EY
Building a better working world

Ernst & Young
Level 4, ADF Haus
Musgrave Street, Port Moresby
PO Box 1380, Port Moresby 121
National Capital District Papua New Guinea

Tel: 675 305 4100
Fax: 675 305 4199
ey.com/pg

Head of Secretariat
Tax Review Secretariat
c/- Department of Treasury
PO Box 542
WAIGANI NCD
Papua New Guinea

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Submission Response: Papua New Guinea Tax Review - Issues Paper No 3

This submission has been drafted by Ernst and Young (EY) and summarizes EY's response to the relevant consultation questions noted in the Issues Paper No. 3 *The case for tax reform and broad reform directions* (hereinafter referred to as the 'Issues Paper') for the Papua New Guinea Tax Review.

1. Overview

The issues paper raised the possibility of some quite significant changes to the PNG tax system, including:

- The introduction of a resource rent tax;
- The introduction of a capital gains tax; and
- An increase in the GST rate.

These proposals raise significant design and transitional issues. The purpose of this submission is to provide comments on key design and transitional issues so that the full impact of what is being proposed is able to be taken into account in the Taxation Review Committee's deliberations.

We have also included comment on useful improvements that we consider could be made to PNG's current tax administration arrangements.

2. Discussion

Our detailed comments are as follows:

2.1 Resources Rent Tax (RRT) vs Government Ownership on Projects

Prior to turning to our discussion of design and transitional issues that would arise if a broad RRT was to be introduced in PNG, we thought it appropriate to draw attention to a broader policy issue. In our view, PNG needs to decide whether it wishes to benefit from its resources through the existing regime allowing government ownership of resources projects, or through a broad RRT. In our view, it would not be effective to require resource companies to be subject to both regimes.

Exploring for natural resources and determining how they may be economically exploited is an expensive and risky business. The risk and reward equation must be positive for resource companies or they will not embark on the exploration and economic feasibility study work that is required for PNGs economic development.

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PNG resource projects are currently subject to the right of the PNG Government to acquire an interest in each resource project on a cost reimbursement basis. The PNG Government then needs to fund its share of the project development expenditure. Where the PNG Government decides to acquire an interest in a project, it is subject to commercial and economic risks on the funds invested.

Resource companies factor the future opportunity cost of the PNG Government's project buy in right when assessing the risk vs reward equation for each resources project. This right can be seen as economically similar to an additional tax on resource projects.

It is our submission that it would not be appropriate for PNG to impose both a Government cost recovery buy in right and a broad RRT. This would in effect add a fourth layer of tax to resource projects, in addition to company tax, royalty/development levy and the Government buy in right.

As a proud people, the PNG people are politically supportive of the Government's resource project buy-in right. We suggest a political review be considered in respect to the ability to swap the Government buy in right for a RRT before the RRT option can be usefully considered in full detail.

2.2 RRT – Transitional and Design Issues

The issues paper refers to ongoing review of the proposal to introduce a broad RRT in PNG. Our comments on the transitional and design issues that would arise if a broad RRT was introduced are discussed below.

2.2.1 Investor Certainty and Transitional Regime

The introduction of a RRT could have a significant impact on the PNG tax outcomes for existing explorers, developers, operators and owners of PNG mining and petroleum projects. Our key submission is that, if it is decided to introduce a broad RRT, it is critical that clear transitional rules be introduced for all affected taxpayers so existing exploration, development and operating projects are not adversely affected.

The Australian Federal Government's recent proposals in respect to the Resources Super Profits Tax (RSPT) and subsequent introduction of the Mineral Resources Rent Tax (MRRT) and expanded Petroleum Resource Rent Tax (PRRT) are clear examples of the dramatic effect on investment certainty and perceptions of political risk that arise when resources tax changes occur without robust transitional rules.

Our suggestions in respect to the appropriate transitional rules are as follows:

- *New regime applicable to new projects* - One possible approach to transitional rules would be for the new resources tax regime to be applicable only to new projects. The existing regime would remain applicable to existing projects. Care would be needed to define what an existing project is. While this needs detailed consideration, we suggest that, as a starting point, all projects that arise out of existing exploration, retention and development resource rights should be regarded as grandfathered existing projects.

- *Optional elect in rule* - Consideration could be given to providing existing projects with the option of electing into any new resources taxation regime to be introduced. This would help manage compliance issues for taxpayers who are comfortable to transition to the new resources taxation regime.

