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THE CORPORATE TAX REGIME IN PAPUA NEW GUINEA

by

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1. INTRODUCTION

Papua New Guinea (PNG) has witnessed outstanding economic growth over the last ten years, accounting for 2.3% of the South Pacific regionōs Gross Domestic Product (GDP). However, according to the Department of Treasury the countryōs impressive economic growth has not been translating into optimal fiscal and revenue yields. The threat to the revenue is projected to reach K1.2 billion by 2018. Consequently, in an effort to stem this potential loss of revenue and improve tax collection and administration, an immediate analysis of the tax regime is critical.

The aim of this paper is to investigate the corporate income tax regime in PNG and make recommendations for tax reform with the view to improving future revenue collections. The paper is organised as follows. Following the introduction, section 2 briefly outlines the main features of the corporate tax regime in PNG. Section 3 identifies concerns with the current corporate tax regime, including revenue trends over the last 5 years. Section 4 describes the features of a good corporate tax system and best practice measures as derived from the Organisation for Economic Cooperation and Development (OECD). Based on some of these features and practices, section 5 considers the various options for corporate tax reform in PNG. Section 6 provides an evaluation of the main options considering the advantages and disadvantages of each. Finally, section 7 concludes by indicating both the short-term and long-term priorities and tax policy implications for the corporate tax system in PNG.

2. THE MAIN FEATURES OF THE CORPORATE TAX REGIME IN PNG

The residence of a corporation for the purposes of the *Income Tax Act (1959)* PNG is similar to that of Australia. Specifically, (1) it is incorporated in PNG; (2) it carries on business in PNG and its central management and control is in PNG; or (3) it carries on business in PNG and its voting power is controlled by shareholders who are resident in PNG. Resident companies are taxed on their worldwide income, whereas non-resident companies are only taxed on PNG-sourced income. Foreign-sourced income derived by resident companies is subject to corporation tax in the same way as PNG-sourced income.[1]

Corporation tax is imposed on a companyȸs profits, which are derived from business/trading income. Assessable income equals gross income less exempt income. Generally, assessable income less allowable deductions equals taxable income. Taxable income multiplied by the tax rate (30 % for resident corporations and 48% for non-resident corporations in 2014) less any credits or rebates, equals tax payable. Normal business expenses may be deducted when calculating taxable income. In this regard if the deduction provided for in the tax law differs from accounting expenses, the deduction must be calculated using the appropriate tax law calculation. Tax losses are subject to the continuity of ownership and continuity of business tests and may be carried forward for 20 years except for primary production ventures where it is unlimited. The carry back of losses and transfers between group companies is not permitted.

There is no capital gains tax in PNG unless the gains are realised as part of a profit-making scheme or undertaking or form part of the ordinary business of the taxpayer. Dividends received by a PNG resident company are subject to a rebate on the portion of tax paid on the dividend, so that they are only subject to tax at the company level: similar to the dividend imputation system that operates in Australia. Likewise, a credit is granted for foreign tax paid on the foreign income of a PNG resident company. The credit is equal to the lesser of the foreign tax paid or the PNG tax payable on such income. No participation exemption or Holding Company regime exists in PNG. Likewise, there is no capital duty, payroll tax or real property tax. However, there is an R&D incentive of 150% deduction on eligible expenditure; while certain industries and projects have been granted exemptions and concessions (e.g. Fishing and Exports).

Final withholding tax rates vary with the type of payment made. Dividends paid to non-resident companies and individuals (whether resident or non-resident) are subject to 17% withholding. Dividends from mining companies and those covered by tax treaties are subject to 10% withholding. Dividends from gas and petroleum companies are exempt. PNG-sourced interest paid by a financial institution or company to a resident or non-resident is subject to 15% withholding tax, unless subject to a treaty. Interest paid to a non-resident financial institution by mining and petroleum companies is exempt from withholding tax. Where the recipient and payer of a royalty are transacting at arms-length, the royalty payment to a non-resident is subject to 10% withholding tax. However, where the parties are associated the withholding tax rate is 30%. Management and technical service fees paid to non-residents are subject to 17% withholding tax. Certain service fees paid to non-residents are subject to 12 %

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[1] Deloitte International Tax ï Papua New Guinea Highlights 2014 http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-papuanewguineahighlights-2014.pdf [accessed 10 April 2014].

withholding tax. PNG also imposes a 3% or 4.8% withholding tax on non-resident insurers and sales of certain prescribed products.[2]

With regards to anti-avoidance measures, the transfer pricing rules follow an OECD-based approach, which requires an arms-length or reasonable commercial value to be used when determining the value of transactions between related entities. Likewise, thin capitalisation rules apply from 1 January 2013. A maximum debt to equity ratio of 2:1 applies for most businesses and 3:1 for resource companies before interest in excess of the ratio is disallowed as a deduction to the PNG borrower where the lender is a non-resident entity. A general anti-avoidance provision operates, which allows the Internal Revenue Commission (IRC) to cancel any tax benefit derived by a taxpayer when carrying out an arrangement for the sole or dominant purpose of obtaining a tax benefit. Specific anti-avoidance rules prevent accelerated deductions, excessive costs for depreciation deductions, and non-arms-length charges for management fees. There is no consolidation/grouping treatment for companies and no Controlled Foreign Companies (CFC) regime. However, investments by foreign-owned entities in PNG must be approved by the Investment Protection Authority.

The tax administration and compliance of companies in PNG is fairly standard. Consolidated returns are not permitted and companies file separate returns regardless of whether or not they are part of a group. Payments of the estimated tax liability for the current tax year are due on 30 April, 31 July, and 31 October of each year. The fiscal tax year runs from 1 January to 31 December and the lodgement date is 28 February following the tax year. Penalties apply for late filing or late payment of income tax. Also a 10% tax is imposed on payments to PNG business entities that undertake certain services and fail to have a certificate of compliance. An income-tax rulings system has recently been introduced which formalises the issue of public tax circulars on matters of administrative practice, procedural instruction, and interpretation of the tax laws. However, there is no formal private ruling system,[3] or formal disclosure requirements for corporations.

[2] Checkpoint World Papua New Guinea ï Key Features http://www.checkpointworld.com [accessed 11 April 2014]

[3] KPMG-Papua New Guinea Tax Profile - July 2013 p4. http://www.kpmg.com/Global/en/services/Tax/regional-tax-centers/asia-pacific-tax-centre/Documents/CountryProfiles/Papua%20New%20Guinea.pdf (accessed 14 April 2014).

3. CONCERNS WITH THE CURRENT CORPORATE TAX REGIME IN PNG

3.1 Growth in Tax Revenues

To meet the countryôs spending needs and to minimise PNGôs budget deficit planned for the four fiscal years (2013-2017), it will be important for the IRC to meet or exceed its revenue performance targets[4]. In 2012, IRC collected a total net tax amount of K6, 863.1 million5 (of which K5, 853.1 million was direct tax and K1, 010 million was GST-see Table 1 below) and transferred to the Waigani Public Account (WPA). This total was below the original 2012 budget revenue projection of K7, 089.9 million, but was above the Mid-Year Economic and Fiscal Outlook (MYEFO) revised projection of K6, 816.9 million.

Table 1: IRC Total Tax Collections, 2008-2012 (Million Kina)

Tax Type	Year				
	2008	**2009**	**2010**	**2011**	**2012**
Individual Income Tax	1 097.9	1 254.5	1 553.1	2 158.8	2 645.1
Corporate income Tax	839.7	1 085.9	1 201.1	1 373.1	1 704.6
Dividend Withholding Tax	190.6	248.6	278.8	290.7	176.6
Mining and Petroleum Taxes	1 991.4	749.9	1 476.1	2 073.5	981.1
Stamp Duty	74.5	57.7	65.4	63.6	70.2
Gaming Machine Tax	84.3	89.2	93.1	111.3	133.9
Other direct taxes	46.6	54.4	68.6	73.2	105.9
Total Direct Taxes	**4 325.0**	**3 537.5**	**4 736.1**	**6 144.2**	**5 853.1**
GST to WPA	647.1	693.0	788.2	560.5	1 010.0
Total Revenue	**4 972.1**	**4 230.5**	**5 524.3**	**6 704.7**	**6 863.1**

Source: IRC 2012 Annual Report p 11.

