Papua New Guinea Taxation Review

Issues Paper No.4:
Taxing Capital Gains?

Prepared by
the Taxation Review Committee

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Consultation Process

The Tax Review Committee (Committee) is seeking your feedback and comments on this Issues Paper. This and other issues papers are being released throughout 2014 and the first quarter of 2015. They are designed to promote targeted exchange and robust debate on particular areas of discussion on PNG's taxation system. Consultation questions have been included throughout this Issues Paper to guide responses but stakeholders should feel free to raise any issue of relevance.

Feedback regarding this Issues Paper will help to inform the development of the Committee's draft recommendation to Government, which will be subject to a further round of consultation before being finalized.

To ensure that there is transparency in the consultation process, all submissions are published on the Tax Review website (www.taxreview.gov.pg) unless the submission is by justification, marked '**CONFIDENTIAL**'.

Submissions in response to this particular Issues Paper are due by 13 February 2015.

All submissions should be sent via mail and/or email to:

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FOREWORD

In 2013, the Government committed to comprehensively review PNG's revenue regime with the main aim of ensuring that it remains relevant, efficient and effective.

Government revenue is critical to funding essential services and infrastructure for Papua New Guinea, to share the benefits of prosperity across families, communities and regions and to lay the foundations for future growth.

The last comprehensive taxation review was undertaken in 2000. PNG has undergone substantial economic, fiscal and technological developments over the past 13 years, so it is timely that another review is done to ensure the country's tax system is modern, robust, is congruent with economic, social, technological and political changes, and is able to support the country's medium and long-term economic and social development objectives. While formally titled a 'Tax Review', the Review will, in fact, consider other sources of revenue, including non-taxation revenues.

This paper is the fourth in a series of Issues Papers to be released as part of the Review process. Whilst the paper does begin to examine some of the design issues associated with introducing a system for taxing capital gains, the primary purpose of the paper is to examine the case for bringing such income into PNG's tax system. Ultimately the design of such a system would require more detailed consideration to ensure that it was appropriate for PNG's circumstances.

The paper puts forward a number of reasons of why PNG should follow many other jurisdictions in the region and around the world, in taxing capital gains. In addition to the prospect of using a tax on capital gains to fund reduced tax rates or significant tax reform in other areas (such as reducing corporate or personal income tax rates), taxing capital gains can help promote the competitiveness of the PNG economy – ensuring that investments are made based on their productivity and economic return, rather than any potential tax advantage. Taxing capital gains will also promote the overall fairness of PNG's tax system.

The Tax Review Committee acknowledges that there may be some sensitivities associated with the introduction of a system for taxing capital gains in PNG – as indeed there is with any significant tax reform process. However, given the

Review's broad terms of reference, the critical need for PNG to identify ways of broaden its tax base, the prevalence of capital gains tax systems around the world and the arguments outlined in this Issues Paper, the Committee's view is that it is useful and would be of value for PNG to consider the taxation of capital gains. Accordingly, the discussion on taxing capital gains forms part of the broader discussion on the future of PNG's taxation system.

As discussed in the Broad Directions paper (Issues Paper #3) released by the Committee, the implementation of any possible reform in this area will pose a number of administrative and transitional challenges for both the IRC and taxpayers alike. This would likely make any reform in this area unrealistic in the short term given the need to focus on other areas of higher priority, such as in building the capacity of tax administration.

Nonetheless the Committee invites interested parties to consider the issues raised in this paper in the context of a medium or longer term vision of PNG's tax system. This Review should not be seen as a means of identifying all reforms requiring immediate implementation but, rather, as a means of developing a roadmap for tax reform going forward.

The fundamental question being asked by the Committee in this paper is whether the taxation of capital gains should form part of that roadmap. The Committee looks forward to receiving views on this and the other issues raised in this paper.

Sir Nagora Bogan, KBE

Chairman, Tax Review Committee

EXECUTIVE SUMMARY

This paper includes a broad discussion on the possibility of including capital gains in the PNG tax system.

In simple terms, a capital gain arises when an asset – such as property, a financial asset (e.g. a bond or share), a mining or petroleum tenement, or an intangible asset, increases in value. In general, PNG does not currently tax such gains.

PNG needs a tax system that provides the revenue necessary to fund essential services and infrastructure for Papua New Guinea and at the same time promote economic growth and jobs.

Taxing capital gains can contribute to both of these objectives, while at the same time improving the fairness of the tax system. Bringing capital gains into the tax system could also provide the revenue base to fund a cut in tax rates (such as the corporate tax rate) in time. Consideration could also be given to using the revenue to fund reform in other areas of revenue generation, such as Stamp Duties.

