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To Sir Nagora Bogan, KBE
Papua new Guinea Tax review Committee

Date 11 September 2014

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Ref ADMIN14-m-0309-CITsubmission (11.09.14)

Corporate and International Taxation Issues Paper - KPMG Submission

Sir Nagora Bogan,

Following the release of Issues Paper No. 2: Corporate & International Taxation (Issues Paper) which was prepared by the Taxation Review Committee (Committee) on 31 July 2014, please find below KPMG's responses to certain questions raised in the Issues Paper.

We have only responded to the questions that we feel are most relevant to Papua New Guinea's (PNG) tax system. Where we have not directly responded to a particular question, no inference should be made with respect to our position in relation to a particular question.

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

We bring the following responses forward to your Committee.

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

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

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

PNG's company income tax rates are relatively high compared to comparable countries as shown in the Issues Paper. Especially the foreign company income tax rate of 48% is not appealing to investors that have choices to invest in different countries in a global economy.

In recent years, various countries have chosen to reduce rates of direct taxes and increase the rates or broadened the use of indirect taxes. Direct taxes are generally levied as income taxes, indirect taxes are mostly called 'consumption' taxes that are levied when persons are spending income or wealth. As such, indirect taxes are not only paid by persons or companies that generate income. For this reason one can argue that it is a more 'fair' taxation. Taking into account that according to this Issues Paper only approximately 2000 companies pay income tax

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(of which 70-80% is paid by the largest 250 companies) the heavy lifting of income taxation is done by only a few strong shoulders.

We suggest that the foreign company tax rate is being reduced to come more in line with PNG's competitors. In addition, while PNG is developing quickly, wealth creation will most probably increase considerably in the near future. Therefore, an option is to reduce taxation on direct taxes and increase taxation on spending of income and wealth in the near future. This will improve the 'earning capacity' of companies and employees and reduce costs of labour which improves competitiveness of PNG as well.

The higher non-resident company tax rate also has a significant impact upon investment structuring within PNG. Due to the significant difference in company income tax rates between foreign and domestic taxpayers, the rate difference leads to market distortion. In a competitive economy, such distortion should be minimized.

A similar argument can be made for the Dividend Withholding Tax (DWT) with a rate of 17% which is regarded as high. The cost of capital to invest in PNG is therefore high based on current global standards. Few investors will seek investment opportunities in PNG being taxed at these rates. We do appreciate and agree that withholding taxes are very important to developing countries but the Government should decide whether it facilitates (stronger) capital inflow and investments that create jobs, educate the work force, improve knowledge and skills of employees and potentially create subsequent investment opportunities or to continue levying high income and withholding taxes on capital.

We therefore support a reduction of the non-resident company income tax rate and the dividend withholding tax rate that are more competitive and in line with global standards. One could suggest a DWT default rate of 15% that can be reduced to 10% under application of a Double Taxation Agreement (DTA), and a reduction of the non-resident company income tax rate to 42% which is still rather conservative in our view.

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?

A provision that automatically permits foreign contractors to lodge income tax returns using the actual basis would be preferred.

However, consideration should be given to the method for taxpayers applying to be assessed on an actual profits basis as well as the timing of making such an application. In this regard, we recommend a simple election be made by the taxpayer within three months of entering into a prescribed contract (for example).

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

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

We strongly recommend moving towards a self-assessment system.

At a minimum we would like to see it applied to medium to large company taxpayers as these are the taxpayers who are most sophisticated and should be capable of understanding and complying with their taxation obligations. A very strong education campaign would be required to ensure that smaller taxpayers understand their obligations under a self assessment system. Further, small taxpayers are more likely to make errors that would better be addressed under an administrative assessment system.

However, we recommend that the self-assessment be opened to other taxpayers who can demonstrate certain characteristics, for example taxpayers who:

- Have a strong compliance history;
- Are subsidiaries of larger global entities; or
- Lodge their returns through a registered tax agent.

We see this as a high priority item and note that a move to a self-assessment system would be welcomed by many stakeholders.

A self-assessment system also improves the predictability of the cash-flow for the Government as profits are being assessed automatically and therefore the underlying taxes are paid within a set time-frame.

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?

We view that the current transfer pricing rules are generally sufficient.

While there may be potential deficiencies as highlighted in the Issues Paper, we recommend engaging in greater audit/review activity to assess taxpayer compliance with current legislation rather than making legislation more complex without clear reason.

This is a low priority item.

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 legislation is not sufficient to handle more complex arrangements (e.g. hybrid instruments) and provide for equitable tax outcomes in relation to these arrangements.

For example, consider redeemable preference shares (RPS) that pay a regular rate of return. Under general deductibility principles, profits paid to equity holders are not generally deductible such that the regular payments made to RPS holders is not deductible, even though these payments may be made under a debt interest.

We recommend the introduction of more appropriate debt and equity tests for these types of investment arrangements.

Further, with respect to the thin capitalization rules, we recommend clarifying the application of these rules to branches.

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

We do not see the negotiation of DTAs as a significant priority and note that in some instances, DTAs can actually be disadvantageous, in particular for developing countries. It potentially creates "treaty shopping" which is not to the economic benefit of PNG and potentially has no commercial reason.