Table 1 displays the trend in total tax revenue collections by IRC[6] over the five years 2008-2012. The revenue trend has been in an upward direction during this period. However, in 2009 PNG experienced a reduction in revenue following the global financial crisis, which saw a drop in world commodity prices and demand, leading to a significant fall in mining and petroleum tax revenue; although corporate tax revenue continued to increase. Since 2009, collections have again been following an upward trend, but revenue growth experienced a slowdown in 2012. It is this concern that requires investigation where revenue collections have improved but not as by much as it should have. Besides the slow growth in corporate taxes, falls in related dividend withholding taxes and mining and petroleum taxes from 2011 to 2012 are also cause for concern.

Tax revenue as a percentage of gross domestic product (GDP) is one indicator used to determine if tax revenue is rising in line with a countryô s gross annual income. Revenue as a percentage of GDP was estimated at 20% in 2012. However, GDP increased more sharply than tax revenue between 2011 and 2012, leading to a fall in the revenue as a percentage of

[4] IRC Annual Report 2012, p11.
[5] Note, net collections are defined as total direct tax revenue plus GST revenue transferred to the Waigani Public Account (WPA). Hence net collections exclude the K272 million of GST transfers to provinces in 2012.
[6] Note that IRC collections include tax on income and profits (direct taxes) and GST (inland GST and import GST) only. Revenue from import duty, export duty, and excise are recorded as Customs revenue, and is not a component of IRCôs revenue.

GDP measure from 22% to 20%. In 2012, total tax revenue collections were 3% below the initial budget projections. Over the past few years, actual collections have been consistently greater than budget forecasts (e.g. 8% greater in 2011), indicating that revenue performance has been better than expected for each year, and projections conservative relative to actual revenue performance. However, this position changed in 2012, when budget projections for the year were strong relative to actual collections. This disparity was largely due to a high projection for mining and petroleum tax revenue[7].

3.2 Corporate Governance

It is evident that corporate governance issues exist within government bodies that may also exist in the private sector. An IRC key objective is to foster public confidence in the IRC‟s management and operations and to analyse corporate risks and identify opportunities for improved performance. While satisfactory audits and investigations of the IRC were carried by the Auditor General, there were concerns regarding staff recruitment and expertise. In particular, the lack of recruitment and retention of suitable candidates has meant that a number of senior internal audit positions have remained vacant. The number of complaints received compared to the staff on strength to address the matters was another challenge faced by the Internal Audit and Integrity Division[8]. At the end of 2012 the total number of completed IRC investigations was 12. Consequently, staff numbers within the Internal Investigation Unit continued to have a negative effect on completion rates.

It is evident that there are also no schemes that specifically encourage good governance. That is, the development of governance strategies that are supported by all levels of management and then communicated to staff is absent. The structures and resources to implement governance strategies are not clearly defined. Policies, procedures, and guidelines still need to be developed, implemented, and communicated so as to support governance strategies. The existence of systems and related processes to support governance frameworks has been adhoc. More specifically, a strategic risk management infrastructure needs to be implemented covering issues such as; Board performance and dealings with stakeholders and service providers.

3.3 Company Tax Rate and Withholding Taxes

Although the company tax rate for residents at 30% is similar to OECD countries[9], this rate may be too high for a developing country such as PNG, which is looking to be more internationally competitive. In particular non-resident companies that pay tax at 48% of their taxable income would find this unfavourable when compared to OECD countries. Special tax rates that apply to resource companies could also be a concern and may require a change in the mix. Resident mining companies are currently taxed at 30% while non-resident mining companies are taxed at 40%. This 10% discrepancy may have an impact upon the willingness to invest in PNG. For instance, for petroleum companies the rate is 30% for both residents and non-residents and for designated gas projects 30% plus an additional profits tax of 7.5 to 10% on cash profits which could also have a negative effect on investment decisions.

Withholding taxes are a very important source of revenue for PNG. They protects the taxing rights of PNG in relation to income sourced from within PNG and, in some cases, apply even

[7] IRC Annual Report 2012, p13.
[8] IRC Annual Report 2012, p9.
[9] http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial (accessed 14 April 2014) for corporate rates ranging from 20% to 30%.

if the foreign company does not have a permanent establishment in PNG[10]. Subject to the main withholding tax rates as outlined in section 2 above, for dividends, interest, and royalties it is important that this mix is appropriate for PNG. Rates currently between 10% - 30% in line with most OECD countries may be too low or too high in certain circumstances and are non-existent in other cases. For example, payments made for construction-related services, are not subject to withholding where the payee produces a certificate of compliance from the IRC. On the other hand, the foreign contractorsô withholding tax is an important means of collecting tax from foreign companies that are rendering services in PNG and should be retained rather than discarded.

3.4 Tax incentives and concessions

The Income Tax Act provides tax incentives to businesses operating in PNG depending upon the nature of the industry, location of their business, and the nature of the activity they engage in. The issue here could be whether the concessions are generous enough to encourage corporations to invest in PNG but at the same time be revenue neutral. The 150% deduction available for Research and Development may need to be increased or perhaps replaced with a tax offset, which would be a more attractive tax concession[11]. This concession may be offset by a reduction in the current 100% accelerated depreciation allowance of expenditure on ñindustrial plantò[12] not previously used in PNG.

Likewise, a 20% accelerated depreciation deduction, which is allowed for capital expenditure on new plant and equipment with an estimated useful life of greater than five (5) years, could be increased and offset with a reduction in the somewhat generous outright deduction for certain capital expenditures in agriculture. Given the increase in taxpayers engaged in mining, petroleum, and gas in PNG, possibly an increase in the 0.75% to 1.5% income allowance for infrastructure development costs is feasible. At present these taxpayers are entitled to special accelerated depreciation deductions for exploration and capital expenditure, which is insufficient when compared to the revenue generated.

It is noted that PNG does not have any grouping provisions for companies or formal consolidation rules. PNG assesses income tax on companies separately regardless of whether they are part of a group or associated entities.[13] Consequently, losses of one company cannot be offset against the profits of another company for tax purposes. Although there are no capital gains tax (CGT) implications on the transfer of assets, the utilisation of available losses is critical and should be addressed. However, the CA 1997 does allow companies to amalgamate and operate as one without adverse tax consequences. In this regard, prior year losses, tax WDV of assets, and DWT credits can be passed on. The issue is whether this falls short of the advantages attributable to a truly consolidated regime.

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10 http://www.oxfordbusinessgroup.com/news/facts-and-figures-overview of a countryôs tax laws (accessed 15 April 2014).

11 For example, a 45% tax rebate was introduced in Australia in 2011 for R&D expenditure instead of the 150% deduction.

12 Industrial Plant refers to plant with an effective tax life exceeding 5 years and used in manufacturing processes.

13 https://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxation-international-executives/papua-new-guinea/pages/income-tax.aspx (accessed 15 April 2014).

