comes to investing offshore.

These measures are aimed entirely at improving the attractiveness of PNG as a location for regional holding companies and particular businesses of foreign groups. However, the main reason for the proposal is that it will enhance the ability of PNG entities with foreign investments to compete for foreign capital and therefore encourage them to remain PNG residents if their foreign shareholding becomes significant.

This measure is intended to ensure foreign dividend income can flow through more than one PNG entity by removing PNG dividend (withholding) tax on this income when it is distributed to non-residents. This ensures that foreign residents get tax relief for foreign dividend income when they invest in a PNG entity which invests in other PNG entities that earn foreign dividend income. This should provide greater flexibility in structuring holding company arrangements in PNG.

We recommend an amendment that:

1. provides an exemption from dividend (withholding) tax to the extent a dividend is paid out of a foreign dividend account; and
2. establishes the mechanism for recording receipts and payments to a foreign dividend account.

Under the proposed measure, a PNG entity can declare all or part of a dividend to be conduit foreign dividend income in a distribution statement. Where that distribution is made to a non-resident, the

PNG entity will not be obliged to withhold dividend (withholding) tax to the extent it is declared to be conduit foreign dividend income.

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?

In our view a simple foreign dividend account rule would not be open to abuse.

Importantly, dividends received by a company in PNG, including dividends received from overseas, are subject to dividend rebate. This means that the dividend is effectively tax free, but that deductions are offset against the dividend income before the rebate is applied.

We are aware that in some jurisdictions pass through foreign income has been used to "generate" tax deductions that can be offset against other income – eg by gearing the foreign investment to create interest deductions, which are then offset against other income (since the foreign dividend is not taxable). This should not be an issue in PNG since the deductions relating to the foreign dividend are offset against the foreign dividend, before applying the rebate, so are not available to be offset against domestic PNG income.

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?

As a general proposition PWC supports a move towards broader corporate transparency. However, it is considered this is not a priority for PNG at the present time. Apart from the additional compliance burden this would place on companies, such initiatives are likely to only be taken up by those companies which are compliant in any case and would likely be limited in their application to larger taxpayers which are themselves public companies or subsidiaries of public companies.

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?

PwC supports this introduction of tax loss transfer rules. Our reasoning and analysis is set out in our submission dated 15 May 2014.

The current prohibition on grouping of losses means that:

- Organisations set up their affairs in single companies – even where different and distinct business are operated – so that losses from (for example) start-up businesses are able to be utilised by profitable businesses. Ordinarily, different businesses should be operated by different companies (for compliance, governance, liability limitation) and the current tax law distorts ordinary commercial decision making.

- In some cases new businesses may not be established because the inability to utilise tax losses in start-up phase, against the income of mature businesses in the same group, means the return on the new business is not sufficient for a positive investment decision.

- Where losses are incurred by an entity in a group the inability to transfer the loss leads taxpayers to create artificial means of transferring the loss through other intra-group transactions.

Tax grouping is a feature of most developed tax regimes. PwC believes that the inability to transfer tax losses distorts economic decision making and potentially stifles new investment in PNG. Allowing tax loss transfer should not be a cost to the State – it is a timing matter only, and in many cases taxpayers are employing tax planning measures to effectively transfer losses anyway.

We also note that the majority of respondents to our survey have stated that the inability to transfer tax losses has affected the structure through which they carry on their business.

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

In our view there should not be any significant integrity issues arising from the ability to transfer tax losses. At the present time taxpayer's typically structure their affairs in a single entity, so the losses are available anyway, and it is the tax outcome that drives the business structure. If losses can be transferred then the business structure may be changed, but the utilisation of the tax loss is not.

In addition, the *Income Tax Act* already contains rules governing the ability to carry forward tax losses (continuity of ownership and same business tests) and these should be sufficient to prevent "trafficking" in tax losses.

PwC would support a measure limiting the ability to transfer tax losses situations where the companies are group companies at the time the loss was incurred, and the time the loss is transferred. This would further prevent the incentive / ability for acquisition of a loss entity for the purpose of accessing its tax losses.

PwC believes that loss transfer rules should be retrospective – ie allow transfer of losses incurred prior to the introduction of the loss transfer rules, provided the usual rules for transfer are met (eg that the companies were group companies at the time the loss was incurred).

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?

The current interpretation of the law by the IRC has enabled share buy-backs and reductions of capital to take place with certainty for off-market transactions. Where there may be some uncertainty is in relation to a share buy-back by a public company. Given the relatively small number of public companies and the ability of the IRC to deal with this on a case by case basis it is considered this is not an issue which requires priority.

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?

PwC supports the expansion of the unit trust provisions in the law.