The paper includes a consideration of the systems for taxing capital gains applied in many other jurisdictions around the world. Ultimately, however, it is for PNG to look at and adopt a system that is right for itself. An important consideration for PNG is recognizing the issues associated with a system for taxing capital gains and customary land ownership in PNG.

The Issues Paper explores some of the key design and transitional issues associated with the introduction of any system to tax capital gains. This includes who should be subject to a tax on capital gains, on which assets should the tax be applied, when should they be taxed and at what rate. Transitional issues have also been explored, including options for avoiding the retrospective taxation of past gains.

Consultation questions

Below are the various questions posed throughout the paper. They are intended to act as prompts only and stakeholders are should feel free to raise any other related views/issues.

Why tax capital gains?

Question 3.1- What are stakeholder's views about the introduction of a tax on capital gains in PNG? Putting aside issues of *when* such a tax could be introduced, are there any other reasons why PNG should/should not consider taxing capital gains?

Design issues for taxing capital gains

Question 4.1 – If PNG were tax capital gains, do stakeholders agree that a system for taxing capital gains should apply to both resident and non-resident taxpayers?

Question 4.2 – If PNG were to tax capital gains, which class of assets *should not be included* in such a regime? Why?

Question 4.3 – If PNG were to tax capital gains, which class of assets *should be included* in such a regime?

Question 4.4 – If PNG were to tax capital gains, should it do so through identifying a specific class of assets or should it have a 'catch all' rule subject to specific exemptions?

Question 4.5 – If PNG were to take capital gains, do stakeholders agree that capital gains and losses should be recognized on a realization basis, in particular where the asset is disposed of?

Question 4.6 – Should a roll-over be provided where a disposal occurs because of the death of the owner of the asset?

Question 4.7 – Are there other roll-overs that should be provided, even where there is a voluntary change in economic ownership? If so, why?

Question 4.8 – What rate/s should apply to the taxation of capital gains in PNG?

Question 4.9 - Should the tax system seek to broadly align the tax on all forms of capital income, with different rates applying to different types of entities (e.g. companies, individuals)?

Question 4.10 – Is there value in PNG considering a capital gains tax system that applies a set rate to all capital gains? What issues might arise with this approach?

Question 4.11 – Do stakeholders agree that the best approach for the treatment of capital losses in PNG would be for these to be quarantined and carried forward against future capital gains?

Question 4.12 – How else could capital losses be treated, in a way that supports the five policy principles?

Transitional issues

Question 5.1 – What class of capital assets in PNG would pose challenges in determining an appropriate market value?

Question 5.2 – Putting aside the revenue considerations how could PNG best transition to a system that taxes capital gains?

CHAPTER 1: CONTEXT FOR CONSIDERING THE TAXATION OF CAPITAL GAINS

Many income tax systems distinguish income from capital gains.[1]

In simple terms, a capital gain arises when an asset increases in value. There are many assets that can increase in value over time – in the PNG context, notable assets include land, financial assets (for example a bond or a share in a company) or mining and petroleum tenements. Further information on what constitutes a capital gain is found at Attachment A.

Generally capital gains are not taxed in PNG.[2]

The Review understands that PNG was considering introducing a broad tax on capital gains in the early 1990s as a way to broaden the tax base. However, the Government of the day considered it not timely to introduce such a tax.

In addition PNG did have a specific tax on gains derived from the sale of shares (former Section 196G). However, this was removed in 1993.

PNG's economy has since undergone substantial economic, fiscal and technological developments. The international economy has also changed. There is increasing mobility of investment and global markets are more and better integrated.

Strong growth in emerging countries and growing demand has created the resources boom in minerals and now gas. One of the objectives in the Development Strategic Plan 2010–2030 is to ensure that the PNG's natural

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[1] A distinction which can be traced back to the English trust law of the Middle Ages.
Another way of categorizing income is to look at its underlying *source*. Under this approach income is categorized as either income from labour or income from capital

[2] The *Income Tax Act 1959* does purport to tax some capital gains – these are gains from the sale of property purchased for profit-making by sale (Subsection 47(1)(1)). However, the challenges involved in determining the subjective intention of an individual means that, in reality, capital gains are generally not taxed in PNG. In addition, the Income Tax Act (section 36B) includes a specific exemption for non-resident shareholders earning income from the sale of shares on the Port Moresby Stock Exchange.

resources are properly managed to ensure their benefit can be sustained through current and future generations.

More broadly, PNG needs a tax system that provides the revenue necessary to fund essential services and infrastructure for the country while at the same time promote economic growth and jobs now and in the future.

Consistent with PNG's Medium Term Fiscal Strategy 2013–2017, the Committee is also considering tax reform measures that will help to ensure better sustainability of the country's revenue system.

The view of the Committee is that taxing capital gains can contribute to these objectives, while at the same time improving the fairness of the country's tax system.