3.5 Double Tax Agreements (DTAs)

PNG has entered into International Tax Agreements[14] with nine countries, namely Australia, Canada, China, Fiji, Germany, Malaysia, Singapore, South Korea and the United Kingdom. As these treaties override domestic tax laws, the residents of these countries enjoy some tax advantages over residents of other countries. Under most of the tax treaties that PNG has entered into, the definition of Permanent Establishment (PE) is narrow and allows the foreign country to apply the same to its advantage and reduce or vary its PNG tax liability[15]. This is a concern and could cause damage to the revenue stream over time and should be addressed by widening the PE definition. As investment in PNG grows in future years, it is also important that further Double Tax Agreements (DTAs) are tightened in regards to regulating the branches of foreign companies. This may require addressing the activities of both the Register of Companies (ROC) and the Investment Promotion Authority (IPA) when dealing with foreign branch companies.

3.6 Tax Compliance/Audits and Penalties

PNG operates on a full assessment basis and companies are required to lodge an annual income tax return by 28 February following the calendar year. PNG collects corporate income tax under a provisional tax system[16] but there is evidence of problems in collections. As a result, company debt makes up the largest portion of total debt (71% see Table 2 below). The reasons are varied and need to be addressed. They include delays in assessing company tax returns (partly due to their technically challenging nature) and delays in issuing assessments. Poor lodgement compliance amongst company taxpayers is also a factor, which has led to many default assessments being issued.[17]

Table 2: 2011 and 2012 End of year Debt by tax type (Million Kina)

Tax Type	**2011**	**2012**	**Percentage Change**
Company Tax	1, 494	1,440.1	-4%
Group Tax	206	227.3	10%
Goods and Services Tax	200	151.0	-24%
Individual Tax	147	136.5	-7%
Business Payment Tax	23	20.2	-11%
Others	52	60.1	15%
Total	**2,121**	**2,035.22**	**-4%**

Source: IRC 2012 Annual Report p 26.

While penalties apply for late filing (not less than K500 and not more than K5,000 plus K50 for each day the failure continues) and late payment of income tax (statutory rate of interest is 20%) perhaps these amounts should be increased in an attempt to curb the level of non-compliance. It is noted that the current taxpayer education and awareness activities of the IRC which involved some 2,344 inspections focused on non-lodgers, non-payers, and non-registrations, yielded 812 million Kina in 2012. [18] Likewise, penalties for breaches in the tax

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[14] See *International Agreements Act 1953.*

[15] http://www.oxfordbusinessgroup.com/news/facts-and-figures-overview of a countryÕs tax laws (accessed 15 April 2014).

[16] This is where a taxpayer makes payments on income in the same year that they derive that income.

[17] IRC Annual Report 2012, p26.

[18] IRC Annual Report 2012, p32.

law resulted in some 14,374 cases, yielding 132,615,947 Kina,[19] which proves that non-compliance had a major impact upon PNG revenue. It is further noted that the imposition of penalties decreased in 2012 from 2011, possibly due to increases in the number of assessments processed and in preparation for a new tax administration (SIGTAS) system. It will be vital to ensure the penalties are more vigorously enforced in future years in order to enhance deterrence.

Overall, the IRC has limited resources to conduct tax audits; and while returns are selected primarily based on industry, there is a need for more corporate audits of other than mining companies. This is because in recent years the IRC tax audits have focused on GST refunds and Group tax (employee withholding).[20] However, the IRCôs approach to tax audits is largely a manual approach including detailed consideration of invoices and key documents. This will need to become more sophisticated, particularly the data matching techniques employed, if revenue detection is to improve going forward.

[19] IRC Annual Report 2012, p33.
[20] See n 3, KPMG-Papua New Guinea Tax Profile - July 2013 p 12.

4. FEATURES OF A GOOD CORPORATE TAX SYSTEM

4.1 OECD Best Practice

Although PNG is not a member of the OECD, lessons for good corporate tax practice can be derived from their member countries, such as a developed country like Australia. Overall, a corporate tax system should encompass a number of standard features as well as special features that may be peculiar to the particular country. They include but are not limited to the following:

- An internationally competitive corporate tax rate;
- Stringent compliance requirements;
- Strong corporate governance guidelines;
- Competitive International withholding tax rates;
- Dividend Holding rules;
- Strict rules for the utilisation of tax losses and bad debts;
- Tax Consolidation and group relief;
- Rules for the transfer of assets and shares;
- Controlled Foreign Corporations (CFC) rules;
- Transfer Pricing Rules;
- Thin Capitalisation Rules;
- A general anti-avoidance rule and specific anti-avoidance rules;
- Anti-treaty shopping;
- A Rulings System;
- Incentives and Concessions; and
- Disclosure requirements.

(i) Internationally Competitive Corporate tax rate and withholding tax rates

It is noted that most OECD countries have statutory corporate tax rates ranging from 20% to 40%.[21] Many Asian countries also have competitive corporate tax rates, such as Malaysia, at 25%. However, what is central to this issue is the statutory corporate rate as opposed to the average and marginal effective rates of tax. Whereas an Average Effective Tax Rate (AETR) measures the share of corporate taxes in the profits of a hypothetical investment, the Marginal Effective Tax Rate (METR) measures the extent to which tax increases the required rate of return for a marginal investment. A large difference between the statutory rate and implicit rates may suggest a need for base broadening and anti-avoidance measures.[22]

Withholding rates for dividends, interest and royalty payments generally hover between 10-30% for most OECD countries. There are strict rules concerning residence and source, business profits and permanent establishments in the DTAôs, which give rise to peculiar withholding payments. It is important that the tax rates negotiated in the DTAôs are competitive and sustainable given that DTAôs override domestic tax laws. Renegotiating agreements and establishing new ones will be an on-going process.

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[21] The 2010 Henry Review recommended a 25% corporate tax rate for Australia, which was rejected.

[22] Heady, C (2006), ñAnalysis of Corporate Tax Burdens- An Introduction,ò OECD Workshop on Effective Corporate Taxation.

(ii) Strict compliance and Disclosure requirements

Enhancing voluntary compliance is achieved through a combination of the service and enforcement functions. Corporate taxpayers need to understand that the tax law and regulations should be strictly adhered to and that non-compliance will be dealt with swiftly via an active revenue agency and a strong penalty regime. In particular, taxpayers need to know that they will be supported via the use of a helpful website and that compliance costs will be kept to a minimum. The costs of doing business in a particular country should not unnecessarily be hampered by strenuous tax obligations and in this regard minimising the complexity of the tax system will be critical.

Disclosure of tax information and encouraging transparency and openness amongst corporations is also a feature of good tax system. The issue of privacy and the right to manage reporting will vary from country to country but minimum disclosure requirements allow a revenue agency and government to track and monitor corporate operations effectively. Whereas disclosure of individual tax information is less common worldwide, corporate tax disclosure is becoming more common.[23]

(iii) Tax Consolidation rules – Losses and Bad Debts

A consolidation regime allows wholly-owned groups of companies to consolidate as a single entity for tax purposes. The major benefits of consolidation are a reduction in compliance costs amongst member companies and ease of reporting. Intergroup transactions between members are ignored as are all transfers of assets and losses. In the absence of CGT provisions, asset transfers are not as critical; but if roll-over relief has been removed and CGT exists, then consolidation becomes an important consideration. The costs and benefits of consolidations should be weighed up when considering optional entry.

Losses are usually subject to either a continuity of ownership test or same business test in order to be carried forward. The carry back of losses is not common but is subject to integrity tests. Generally, it only applies to revenue losses and is limited to the companyøs franking account balance. Similar tests apply for the deductions for corporate bad debts.

(iv) Controlled Foreign Corporation (CFC)Rules

The broad scope of the CFC rules is to tax resident shareholders on their share of CFC ñtainted incomeò[24] as it is earned unless that income is comparably taxed offshore or the CFC mainly derives its income from exclusively active business activities. The CFC rules generally apply accruals taxation to CFC residents in ñunlisted countriesò. The accruals legislation will generally not apply to income derived by CFC that passes an ñactive business testò.[25] The main aim of the CFC rules is to ensure that the relevant income is attributable to the respective corporations. As such it acts as an integrity measure for the safeguard of the revenue.