We suggest amendments to assist in the establishment of property unit trusts as an investment vehicle in PNG. Although there are existing concessions in the Income Tax Act it is submitted these are not sufficient to encourage the use of this form of investment vehicle and as a result unit trusts have not been used for public investment in commercial property or residential property due primarily to the costs of establishment, the taxation rate applicable to unit trusts and other restrictions imposed by the income tax law.

Against this background we recommend changes in the law which would retain the original policy intent of the current taxation treatment of income of unit trusts but make property unit trusts a viable option as a vehicle for property investment and more attractive for PNG's largest investors.

Some years ago the income tax law was amended to provide concessional taxation treatment in respect of the income of a property unit trust. To qualify for concessional treatment, the trust must be a resident of Papua New Guinea, and the property unit trust's only undertaking must be investing funds of the trust. Funds invested must be not less than K10m, and no less than 80% of the funds must be invested in property in PNG.

Where the concessional tax treatment applies the trustee is taxed at 30% and distributions to unit holders are exempt from income tax. In addition, distributions of capital (for example realized or unrealized capital gains) or exempt income to the unit holders would not be subject to tax in the hands of the unit holders in accordance with the general principles of taxation of distributions from a trust or unit trust.

Although the taxation of unit trusts is relatively favourable they do not seem to have been widely used as an investment vehicle in PNG. It is submitted there are a number of reasons for not using unit trusts for public property investment including:

- The difficulty of meeting the ownership tests to qualify for unit trust status which include a requirement that 25 or less beneficiaries cannot hold 75% or more of the trust and no one beneficiary can hold 20% or more of the trust.

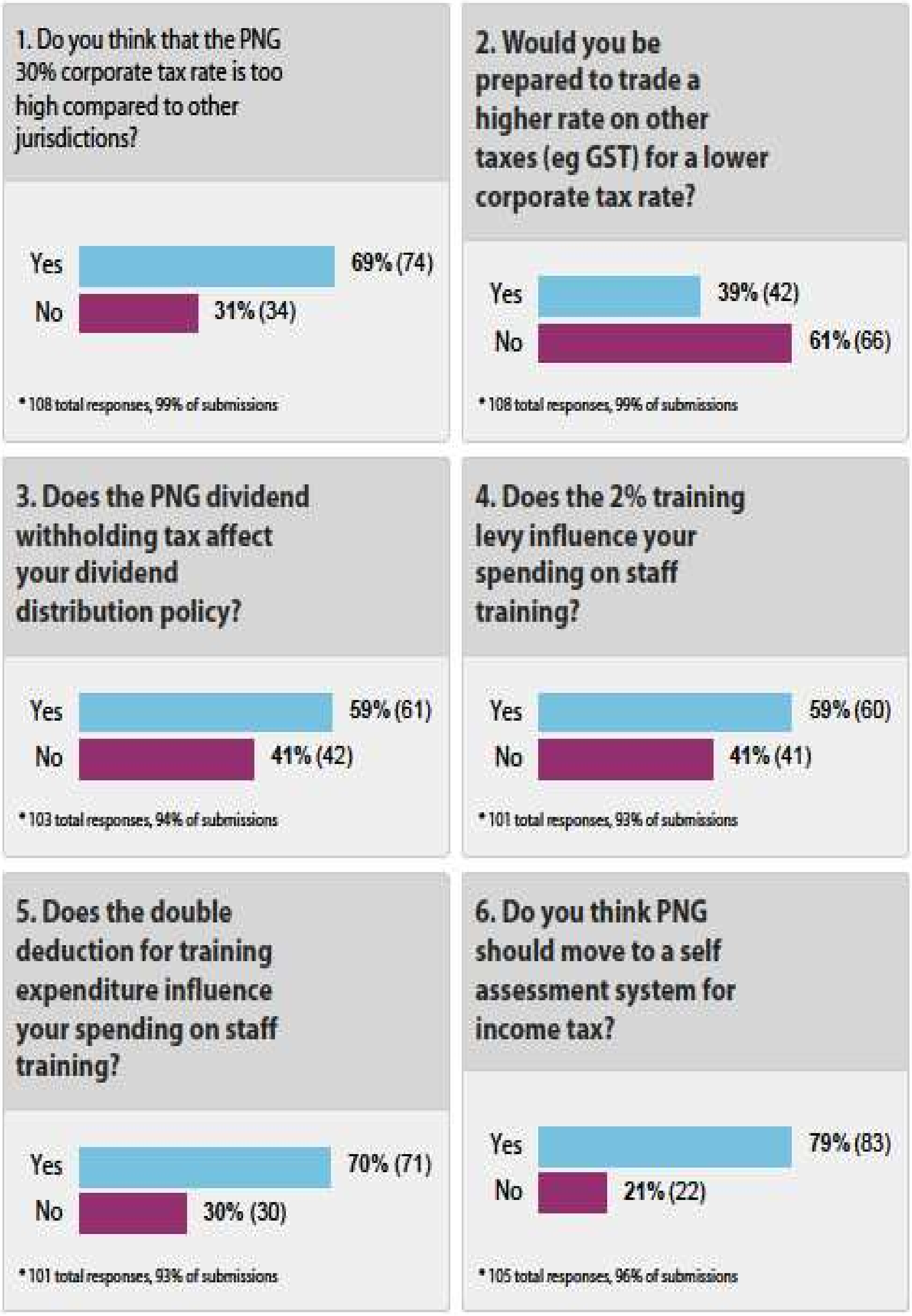
- The difference between the tax rate applicable to the income of an authorised superannuation fund of 25% and the 30% tax rate applicable to the income of a property unit trust means an authorised superannuation fund would prefer a direct investment in property over an investment in a property unit trust.