Traditionally, the benefits of a DTA in the context of a developed country entering into a DTA with a developing country are disproportionately favourable to the developed country. As PNG is generally an inward investment country, it receives the general economic benefits of having an inward investment but its tax collections are reduced as a result of having a DTA in force.

As the benefit of PNG entering into DTAs is questionable, we feel that PNG should not seek to negotiate new DTAs without a clear and quantifiable benefit for PNG.

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?

The exchange of information on tax matters is of importance to PNG's tax collections as there may for instance be unreported income derived by PNG taxpayers elsewhere. We strongly recommend PNG entering into agreements that permit the exchange of tax information between countries as this could potentially significantly increase tax collections and provide for better insights in tax structuring into PNG.

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 acknowledge that the depreciation schedule overall is mostly inadequate for use by many taxpayers.

However, updating the depreciation schedule should be a relatively low priority even though taxpayers may not be using the rates appropriately or assets may not be included in the schedule. Where the depreciation schedule is not used, taxpayers typically use accounting depreciation or make a self-assessment based on other assets. While this is not technically correct, we note that a similar outcome is achieved and this is usually not an attempt to avoid complying with tax legislation. Further, even though the concepts of effective life (taxation) and economic life (accounting) are different, the principle that an asset's value/utility will decline over time is present.

As such, we recommend that where an entity is audited by a Certified Practicing Accountant, that the tax depreciation rates allowable to the taxpayer is the same as the accounting depreciation rates for each class of asset. This would greatly simplify the need for taxpayers to maintain separate tax and accounting ledgers and reduce the costs of compliance.

Further, we agree with the recommendations made in the 2000 Tax Review Report with respect to depreciation. We refer to page 6 of this letter.

Notwithstanding our comments above, should changes be made to the depreciation schedule, we recommend simplifying the schedule to ease the administrative burden on taxpayers. In addition, we recommend a default category (e.g. 10%) for assets that may not fit clearly into one of the existing depreciation classes.

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?

This suggested simplification would be valuable for taxpayers as it provides an immediate basis for expensing assets rather than the costly process of maintaining a complex fixed asset register. Further, smaller taxpayers (e.g. new businesses) with assets that are necessarily part of their business will then be able to immediately claim a tax deduction. Given the difficulties of financing small business operations, small businesses would appreciate any mechanism which allows the deferment of tax payments.

We recommend a threshold of K5,000 be applied. A lower threshold might not be sufficient to reduce the complexity for taxpayers, whereas a significantly higher threshold reduces the effectiveness of the depreciation provisions.

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

Simplification is more beneficial to smaller business as it enables them better to meet their tax obligations. We further acknowledge that simplification should target small businesses given the number of small businesses in PNG and the disproportionate costs of complying with tax legislation for small businesses.

All taxpayers benefit from simplified tax systems as it reduces the cost of compliance, however simplification must be weighed up against the revenue foregone before oversimplifying a tax system.

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

PNG requires blackhole expenditure rules to consider capital costs that are incurred in the ordinary course of business by a taxpayer that are not otherwise covered by PNG legislation.

As complexity of transactions entered into by taxpayer’s increases, a number of transactions may not be covered by the existing or further simplified legislation. Furthermore, there is no reason for transactions that should be permitted as legitimate business deductions (e.g. restructuring expenses) to be non-deductible for PNG income tax purposes. This also improves the competitiveness of PNG with less ‘surprises’ to (foreign) investors when acquiring or expanding business operations in PNG.

Therefore in order to balance the simplification of a tax system with the complexities of conducting business, we recommend ‘blackhole’ expenses rules be introduced. Anti-avoidance provisions could be included to prevent “undesirable” expenditure from being deductible.

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

We agree with comments made in the 2000 Tax Review Report with respect to depreciation, namely (we have increased the threshold from K1,000 to K5,000 in line with our comments on Page 5 – Question 7.2):

1 Allowing purchases of assets with a value of less than K5,000 to be immediately deductible;

2 Allowing assets valued between K5,000 and K100,000 with the same depreciation rate to be pooled together and depreciated, effectively, as a single asset.

Revised thresholds should be implemented.

Further, in relation to pooling of assets, we recommend that smaller taxpayers be allowed to pool all assets, regardless of depreciation profile, costing up to a certain threshold (e.g. K25,000) and depreciate them as a single asset over time using a blended depreciation rate (e.g. 20%).

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?

We agree with the principles behind foreign dividend accounts, however foreign dividend account rules are generally complicated.

We therefore are wary that introducing foreign dividend account rules will increase the overall complexity of the tax system without resulting in significant benefits for PNG.

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?

In principle, we agree that transfer of loss rules should exist between members of wholly owned groups in PNG. The transfer of loss rules could be limited to ‘horizontal’ loss planning, i.e. offsetting losses within the group for the same year of tax. It becomes more complicated if also ‘vertical’ loss planning is allowed which includes offsetting the losses of a group company by another group company with different years of income, including losses incurred before or after a company has left the group (for instance, the shares in a group company are being sold to a third party).

We therefore recommend that anti-avoidance rules should be implemented for companies entering and/or leaving groups to reduce the risk of loss manipulation.

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 legislation does not provide for specific rules with respect to share buy-backs. We recommend that legislation be implemented to provide greater certainty with respect to share buy-backs, however this is not a significant item in the overall context of the tax review.