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[23] See the introduction of new corporate disclosure requirements in Australia *Taxation Law Amendment Bill (2013)* where the corporate has total income of $100 million or more for the year.

[24] ñTainted incomeò is generally income from investments or arrangements that are likely to be significantly affected by taxation considerations, e.g. interest, dividends, and royalties.

[25] The active business test is where more than 95% of income is derived from genuine business activities. The distinction between active and passive income is critical.

(v) Transfer Pricing and Thin capitalization

Revenue agencies around the world develop transfer pricing regulations to capture their share of tax on profits from an increasing volume of international trade, especially in services and intangibles.[26] OECD members have accepted the arms-length principle as the basis for their transfer pricing regulation and a number of acceptable methodologies for determining those prices. Transfer Pricing guidelines are under continuous review[27] and require constant monitoring in order to keep pace with global changes. The determination of whether an entity has received a transfer pricing benefit must be done consistently with these guidelines and conventions. Safe harbour provisions and Advanced Pricing Arrangements (APAs) are also highly desirable features.

Thin capitalisation rules prevent multinational enterprises shifting profits out of the country by funding the countryȏs operations with high levels of debt and relatively little equity in order to reduce their taxable income. Consequently, thin capitalisation rules limit deductions for interest expenses and borrowing costs (debt deductions) where the debt to equity gearing ratios exceed, prescribed debt limits.[28] There are a number of different debt limits for calculating the maximum debt allowed, including a ñsafe harbour limitò ñarms-length limitò and the ñworldwide gearing limitò. Ultimately, although debt limits vary depending on the type of entity, it is important that governments monitor and review the ratios in order to protect the revenue from excessive interest deductions. In this regard smaller businesses should be excluded from the thin capitalisation regime if they operate below a de minimise threshold[29] to minimize compliance costs.

(vi) Corporate Governance

As indicated earlier, within the framework of good corporate governance lie a number of important elements. Initially, governance needs to be taken seriously and good governance practices need to be put into place. The governance framework should start with a strategy that is well defined and aligned and supported by all levels of management and communicated to all staff. With regard to risk and process management, the resources to implement the governance strategy need to be well defined. All policies, procedures, and guidelines need to be developed, communicated, and effectively supported by the governance strategy. Processes should be in place to effectively implement, maintain, and monitor policies and procedures. Finally, a strategic risk management infrastructure should be implemented covering Board performance and other dealings with stakeholders and service providers.[30]

To make good governance a reality, it is vital that the decision making of the board and upper management is ethically sound. Typically, a code of conduct would also be properly implemented and communicated in order to facilitate this.

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[26] Australian Master Tax Guide (2014) 54th Edition, CCH, p 1239.

[27] See the *OECD Transfer Pricing Guidelines for Multi-national Enterprises and Tax Administrations* 2010, and its *White Paper on Transfer Pricing documentation*, 30 July 2013 at www.oecd.org [accessed 20 April 2014].

[28] Australian Master Tax Guide (2014) 54th Edition, CCH, p 1260.

[29] In Australia the de minimise threshold is $2,000,000 debt deductions.

[30] http://intelliconnect.wkasiapacific.com -Corporate Governance & Compliance Law>*Australian Corporate Practice Manual> Your Corporate Practice Manual: the bigger picture* [accessed 20 April 2014].

(vii) General anti-avoidance rule and specific anti-avoidance rules

Typically, both the general anti-avoidance rule and specific anti-avoidance rules will operate to up hold the integrity of the tax system and protect the revenue stream from abuse. The general anti-avoidance rule is a provision of ñlast resortò in that it may apply to a taxpayerôs situation where specific anti-avoidance rules have not applied. Where specific anti-avoidance rules may target a variety of situations (e.g. alienation of personal services income, accelerated deductions, or non-armôs length charges for management expenses) the general rule acts as a fall back measure for the tax authority. The effectiveness of the general anti-avoidance rule is thereby critical in order to catch what may have escaped the specific provisions. A good general anti-avoidance rule is usually premised on the identification of a particular scheme that the taxpayer has entered into for the sole or dominant purpose of obtaining a tax benefit. If these elements can be established, then the tax authority should be able to effectively cancel the tax benefit and impose a penalty accordingly.

(viii) Anti-treaty shopping

The OECD has a Model Tax Convention plus associated commentary and guidelines, which may be used as a basis for the negotiation, application and interpretation of bilateral tax treaties. This is crucial to counter the spread of treaty shopping in order to achieve the best tax result. It is possible that the anti-avoidance rules may also apply to treaty shopping schemes (e.g. where there is an investment in the shares of a local company by an entity resident in a tax haven like Cayman Islands through a complex series of interposed entities). Having either working guidelines or legislation to tackle treaty shopping would certainly be an element of good corporate tax regime.

(ix) Rulings System

A sophisticated rulings system is certainly a feature of a good tax regime and assists in the interpretation and application of the law and provides certainty for taxpayers. Rulings should be both private and public and oral rulings are also a desirable option. As rulings are only the Revenue Authorityôs interpretation of the law, they can still be challenged in an appeals process. However, rulings should be legally binding on the Commissioner of Taxation where they apply to a taxpayer and the taxpayer relies on and acts in accordance with the ruling. Failure to follow a ruling should not result in a penalty but it may go towards determining whether the taxpayer has a reasonably arguable position in a court of law.

(x) Incentives/Concessions

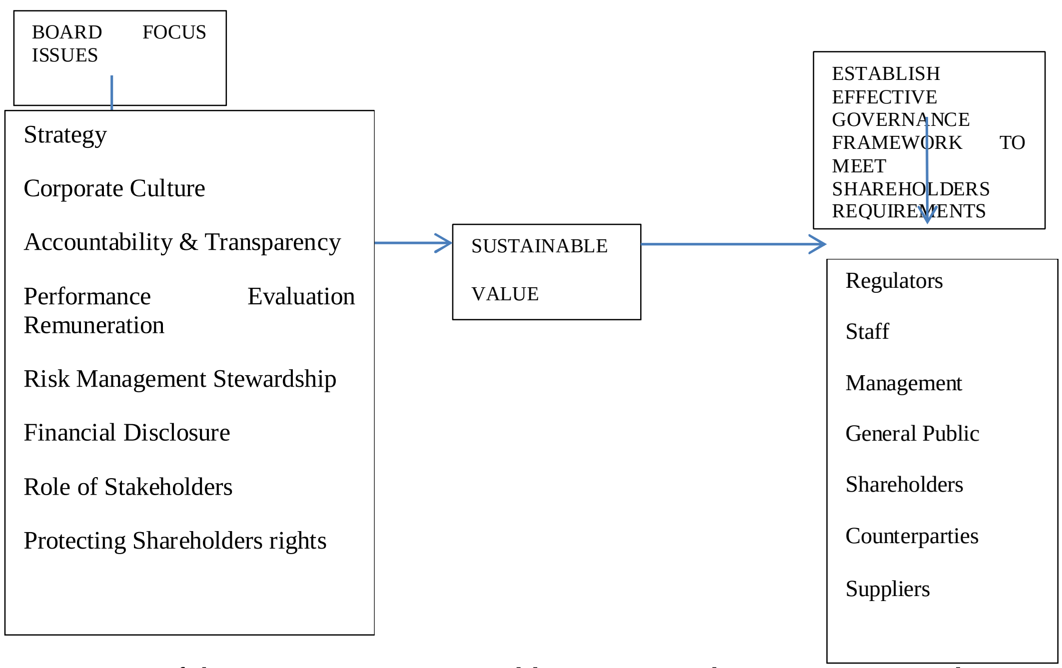
Tax incentives and concessions can take a number of forms but are highly desirable for modern corporate tax regimes. More common ones include: research and development, intellectual property, concessions for primary producers, mining companies, investment allowances and exemptions and concessions for certain industries that are relevant for the particular country. Special deductions for capital expenditure are critical in order to encourage investments in major capital projects. Other concessions may take the form of dealing with abnormal receipts or insurance recoveries and providing tax relief by way of elections and income averaging. Tax credits for mining exploration expenditure and environmental protection activities are also common.