- *Market value starting base relief* - The key political problems that arose for the Australian Federal Government in respect to the proposed introduction of the RSPT and the introduction of the MRRT and expanded PRRT related to the development of appropriate market value starting base relief to have regard to investments made and value created prior to these new regimes being introduced. As discussed below, this is a critical matter that needs detailed consideration.

2.2.2 Design of a Resource Rent Tax

We have submitted below our views in relation to the design of any resource rent tax PNG may decide to introduce. In making our submission below, we have relied on our experience with the recent reform process in Australia which involved the introduction of the MRRT and expansion of the PRRT resources rent taxes. In our submission, we have sought to focus on the issues associated with the design and technical application of a resource rent tax. We have therefore chosen not to focus on the economic arguments which are generally relied upon to support a tax on resource rents.

2.2.2.1 Background to Australian Experience

Any reform process in PNG to introduce a resource rent tax must have regard to the recent Australian experience. As our experience with the Australian regime contributes heavily to the points raised in our submission, we have outlined a brief summary to the Australian regime.

Australia introduced a specific resource rent tax regime targeted at offshore petroleum projects in 1987. As part of the Henry Review into Australia's tax system, commissioned by the Federal Government and published in 2010, it was recommended that the resource rent tax be expanded to onshore petroleum and all other resources.

Acting upon the recommendation in the Henry Review, the Federal Government proposed the Resource Super Profits Tax (RSPT) in May 2010. The RSPT was proposed to be a broad ranging tax, applicable to all minerals. The RSPT did not include any material starting base for existing projects transitioning into the regime. A relatively low augmentation rate was applicable to unused expenditure but a cash refund was available for excess State royalties paid. The Federal Government was widely criticised due to a lack of consultation with affected stakeholders in relation to the design of the RSPT.

Following extensive political backlash and a change in Prime Minister, the Federal Government announced that the RSPT proposal would be discontinued. A working group was established, involving BHP Billiton, Rio Tinto and Xstrata to redesign the proposed resource rent tax in a manner that would be more palatable to the industry. Following extensive consultation, the Minerals Resource Rent Tax (MRRT) was announced in 2011 which was to be applicable from 1 July 2012 and only applicable to iron ore and coal. The expansion of the Petroleum Resource Rent Tax (PRRT) to onshore petroleum projects was unaffected by the political process surrounding the RSPT and MRRT.

Ultimately, with the recent change to a Coalition Government, the MRRT has been repealed. The expanded PRRT will continue to apply.

We are of the view that PNG should take close interest in the political process surrounding the RSPT / MRRT and ensure that any design of a PNG resource rent tax reflects the learnings from the Australian experience. Our comments below reflect this accordingly.

2.2.2.2 Government Consultation with Affected Stakeholders

The key learning that can be taken from the failed RSPT in Australia is the lack of industry consultation that occurred in the key design process. As a result, the Federal Government was required to deal with significant political instability.

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The Federal Government was criticised for not taking into consideration the ability, in a global economy, for miners to easily redirect their investment to other jurisdictions. The process surrounding the initial announcement and design of the RSPT adversely impacted the perceived political and investment risk of Australia as a destination to attract mining and exploration projects. To avoid this, PNG should ensure it consults with its key stakeholders at all stages through the policy and technical design process.

2.2.2.3 One Regime or Multiple?

The Australian MRRT and PRRT regimes, whilst based on the same policy considerations, are quite dissimilar in terms of their legislative drafting and technical application. This makes applying both regimes more difficult for taxpayers, advisors and the tax administration.

PNG already has the Additional Profits Tax (APT) which taxpayers, advisors and, in particular, the IRC are already familiar with. It could be a significant strain on the IRC's already limited resources to expect them to effectively and efficiently administer separate RRT regimes.

As such our suggestion would be that if PNG decides to proceed with the introduction of a broadly based resources rent tax, then it should consider expanding the APT rather than introducing a new broader ranging RRT regime. Thought will need to be given to allow the APT to reflect the commercial differences between minerals projects and petroleum projects.

2.2.2.4 Rate of Tax

A decision will need to be taken as to PNG's preferred rate of tax for its resource rent tax. In Australia, the Federal Government originally announced that the RSPT would carry 40% rate. However, as part of the political process, this was reduced to 22.5% for the MRRT. The PRRT rate for both offshore and onshore projects is 40%.