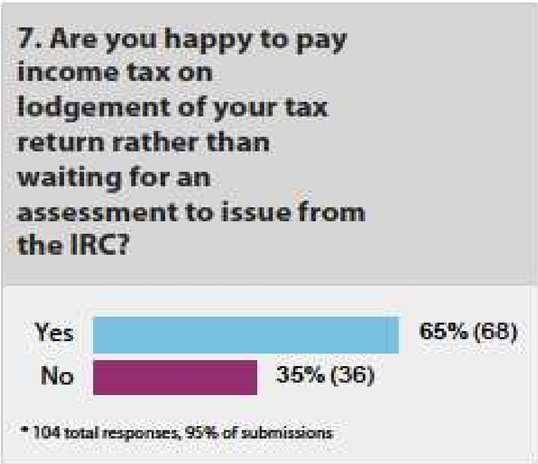
- The restriction on investment within Papua New Guinea allows no diversification of investment.

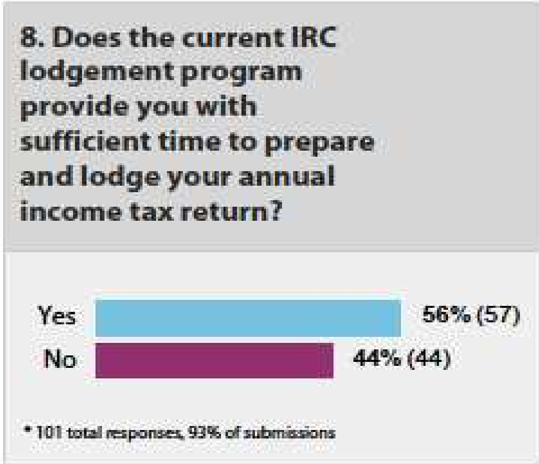
- The high stamp duty cost of the transfer of property to a unit trust means investors are unwilling to establish these investment vehicles and as a result there has been no Government revenue generated to date from the establishment of property unit trusts.

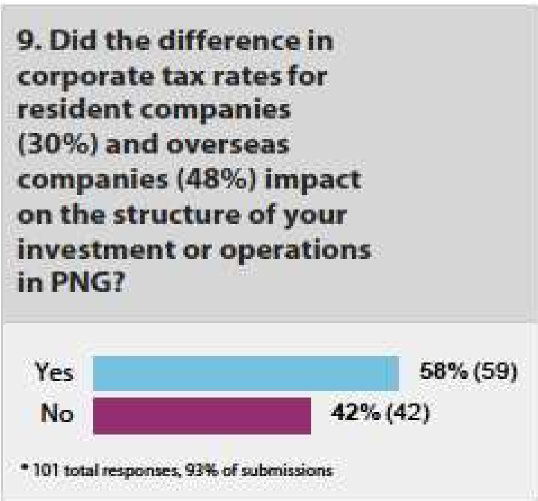
As unit trusts have not commonly been used as an investment vehicle it appears the original policy intent of providing concessions to unit trusts has not been achieved. In addition, as no revenue is currently generated from the establishment of unit trusts and property unit trusts it seems likely adjusting the concessions will result in a positive revenue impact. It is submitted the original policy intent could be achieved by making it easier to qualify as a unit trust or property unit trust without any reduction in current revenue (and in fact increasing revenue) and maintaining the original intent of preventing abuse of unit trusts and property unit trusts as investment vehicles.