5. OPTIONS FOR REFORM OF THE CORPORATE TAX REGIME IN PNG

Given the preceding discussion regarding the features of a good corporate tax regime, certain options and possibilities can be identified for corporate tax reform in PNG. Overall, there appears to be a strong need to improve corporate governance, tax compliance (including audit and penalty), and disclosure measures. In particular, the company and withholding tax rates, tax incentives/concessions, and the rulings system need to be revisited. Consideration should also be given to the introduction of a CFC and consolidation regime. Increasing the number of DTAôs and fine tuning the transfer pricing and thin capitalisation rules are also other possible options. The options specific to PNG corporations that are considered a priority are briefly outlined below.

(i) Improving Corporate Governance

Development of a corporate governance strategy would begin with developing a conceptual framework of government processes for the establishment of sustainable value: Displayed below is a conceptual framework of governance processes for the establishment of sustainable value.



Source: Diagram of the Corporate Governance model- Companies and Securities Law/Australian Corporate Practice Manual, Governance Risk and compliance.

As indicated in the diagram above, concentration on the boardôs issues of developing the main elements in the framework will provide ongoing value to all the corporationôs key stakeholders, both in PNG and externally. The accountability of boards to their shareholders includes issues such as óvalue and ethics,ô ófair and equitable treatment,ô óaccess and transparency,ô óthe environment,ô and ócommunity welfare.ô[31] Consequently, these elements are important considerations if corporations wish to be viewed as good corporate citizens.

[31] Barrett P, (2013), Auditor General of Australia, Companies and Securities Law/Australian Corporate Practice Manual, Governance Risk and Compliance.

(ii) Improving Corporate Tax Compliance/Audit and Penalties

As indicated earlier in the paper there is a need to dramatically improve corporate compliance by conducting more sophisticated corporate audits. Initially, the training and qualifications of IRC personal (Auditors) needs to improve and money should be invested wisely in this venture. Another issue entails developing strong data matching techniques for interest and dividends with financial institutions and various corporate bodies. An automated and refined approach should be adopted for case selection and investigation where particular sections of the taxpayer community can be easily identified. Other techniques that promote voluntary compliance should be encouraged, given the limited resources of the IRC. In this regard, increasing the advertising of IRC activities amongst members of the community and educating them as to the benefits of operating in PNG can have a positive influence upon compliance behaviour.[32] Generally, more IRC visibility through the local media (TV, radio, and newspapers) can also have a deterrent effect.

As well as performing both a service and an enforcement function, the IRC should be imposing substantial penalties upon those corporate taxpayers who breach the tax law: which would also assist in acting as a deterrent. There is evidence suggesting that it is the audit activity as opposed to the penalty per se that drives compliance[33] but where resources are limited such as in the case of PNG, strong penalties combined with voluntary initiatives can increase deterrence. Currently, the statutory penalty rate of 20% for late payment and between 500K and 5000K for late lodgement and 50K a day for each day the failure to lodge corporate returns continues may also need to be revisited. Arguably, the penalty that is levied on private company directors for failing to act on IRC notices of non-remittance of salary and wages could also be heavier.

(iii) Increasing Corporate Disclosure Measures

Improving the visibility and transparency of corporate operations is also highly desirable. The main aim is to discourage aggressive tax avoidance practices, promote greater tax policy debate, and enable better public disclosure of aggregate tax revenue collections despite taxpayers being potentially identified, and to allow improved sharing of tax information between government agencies. However, the particular level or threshold of disclosure in PNG Kina will be critical in determining the effectiveness of the measures. The implications of increased disclosure will vary for listed, privately-held, large businesses and PNG subsidiaries of foreign-owned, multi-national groups. It will also depend on the cash tax profiles of large businesses.

Other than revenue considerations, increased disclosure may have the effect of updating PNGõs tax rules to be able to cope with the modern global economy. In the digital age the ability to conduct business over the internet anywhere in the world, has to some degree, highlighted the inadequacy of residence and source rules. In this regard, new disclosure measures may be the first step to diagnosing deficiencies in the tax system and pave the way to aligning it to a digital and global economy.[34]

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[32] Hite, P. A., (1997), "Identifying and Mitigating Taxpayer Non-compliance," *Australian Tax Forum,* Vo1. 13, No. 2, pp. 155-180.
[33] Wickerson, J., (1994), ñThe Changing Roles of Taxpayer Audit Programs: Some Recent Developments in the Australian Taxation Office,ò *Revenue Law Journal*, 4, pp. 125-143.
[34] Grieve, S, Bertram, K and Smith, C, (2013), Confession time on Tax? *The Australian Financial Review,* 14 February, 2013.

(iv) Review company and withholding tax rates

As indicated in section 3 of the paper, the international competitiveness of PNGôs company tax rate and withholding tax regime is critical for future investment and revenue protection. In this regard the rates and regulations themselves may need to be reviewed. Entities that make dividend, interest, and royalty payments to an overseas person or an entity that receives such a payment on behalf of a non-resident must withhold. No deductions will be allowed for an amount of interest or royalty unless withholding obligations have been fulfilled. A payer must also withhold an amount from interest, dividend, or royalty if it is authorised to pay it at a place outside PNG.

When receiving a payment from a non-resident, an entity should withhold immediately afterwards, or if the non-resident becomes entitled to receive the payment at a later time, immediately after that time. A PNG entity acting as agent for a non-resident licensor is also required to withhold tax from royalty payments it receives in PNG on behalf of a non-resident licensor. Also with regards to overseas permanent establishments, any PNG resident entities that derive interest payable in PNG in carrying on business in a foreign country through a PE must notify the payer of those facts. This should also be the case where interest is payable to entities where at least one is a PNG resident that derives interest through an overseas PE.

(v) Introduce a CFC Regime

As indicated in section 4 of the paper, a CFC regime can assist in safeguarding the revenue. A company is treated as a CFC where it satisfies particular ñcontrol tests.ò In applying the CFC rules it is important to determine whether a country is a ñlistedò or ñunlistedò country.[35] Listed countries would generally include those that have a tax system closely comparable to PNG. All other countries would be considered unlisted countries. As the CFC rules operate under a self-assessment regime, the taxpayer is required to include income derived by a CFC in their assessable income. An ñattributable taxpayerò in relation to a CFC is where the taxpayer has a minimum percentage of ñassociate inclusive control interestò[36] in a CFC.

It should be noted that although the CFC regime will need to be specifically designed to suite PNG, there will be other more general aspects that need to be considered. One area is when the IRC will need to make adjustments to amounts included in CFC-recognised accounts to reflect the application of the armôs length transfer pricing principles of the CFCôs transactions with related parties. Also, where a CFC resident in an unlisted country passes the active income test, its attributable income will not include its ñadjusted tainted incomeò (passive income tainted sales and services income that is subject to certain modifications). Modifications may include gross amounts instead of net gains from the disposal of tainted assets and commodity investments; and from currency exchange rate fluctuations. Where a CFC resident in a listed country satisfies the test, however, there will be no attribution in respect of its designated concession income.

[35] The CFC residency rules may have to be quite detailed.

[36] ñAssociate inclusive control interestò is the aggregate of the direct and indirect control interests held by the taxpayer and the taxpayerôs associate.