It was difficult to reconcile the rate of tax for MRRT with that applicable to PRRT. We would recommend that PNG consider the merits of imposing a comparable rate of tax applicable for all of its resources. As a related matter, the total effective tax rate on projects should be considered from a global comparative perspective. Whilst many studies were produced by the various stakeholders in respect of the Australian MRRT, the general industry consensus was that the effect of the RSPT as originally announced would be to impose a total effective tax rate significantly higher than that experienced by industry participants in other resource rich jurisdictions.

The rate of tax will have significant impact on forecast profit for all PNG projects in the future. It will be necessary that the Government balance the rate between the country's revenue and a fatal impact on available profit from a project which could force miners and petroleum companies to send their capital to other jurisdictions.

2.2.2.5 Starting Base

A key issue with the RSPT was the lack of transitional relief for existing mining projects (an allowance equal to the accounting value of assets, excluding the resource was allowed but this was not considered significant in the industry). Following the political process, the MRRT included a 'starting base' which was provided to reflect the value of the project at the time of implementation of the regime. Prior to the inclusion of a starting base, a significant number of existing projects that were operating at a marginal profit prior to the introduction of a RSPT would have been required to discontinue operations at an earlier stage due to the unsustainable additional layer of tax.

We therefore recommend that PNG include a starting base in the design of any broader RRT to be introduced, or as a minimum some other form of transitional measure to ensure that industry participants who have made investments or capital commitments to projects are not penalised for decisions made under the current law.

A question will arise as to what stage a project should be at in order to be eligible for a starting base. It is not reasonable to require that a project be at a production licence phase in order to receive a starting base as this disadvantages those projects where exploration work has commenced but where a production licence has not yet been granted. Similarly, it is not uncommon for participants to have invested significant funds in acquiring exploration rights. In Australia all projects over which an exploration tenement was held was eligible for a starting base, regardless of the exploration spend that had occurred up to that point.

The other issue that will arise with starting base is the methodology for determining the quantum of the starting base shield. The MRRT included two main approaches being the book value and the market value method. PRRT provides for the same methods but also includes a look back method which allows the project to utilise the sum that has actually been spent on developing the project from a defined point in time (including the ability to attribute purchase prices for acquisitions of project assets or project companies). The PRRT also includes another method, specifically for Coal Seam Gas projects which is a shortcut method that allows the miner to utilise existing reported reserves and multiply that number by a price. In the PRRT case, the price was arrived at using a specified value that was used in a major transaction that occurred around the time of the introduction of the expanded PRRT regime. As a result, the shortcut is only available for assets that were subject to a transaction around a similar time.

In our view, the approach that PNG adopts for calculating a starting base needs to achieve a balance between simplicity and fairness. Ultimately, the methodology/(ies) should broadly ensure that taxpayers are able to obtain a starting base at least equal to expenditure incurred prior to commencement of the new law. A market value methodology should be made available for those miners that choose to invest in obtaining a valuation. However, more simple options should also be available. Under both the MRRT and PRRT, the book value method excluded the value ascribed in the accounts to the project's resource which resulted in few projects using this option. PNG should consider allowing a book value, including the value of the resource and a look back approach as approaches resulting in simple yet fair outcomes. In addition, PNG should consider a similar shortcut approach to the CSG shortcut used for PRRT purposes.

Once determined, the starting base under MRRT and PRRT is used as the last class of allowance against calculated mining/petroleum profit. The starting base is generally written off over the project life but for MRRT purposes was capped at 25 years. PNG should also consider the starting base as the last available allowance in determining the tax payable and should generally allow the starting base to be written off over the project life.

2.2.2.6 Rate of Return

Under a RRT, it is necessary that the Government allows a rate of return to the resource project which can be earned on costs being recouped prior to the State taking its rent from the resource profit. A key issue that will need to be determined is what the rate of return should be.

Under the original RSPT proposal, the Government proposed a Government bond rate applicable to all baskets of expenditure. This was subsequently changed to a long term bond rate plus 7% once modelling developed by industry indicated that the Government bond rate was not a sufficient allowance to define a 'super profit' for a project.

We note that the original RSPT rate was justified on the basis that a cash refund of state royalties would be provided. Practically, this original regime was more closely aligned to the Australian Government "derisking" relevant projects to a degree. However, from an industry perspective, the strong preference was to self-manage resource project risk. Further, such considerations should be addressed in light of the PNG Government's existing ability to obtain an equity participation (and any proposed changes in relation thereto).