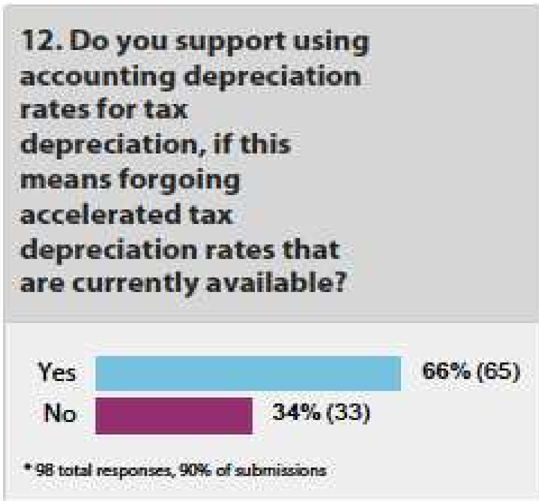
Appendix: PwC tax reform survey

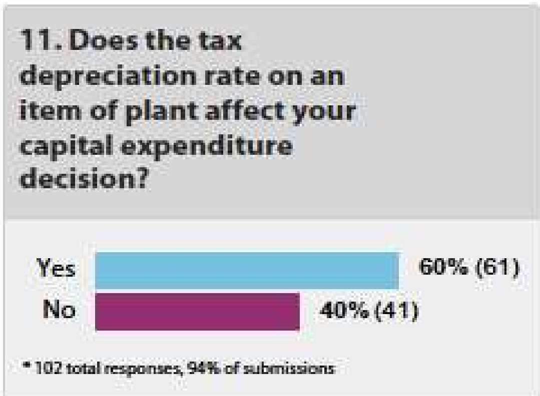


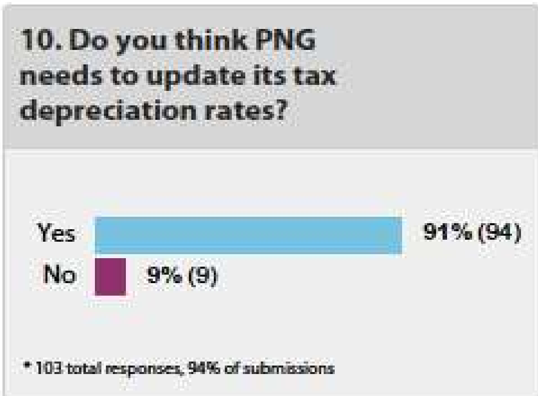

7. Are you happy to pay income tax on lodgement of your tax return rather than waiting for an assessment to issue from the IRC?
Yes
65% (68)
No
35% (36)
* 104 total responses, 95% of submissions


8. Does the current IRC lodgement program provide you with sufficient time to prepare and lodge your annual income tax return?
Yes
56% (57)
No
44% (44)
* 101 total responses, 93% of submissions


9. Did the difference in corporate tax rates for resident companies (30%) and overseas companies (48%) impact on the structure of your investment or operations in PNG?
Yes
58% (59)
No
42% (42)
* 101 total responses, 93% of submissions


12. Do you support using accounting depreciation rates for tax depreciation, if this means forgoing accelerated tax depreciation rates that are currently available?
Yes
66% (65)
No
34% (33)
* 98 total responses, 90% of submissions


11. Does the tax depreciation rate on an item of plant affect your capital expenditure decision?
Yes
60% (61)
No
40% (41)
* 102 total responses, 94% of submissions


10. Do you think PNG needs to update its tax depreciation rates?
Yes
91% (94)
No
9% (9)
* 103 total responses, 94% of submissions

13. Does the absence of tax grouping and tax losses transfer affect the structure of your business - ie. whether separate entities are used for different businesses?

* 99 total responses, 91% of submissions

14. Do tax concessions affect your business decision making?

* 102 total responses, 94% of submissions

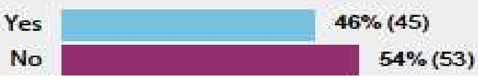
15. Would you be prepared to forgo tax concessions in exchange for a simpler overall tax system?

* 99 total responses, 91% of submissions

16. Do you support the retention of the infrastructure tax credit scheme?

* 96 total responses, 88% of submissions

17. Have PNG's new thin capitalisation rules affected the capital structure of your business?

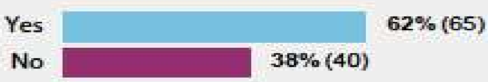


18. Are you satisfied with the timeliness of assessments issued by the IRC?

19. Have you had an audit or review by the IRC of any taxes in the last 3 years?

* 105 total responses, 96% of submissions

20. Do you believe the recently introduced penalty regime of a flat 20% on late lodgement / payment (plus interest) of withholding taxes will encourage compliance?



* 105 total responses, 96% of submissions