(vi) Introduce a Consolidation Regime

As indicated earlier, the major benefits of consolidation are the reduction in compliance costs amongst member companies and the ease of reporting. Generally, the head entity of a consolidated group will choose for itself and its eligible subsidiary entities to be treated as a consolidated group and this decision may be irrevocable. The consolidated group would continue to remain in effect until the head company ceases to be a head company. A foreign-owned group of PNG resident subsidiaries that does not have a single PNG resident head company may still be able to consolidate by forming a multiple entry consolidation (MEC) group.

Where the group consolidates and is treated as a single entity for tax purposes, obligations will be simplified and cost savings identified. Particular features include; the pooling of losses and credits, elimination of provisions that apply to intra-group transactions, and the facilitation of corporate restructuring. It should be noted that although the head company pays the income tax liability on behalf of the whole group, other tax liabilities such as GST and other withholding taxes remain the responsibility of the individual members.

(vii) Increasing and improving DTAs

With only a limited number of operational DTAøs, PNG falls back on its tax law when dealing with the majority of overseas countries. This can create some bias and preferences for those particular DTA countries while disadvantaging other non-DTA countries. In order to create a more level playing field and promote international business worldwide, increasing and improving DTAøs is highly desirable. A critical element in the DTAs is the definition of a PE. Generally a primary definition of PE includes a fixed place of business through which the business of an enterprise is wholly or partly carried on.[37] If the definition is interpreted narrowly, this will have implications for the revenue.[38]

Another important feature of a good DTA is the reciprocal recovery of taxes. For instance, this DTA provision allows the mutual recovery of tax by the IRC from foreign states. Other measures include Tax Information Exchange Agreements (TIEAs) which support DTAs and enable the exchange of information between participating countries. For the TIEAs to be effective they should be negotiated with a wide cross section of countries and possibly supported by offshore information notices.

(viii) Amending Transfer Pricing Rules

In addition to safeguarding PNG revenue via DTAs, strict transfer pricing rules can be embedded both within the domestic tax law and within DTAs. In this regard it is important to align the application of the armøs length principle in PNGøs domestic law with international transfer pricing standards.[39] In particular, this will require amending the current PNG rules with regards to dealings between associated and non-associated entities and to attribute an entityøs actual income and expenses between its parts. Consequently, the amount bought into

[37] Australian Master Tax Guide (2014) 54th Edition, CCH, p 1229.

[38] See the OECD Guidelines regarding the attribution of profits to permanent establishments, which suggest that the ñfunctionally separate testò should be adopted (2012) at http:// www.oecd.org [accessed 22 April 2014].

[39] See the *OECD Transfer Pricing Guidelines for Multi-National Enterprises and Tax Administrations* 2010, and its *White Paper on Transfer Pricing documentation*, 30 July 2013, at http://www.oecd.org [accessed 22 April 2014].

PNG as tax from non-armôs length dealings should reflect the economic contribution made by the PNG operations.

Current transfer pricing rulings issued by the IRC can be expanded to cover the more detailed regulations and, in particular, incorporate safe harbour rules that are currently not prescribed in the legislation. While safe harbour rules offer taxpayers some measure of protection, the administrative penalty under the transfer pricing rules would not be reduced on the basis that the taxpayer had a reasonably arguable position, unless it complies with specific documentation requirements. The records kept would need to ascertain, matters relating to the arms-length conditions, the actual conditions and comparable circumstances, possibly particulars of the methods used, and their effects in the particular circumstances.

(ix) Amending Thin Capitalisation Rules

The interaction of the above transfer pricing rules with the thin capitalisation rules is important. Broadly, the arms-length rate determined under the TP rules is applied to the entityôs actual debt to determine the amount of transfer benefit and then the thin ñcapitalisationò rules are applied to the amount of debt deductions remaining after the transfer pricing benefit; has been negated. If the amount is excessive under those rules, the relevant deductions will be reduced further. Even if there is no excess debt under the thin capitalisation rules, the TP rules may still apply.[40]

It is noted that PNG has re-introduced thin capitalisation rules from January 2013 for non-resource companies at a debt to equity ratio of 2:1. For mining and petroleum companies the ratio remains at 3:1. However, it is suggested that a tightening of the debt/equity ratio could be considered that provides for safe harbour limits and worldwide gearing ratios; such as, for non-resources companies or general entities the safe harbour limit could be reduced from 2:1 to 1.5:1 on a debt to equity basis. The effect could see a reduction in interest deductions by up to 20%. Further amendments could include reducing the safe harbour debt limit for non-bank financial entities to 15:1 on a debt to equity basis and extending the worldwide gearing ratio to inward investors. This change would allow PNG operations of foreign multi-nationals to claim debt deductions on debt if they were geared to the same level as their world-wide group, even if it exceeded the ñsafe harbourò limit.[41] Finally, as indicated previously, to reduce compliance costs and ensure small businesses are excluded from the thin capitalisation regime, a feasible de minimise threshold of debt deductions should be in place.

[40] Australian Master Tax Guide (2014) 54th Edition, CCH, p 1257.
[41] Australian Master Tax Guide (2014) 54th Edition, CCH, p 1261.

6. EVALUATION OF THE MAIN OPTIONS FOR REFORM OF THE CORPORATE TAX REGIME IN PNG

The following section of the paper brings together the main short-term options suggested for the reform of the corporate tax regime in PNG. The advantages and disadvantages of each option will be briefly outlined as part of the evaluation.

Option A: Increasing the Disclosure Rules for Corporations

The main advantages of increasing the disclosure rules for corporations revolve around discouraging aggressive tax avoidance practices and allowing for improved sharing of tax information between government agencies. As indicated earlier, disclosure rules may also assist in aligning the digital and global economy by making information more transparent for conducting international business. Advocates of publicity see disclosure as increasing taxpayer confidence in the tax system; which in turn has the salutary effects of increasing voluntary compliance and revenues.[42] Likewise, publicity can improve taxpayersô knowledge of tax law; which in turn can diminish both intentional and unintentional non-compliance.[43] Targeted disclosure also has the capacity to improve education and tax knowledge as advocated by Kornhouser (2005) and Mazza (2003). Corporate taxpayers may think twice before engaging in more tenuous legal tax avoidance because of the shaming that follows as the detection if not enforcement function is increased as the public may discover schemes not caught by tax officials.

The main disadvantages of increasing disclosure are the negative public perceptions that may arise. For example, if businesses have low cash tax payable due to factors such as carry-forward losses or R&D deductions, increased queries may arise in the absence of full information, from analysts, the public or social welfare groups.[44] Another danger for business is that mandatory disclosure of tax information may adversely affect consumersô buying behaviour (similar to the recent protests directed at Starbucks in Britain).[45] In addition, government themselves are large consumers of goods and services and may take information on tax contributions into account when making purchasing decisions. There have also been reports about ñethical investorsò who ignore purchasing shares in companies that are not viewed as tax compliant.[46] Any bad publicity could have financial implications and may influence the investment decisions of companies currently operating in PNG and those considering establishing a business in PNG. In this regard, it is vital that corporations review the appropriateness of their business and entity structures and transfer pricing policies so that they are not exposed to legitimate criticism. Potentially, the legal costs of large businesses and multi-nationals will rise if they need to take advice on whether increased disclosure breaches any legal or commercial confidentiality obligations. Consequently, one danger more onerous disclosure obligations could bring is a ñrace to the bottomò as enterprises discover

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[42] Kornhouser, (2005), Linder, (1990), Mazza, (2003), Schwartz, (2008), Thorndike, (2009) and Bernasek, (2010).

[43] Kornhauser, M. E, (2005), Doing the Full Monty: Will Publicizing Tax Information Increase Compliance? *Canadian Journal of Law and Jurisprudence*, Vol. XVIII, No. 1, pp 1-23.