PRRT utilises different augmentation rates depending on the basket of expenditure. For general expenditure (including capital expenditure), the applicable rate is long term bond rate plus 7%. For

exploration expenditure, to reflect the additional risk associated with long lead times to recoupment, the applicable rate is long term bond rate plus 15%.

In our view PNG should apply an approach similar to the PRRT in applying separate rates depending on the nature of expenditure. This provides the resources project developer with an appropriate incentive to engage in long term exploration activity, with the associated rewards to the PNG economy. In terms of the specific rate to be applied, we recommend that this be agreed based on discussion with affected industry stakeholders.

2.2.2.7 Breadth of Application

It will need to be determined how broadly the proposed RRT applies. In the RSPT case, it was proposed to apply to all major minerals. This was subsequently whittled down to just coal and iron ore following the political process.

Fairness and simplicity might dictate that the RRT would apply across the board with no exceptions. Inclusion of exceptions promotes inefficiencies in the tax. However, PNG would need to take care to ensure that it does not discourage investment in emerging resources.

Practically, any RRT is likely to impose a not insignificant compliance obligation on relevant taxpayers. As such, we recommend that de minimus provisions are contemplated to exempt smaller players from such onerous obligations. Such provisions were developed under the Australian MRRT.

2.2.2.8 Transferability of Attributes

A RRT is generally a project based tax with a strict project ring fence applicable to define a project's profit subject to tax. However, commonly, many resource companies will have an interest in multiple projects in the same jurisdiction. Where a taxpayer holds an interest in both a profitable and a loss making project, it may be economically inefficient for the taxpayer to continue to hold the interest in the loss making project unless it is able to offset losses against its profit making projects.

The MRRT contained a limited transferability of excess expenditure, but only within the same resource category (i.e. you could only transfer from a coal project to another coal project and not between coal and iron ore projects). The PRRT regime also incorporates the capability to transfer certain expenditure between petroleum projects. We note that, consistent with the project nature of the taxes, the Australian regimes do not facilitate a step up to market value on transfer of ownership, nor does the transfer of ownership trigger a taxing event for the vendor.

We recommend that PNG give consideration to transferability of attributes between resource projects subject to the proposed RRT. Like the MRRT, this may only be limited to transfers between projects of the same resource category (e.g. gold project to gold project).

Similarly, the transferability of attributes on transfer of a project should also be considered. As a minimum, we would expect that historic attributes would transfer with a project as the underlying ownership of the project changes (whether by direct transfer or via an entity acquisition). The absence of an ability to transfer attributes under a change of ownership would likely be a disincentive to investment.

2.2.2.9 Refundability of Excess Royalties

Under Australia's Constitutional system, States have the right to tax resources contained in that State. This has historically been applied to give effect to a State Royalty regime operating in each Australian State. Double tax potentially applies where a royalty regime and a RRT apply to the same resource project. As a result, the original RSPT contained a mechanism by which State Royalties were to be credited against RSPT liability with the excess of State Royalties refunded by the Federal Government. Under the MRRT, the Federal Government removed the refundability of the State Royalty credits with unused royalty credits being augmented at the long term bond rate plus 7%.

PNG has a production royalty system administered at the provincial government level. In an ideal system, such a royalty regime would be replaced by a RRT with the provincial governments compensated through RRT revenues raised. Failing the ability to replace the royalty regime, the RRT should provide some form of relief for production royalties paid. This should be in the form of a credit against RRT liability, a grossed-up deduction or as a minimum, reflected via a reduction in the rate of the RRT such that the total tax rate does not result in PNG becoming an unattractive investment destination. In the event that the relief is not utilised against RRT in the year that the production royalty is paid, consideration should be given to either refunding the credit to the taxpayer or, if that is not economically viable, allow the ability to carry forward the royalty credit with an appropriate augmentation applied to the unused credit to preserve the real value of the credit once used.

2.2.2.10 Deduction for Income Tax

In order to mitigate the imposition of double tax on the same project profits, some form of income tax relief will need to be provided. This could be provided by way of a credit against income tax or an income tax deduction.

Australia provides an income tax deduction for PRRT and MRRT paid. Whilst such an outcome might arguably arise under PNG's general deduction provisions, specific clarification in this regard would be appropriate.

2.2.2.11 Treatment of Close Down Expenditure

An important consideration in designing a RRT is the treatment of rehabilitation or close down expenditure. The difficulty with such expenditure is that, due to a RRT being a project based tax, close down expenditure is generally incurred at a point too late to be able to be offset against project profits.

Options available for close down expenditure include a refundable credit or deduction for such expenditure. This option most closely reflects the policy of a RRT, being the State's contribution to the closing down expenditure of the project. A similar option could involve a 'carry back' of the expenditure to offset such expenditure against project profits in prior years. This would effectively result in a refund of RRT liabilities of prior years. The final option could include some form of transfer of such expenditure to other projects that the taxpayer has an interest in.

2.3 Capital gains tax – transitional and design issues

Again we have set out our comments on the transitional and design issues associated with an introduction of a capital gains tax based on our Australian experience.

2.3.1 Pre CGT assets exclusion vs deemed starting cost base

When CGT was introduced in Australia in September 1985 all assets acquired prior to 20 September 1985 were treated as pre CGT assets and were excluded from CGT on their disposal. We favour this approach if CGT were to be introduced in PNG.

The alternative transition approach is to deem taxpayers to have a starting cost base in respect to all assets. Generally such a starting cost base would be equal to the market value of the assets or a look back to the cost of the asset.

2.3.2 CGT design issues

CGT taxation is a complicated area in its own right. Many issues arise that would need to be considered including:

- What the CGT rate would be;
- Whether indexation shelter or a discount for assets satisfying a holding period rule would be provided;
- Whether CGT rollovers would be provided to various restructure transactions;
- Whether non-residents should be subject to CGT on all assets or only direct and indirect interest in real property and resource projects.

If CGT is introduced, then additional considerations arise for resource projects, in particular whether acquirers of resource projects should be entitled to tax depreciation on the cost of acquiring projects.

We would be pleased to provided further comments on these and related design issues in the event that PNG decides to proceed with a CGT regime.

2.4 Administration of PNG tax regime

In addition to considering the introduction of new taxes and revenue measures we submit that there are a number of existing provisions that should be repealed. These are provisions that are either impractical to administer, are covered by other provisions or do not result in net additional revenue collections. These provisions include section 68AE dealing with lease payments and section 189B(1)(b) in relation to dividend withholding tax.

2.4.1 Section 68AE Lease Payments

This section applies to leases of property by a PNG taxpayer from a non-resident associate. The intention of this provision is to limit the amount of the deduction allowable to the lesser of the actual lease payments made and the total of notional depreciation and notional interest. The notional interest is determined with reference to a rate as advised by the Commissioner General from time to time by notice in the National Gazette for that loan class or in any other case by the long term bond rate increased by 5%.

To our knowledge the Commissioner General has never published any applicable rate in the National Gazette. The long term bond rate is the rate applicable to five year Government Inscribed Stock as quoted by the Bank of Papua New Guinea for 1 January of the relevant year. From information available on the Bank of Papua New Guinea website we understand that a 5 year rate Government Inscribed Rate may not be quoted each year.

The above uncertainty in respect of the applicable prescribed rate makes the provision difficult to administer. Given that related party transactions with non-residents are covered under the existing transfer pricing provisions the amount which is deductible is limited to the arm’s length consideration. We further note that as the Commissioner General has issued Taxation Circular 2011/2 setting out the Commissioner General’s guidance notes on the administration of transfer pricing we believe that the measure contained in section 68AE is no longer required.

2.4.2 Section 189B(1)(b)

Division 13A is headed Dividends paid by Resident Companies and in addition to imposing a liability to withhold tax (“DWT”) from relevant dividends paid by resident companies it also applies by virtue of section 189B(1)(b) to impose a withholding tax liability on dividends derived from sources outside PNG

by a company that is a PNG resident. The DWT is available as credit to offset the DWT liability on subsequent dividends paid by the PNG company.

In situations where the foreign sourced dividend is immediately passed on to the shareholder of the PNG company there is no cash flow detriment for the PNG company. However, where the foreign sourced dividend is retained by the PNG company to meet working capital or other requirements the 17% DWT liability can be a significant impost.

We understand that collection of DWT from foreign sourced dividends has not been enforced by the IRC. However, to provide certainty and consistency for all taxpayers we submit that the provision be repealed.

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If you have any queries in relation to the comments made please contact me on 305 4125.

Yours sincerely

Colin Milligan
Tax Partner