[44] Ernst & Young (2013) Australiaôs tax disclosure by large Australian businesses: Disclosure items and business implications, *Global Tax Alert*, 3 April 2013.

[45] Coffee chain Starbucks agreed to voluntarily pay an additional 20 million pounds in tax over the next two years after it was revealed that, despite having generated over 3 billion pounds in sales since 1998, it had only paid 8.6 million pounds in income tax.

[46] Grieve, S, Bertram, K and Smith, C, (2013) Confession time on Tax? *The Australian Financial Review,* 14 February, 2013.

they are paying more tax than their competitors.[47] This could negate the overall benefits derived from increased disclosure.

Option B: Improving Corporate Governance

Improving corporate governance brings a number of positives to a corporation as well as enhancing the corporationôs governance regime. As indicated previously, having a governance strategy in place regarding the running and operation of a company can improve the culture, accountability and transparency, performance evaluation remuneration, risk management stewardship, and financial disclosure of the enterprise. Importantly, good governance provides sustainable value to management, suppliers, regulators, shareholders, and the general public. Sound governance policies will clearly identify the responsibilities and functions of the board of directors, monitor board performance including induction, continuing education, and remuneration, and help avoid any potential conflicts of interest for directors. An established governance program will also allow for periodic checks of performance and allow a corporation to emerge in accordance with its corporate gaols.

However, with improving corporate governance come the risks associated with the absence of an ethical code or whistle blower protection. Without a sound code of conduct, directors may find themselves in a position or have an interest that conflicts with an interest of the organisation or gives the appearance of a conflict.[48] Likewise, the confidential reporting of issues of unacceptable behaviour or undesirable conduct must be available so that bad governance can be eradicated. Occasionally, board members appear to be more concerned about ethics as a reaction to say, bad publicity or high profile board member remuneration, rather than as a critical part of good corporate governance. Inadequate ethical standards will result in sub-standard formal practices or processes at board and management level. This ñexpectation gapò between the formalities of governance and the realities of its operation is what needs to be properly closed.[49]

Option C: Changing the Corporate tax and Withholding tax rates

The potential change in the corporate tax rate of the current 30% to a proposed 25%[50] may initially be viewed as a reduction in government revenues. However, it is the potential increase in investment that this will attract into PNG by making it more competitive with other OECD countries that is critical. Consideration should also be given to bringing the rate for corporate non-residents (currently 48%) closer into line with residents and there should be closer synergy between the rates for resident and non-resident mining companies (currently 30% and 40% respectively) as PNG has huge potential in this area.

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[47] Under performing and reporting less income so as to avoid disclosure requirements.

[48] Corporate Governance & Compliance Law>*Australian Corporate Practice Manual*> *Your Corporate Practice Manual: the bigger picture*- http://intelliconnect.wkasiapacific.com [accessed 21 April 2014].

[49] Corporate Governance & Compliance Law>*Australian Corporate Practice Manual*> *Your Corporate Practice Manual: the bigger picture*- http://intelliconnect.wkasiapacific.com [accessed 21 April 2014].

[50] Currently Malaysia, a neighbouring country to PNG, has a 25% corporate rate, which is closer to the OECD average corporate rate.

In this regard, consideration could be given to removing some of the ad hoc tax incentives and concessions (including tax holidays and favourable deductions) given to mining companies and perhaps reintroduce the discarded Additional Profits Tax (ATP).[51]

Overall, as indicated in section 4, it is the METR that measures how the tax increases the required rate of return for a marginal investment, so as long as investment; per se is increasing, the lower rates of tax can be sustained. In this way, there will hopefully be no need to broaden the tax base or strengthen anti-avoidance measures.

Manipulating withholding tax rates may also be desirable, given the variation in the current rates. At present, withholding rates for dividends, interest, and royalties vary between 10-17%, which is consistent with most OECD countries. However, whether this is the right mix for PNG, given the large resource base the country boasts is questionable. It is noted that non-resident contractors may be charged 12% withholding, whereas non-resident insurers without a PE in PNG can be taxed at 48%. It is this degree of variance that may also be restricting participation and sending mixed messages to potential foreign investors. Perhaps, foreign contractors could be taxed at a rate within the vicinity of 20-25% and be encouraged to incorporate while foreign insurers could also be taxed at a lower 20-25%, which would potentially improve overall fairness and voluntary compliance.

Against the potential advantages of reducing tax rates comes the danger of reduced revenue; particularly if economic conditions change dramatically. If there happened to be a reduction in investment in PNG in coming years, including in the resource sector, lower tax rates would not clawback the lost revenue. The trade off or mix of tax rates has to be appropriate for PNG; which should be seeking to encourage mining sector investment but not to the detriment of the financial sector. Possibly other tax incentives and concessions for investors may also need to be considered here in conjunction with tax rates. Broadening the tax base, introducing a capital gains tax (CGT), or increasing the GST rate are other possible trade-offs to reducing the corporate tax rate a discussion of which is beyond the scope of this paper.

Option D: Increasing and improving Double Tax Agreements

PNG has entered into nine DTAs and should look to expand this number in view of increased future trade and international business. As DTAs override domestic laws,[52] they have the ability to clarify and ascertain transactions between countries; and the tie breaker rules contained within help to resolve any deadlocks or inconsistencies in tax treatment. Improving the existing agreements will also be a priority, especially widening the definition of PEs and tightening the regulations that deal with foreign company branches. In this regard, the Investment Promotion Authority and Register of Companies can work alongside the IRC in addressing their regulations when dealing with foreign branch companies. As PNG continues to develop the number of trading partners will increase and consequently the number of DTAs (particularly with south East Asian countries and the USA) will also need to increase.

The constant danger with DTAs is treaty shopping. Treaty partners may find loopholes and inconsistencies in poorly drafted DTAs and takes advantage of them to improve their own tax situation. Broad rules in DTAs that allocate the taxing rights between countries are based on

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[51] The APT, which was originally introduced in 2008, was an additional 7.5% when the Papua New Guinea LNG project's internal rate of return exceeded 17.5% and was another 10% when the rate exceeded 20%. http://www.ogj.com/articles/2008/06/papua-new-guinea-revives-profits-tax.html [accessed 23 June 2014].

[52] A DTA is given the force of law by virtue of s 4 of the *International Tax Agreements Act 1953(Cth).*

residence and source. However, a treaty can only impose tax on income via its domestic laws and is not self-enforcing. In this regard, treaties are only as strong as the laws on which they are premised. The general structure of most DTAs is based on the *OECD Model Tax Convention on Income and Capital,* which member countries may adopt as the basis of negotiating individual DTAs. As PNG is not an OECD member, this may create some problems in both developing and endorsing compatible DTAs with some countries. Some countries may also find that in attempting to prevent fiscal evasion and secure revenue via a DTA, the general anti-avoidance rules need to be improved. This could also hamper the development of further DTAs.

7. CONCLUSION

This scoping paper has provided a general analysis and investigation of the current corporate tax regime in PNG, identified the features of a good corporate tax system, and made an evaluation of the various options for reform of the corporate tax regime in PNG. Of the suggested reforms some fall into the category of short-term while others are more long-term solutions (See Appendix).

Short term priorities

It is highly recommended that, as a short-term priority PNG looks to increasing and improving the corporate disclosure and governance rules. These priorities although requiring changes to the law, can be implemented fairly quickly and become operational in the near future. Receiving the endorsement of both corporate taxpayers and community groups for these changes should not be problematic. Other short-term measures include changes to the corporate and withholding tax rates, which again require legislative changes but will produce immediate results for PNGôs international competiveness. However, where the rates are lowered, the revenue gains may only be realised over time as investment increases. Increasing and improving DTAs can also begin immediately. The negotiation of new treaties and amendments to existing treaties may take some time and requires a diplomatic approach. However, this work can have immediate benefits for international relations and business.

Long term priorities

It is recommended that a more cautious approach be adopted for introducing a consolidation and CFC regime. These two recommendations involve major tax reform requiring extensive consultation and negotiation of all interested parties (business community, shareholders, government representatives, and community stakeholders). It is suggested that the CFC and consolidation regimes of other countries be carefully examined and changes made to adapt to local customs and law. The complexity of consolidation and CFC regimes in other countries will need to be avoided, but attention to detail will be paramount. Improving general compliance with the tax laws will also be an on-going reform requiring both a mix of improved enforcement and service. Audit will depend upon available resources and qualified staff while penalties will need to be reviewed. However, establishing a culture of voluntary compliance takes time and proactive measures will need to put into place progressively in order to reap benefits in the long-term.

Tax Policy Implications

Overall, it will be the staged implementation of the proposed reform options that should see sustained economic growth in PNG over the coming years with coincidental improvement in the revenue stream. This will assist PNG in positioning itself in the global economy.

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APPENDIX

Option E: Improving Corporate Tax Compliance (audits and penalties)

More sophisticated corporate tax audits run by highly qualified IRC tax auditors has the potential to improve compliance and revenue collections. Improved data matching and case selection techniques that identify key areas that are a risk to the revenue stream will be critical elements of corporate compliance. In the absence of a large IRC presence in PNG for audit activity, the utilisation of appropriate penalties is vital. The size of the penalty may act as a deterrent but it is the certainty of its imposition on those corporates that have been in breach of the tax laws that will have a larger deterrent effect. Slemrod (2007) noted that while there is no compelling empirical evidence addressing how non-compliance is affected by the penalty for detected evasion, it is the probability that non-compliance will be subject to punishment (including prosecution) that is the greater deterrent.[53]

However, improving voluntary compliance through increased media advertising and education of the public will bring more sustained, long-term improvements in compliance behaviour and is recommended for PNG. The disadvantages of employing only audit and penalties to improve compliance are well documented. In particular, it appears that relying on legal sanctions and punitive mechanisms alone will not produce favourable outcomes, particularly if taxpayers are unaware of their tax obligations and responsibilities as may be the case with many PNG nationals.

Studies suggest that the combination of lighter enforcement and better service by the revenue authority is highly desirable for improving compliance.[54] Feld and Fry (2003)[55] found that deterrence could be achieved by the tax authorities if they practised procedural fairness and justice, and displayed a general respect for taxpayers.[56] Importantly, a systematic relationship between external intervention and intrinsic motivation was also established through the study.[57] A further US study conducted by Alm et al, (2010), which investigated deterrence from the ñserviceò paradigm rather than the ñenforcementò paradigm,[58] found that when the tax agency provided information at low cost to the taxpayer it reduced the level of uncertainty and tax compliance improved.[59] The study acknowledged that while a compliance strategy should emphasise enforcement, it should also emphasise other administrative policies such as taxpayer services in order to provide balance and increase effectiveness.[60]

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[53] Slemrod, J, ñCheating Ourselves: The Economics of Tax Evasion,ò (2007), Vol. 21, No. 1, *Journal of Economic Perspectives*, pp 25-48.

[54] See Sheffrin, S M and Triest, R K, (1992), Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer compliance in Slemrod (ed), Why people pay taxes: Tax Compliance and enforcement, University of Michigan Press, Michigan, pp 193-218. The study indicated that broadly-based enforcement programs might reduce the chance of adversarial relationships between the IRS and taxpayers and lower taxpayersô estimates of the probability of detection as a result of being affected by the enforcement program.

[55] Feld and Fry, ñDeterrence and Tax Morals: How Taxpayers and Tax Administrators Interact?ò(*Centre for Tax System Integrity*, Canberra Conference, Australian National University, 2003), pp 1-19.

[56] Ibid16.

[57] Ibid 17.

[58] Alm, J, Cherry, T, Jones, M and McKee, M, ñTaxpayer Information Assistance Services and Tax Compliance Behaviour,ò (2010), Vol. 31, 4, *Journal of Economic Psychology*, pp 577-586.

[59] Ibid 581.

[60] Ibid 583.

Option F: Introducing a CFC Regime

The aim of the CFC legislation is to ensure that PNG residents cannot store certain profits derived from foreign operations in offshore companies and trusts and thereby defer PNG tax on them. It is consequently a measure employed to protect the revenue stream particularly in a growing economy where foreign investment is increasing. As the CFC rules apply accruals taxation to CFC residents in unlisted countries, it has the capacity to catch revenue that would normally go undetected or be unrecognised. In widening the net, it supplements existing international tax rules such as the foreign tax credit system. In determining the attributable income of a CFC, it is its taxable income determined on the assumption that the CFC is a resident of PNG. CFC legislation should specifically list the amounts to be included in the calculation to ease the duty of reporting and compliance. Eligible designated concession income generally comprises profits that are either not taxed at all or taxed at concessional rates in the foreign jurisdiction. A CFC regime would ensure that these profits are brought back into PNG and taxed accordingly.

The major disadvantage of the CFC regime is its potential complexity. There are likely to be a number of detailed rules and provisions that require technical interpretation and may lead to increased tax disputes and litigation. One example of the complexity could be found in the definition of ñadjusted tainted incomeò and what should be included. Also, other modifications required such as currency exchange rate fluctuations could be problematic. Australiaõs CFC regime has become quite complex but the proposed rewrite of the rules to make them simpler and more streamlined has not been adopted. Also, history indicates that the CFC mechanism operated with limited success in the United Kingdom and with some variations in the USA, Canada, France, Germany, and Japan.[61]

Option G: Introducing a Consolidation Regime

This could be one of the most fundamental corporate tax reforms recommended for PNG (i.e. allowing a group of related entities to be treated as a single entity for income tax purposes only). In doing so the main advantages would be to prevent double taxation of the same economic gain realised by the consolidated group while also preventing duplication of the same economic loss (i.e. value shifting). The other main advantage of consolidation is the potential reduction in compliance costs and improvements in business efficiency achieved through a reduction in complexity and simplification of procedures. Consequently, many tax consolidation regimes require an ownership level equal or close to 100% between group members. As indicated earlier, a single entity regime also allows for the pooling of losses and credits, which simplifies obligations and delivers cost savings, eliminates complex provisions applying to intra group transactions, and reduces impediments to group restructuring. Overall, a consolidation regime is designed to promote equity and improve the integrity of the tax system.

Similar to the CFC regime, the major disadvantage of a Consolidation regime is its potential complexity. There are likely to be a number of detailed rules and provisions that require technical interpretation, which may lead to increased tax disputes and litigation. Certainly this was found to be the case in Australia where the sheer volume of the technical legislation and related materials issued has been overwhelming; not to mention the substantial resources that

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[61] Hamilton, R and Deutsch, R, ñUnderstanding Australian International Taxation,ò 2nd edition, 1988, CCH Australia, Limited.

have been devoted in order to implement the regime.[62] Specifically, the costs of consolidation to the company will involve software changes, generation of information, and increased accounting/legal fees in order to set up. Other up-front compliance costs will involve determining asset values (complex calculations required) for joining subsidiary members; or a groupǿs available fraction may need to be calculated when a loss entity joins the group. This calculation requires valuations of the loss entity and the whole group as at the joining time.[63] A company group will need to weigh up the costs and benefits of consolidation carefully as, while joining may be optional, the decision once notified will generally be irrevocable.

[62] Sadiq, K et al, Principles of Taxation Law, 2013, Thomsons Reuters, pp 656-657.
[63] Australian Taxation Office (2002), Consolidation Reference Manual-ñTaxing wholly owned groups as single entities.ò