International comparisons

First and foremost, whether to tax capital gains – and if so, the best way to do it – should ultimately be determined by the needs of and conditions in PNG.

In particular any system for taxing capital gains in PNG needs to recognize the significance and nature of PNG's customary land. Customary land is held for the benefit of the clan and not owned by any particular individual. This is inconsistent with the concept of individual ownership that underpins most, if not all, approaches to taxing capital gains.

Care should also be taken when comparing tax systems across countries, particularly in the case of capital gains as they can vary depending on the type of asset, who holds the asset (for example, individual, company or superannuation fund) and how long it has been held – plus there is the matter of the treatment of capital losses.

A full analysis requires comparing the entire tax systems of a range of different countries, including personal income taxes, corporate income taxes, wealth and land taxes, and consumption taxes[3]. Accordingly, comparisons with

[3] For example, hypothetically country X that raises all its revenue through consumption taxes has no explicit tax on capital gains, but taxes consumption funded by capital gains exactly the same as consumption funded by salary and wages or any other form of income.

individual countries that do not tax capital gains, exclude certain assets, or provide particular concessions should be treated with caution.

Nevertheless, other countries' approaches to the taxation of capital gains can provide useful lessons for PNG.

(How) Do other countries tax capital gains?

A summary of what other countries do in terms of taxation of capital gains is contained in Attachment B.

As can be seen, many countries tax capital gains in some form, either with an explicit capital gains tax or by treating capital gains as inherently part of 'ordinary' income.[4] Countries have also take different approach to the design of and transition into a capital gains tax regime (discussed further below).

Several countries have also recently increased or announced plans to increase taxes on capital gains, such as Egypt and Mozambique. Kenya recently voted to reintroduce a capital gain tax, thirty years since it was last repealed[5].

In many systems, countries exempt or provide preferential treatment for gains on certain asset types. The most common example is exempting an individual's main residence. Some countries provide a capped or partial exemption and/or allow a tax deferral if sale proceeds are used to purchase a replacement home.

Another asset type that is sometimes exempt, is (listed) shares (although this is less common than the exemption for a main residence). Almost all such tax systems nevertheless treat regular or 'professional' trading as ordinary income.

More generally across asset types, many countries tax capital gains made by individuals at concessional rates compared with taxes on wage and salary income – although short term gains are often taxed at full marginal rates.

However, some countries make no distinction between capital gains and any other income, particularly for companies.

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[4] Low or no-tax jurisdictions – often referred to as tax havens – exempt most forms of income, including capital gains.

[5] Financial Time, 'Kenya votes to reintroduce capital gains tax', 28 August 2014, viewed at www.ft.com.

Consistent with the OECD Model Tax Convention, non-residents are often only subject to tax on capital gains made on 'real property', such as land and natural resources. This is on the basis that capital gains derived from other assets are best taxed in the country of residence.

Most countries that do not comprehensively tax capital gains do nevertheless have targeted rules to bring certain gains into the 'ordinary' income tax system, which are then typically taxed at full marginal rates. For example, New Zealand does not have a general tax on capital gains, but has comprehensive rules to tax gains made by property developers or people who buy property with the intention of resale.[6]

What about developing countries?

Since at least the middle of the 20th century, economists have generally agreed that capital gains can be a proper source of revenue for developing countries (Amatong 1968) – the reasons why capital gains should be taxed are explored further in the following Chapter.

Indeed many developing countries do impose a tax on capital gains in some way. This is highlighted in Attachment B. In the region Fiji introduced a capital gains tax effective from 1 May 2011. This tax applies to a prescribed list of assets at a rate of 10% of the gain arising from disposal.

The nature and pattern of capital gains in developing countries can differ from those in developed countries. In particular, capital gains in developing countries are mainly from real property and potentially natural resources – whereas in developed countries, the sale of securities and other assets plays a more significant role. This difference arguably strengthens the case for taxing capital gains in developing countries, as gains on property are less mobile and taxes are therefore less distorting. Furthermore, speculative investment in existing property or *idle* land and natural resources is typically less socially productive than other forms of investment.

On the other hand, one argument against taxing capital gains in developing countries is the potential complexity of the system, making it more difficult to

[6] The PNG tax system has similar rules about taxpayers who acquire assets with the intent of selling for a profit, but this rule is difficult to enforce.

administer – particularly in countries (such as PNG) that adopted the British common law tradition of treating income and capital differently.

Building the capacity of revenue authorities before implementing a system of taxing capital gains is therefore essential. Similarly, any tax on capital gains should be as simple as possible, subject to other policy considerations.

For a strongly growing country such as Papua New Guinea, broadening the tax base with a well-designed tax on capital gains would help to support economic growth and improve revenue sustainability.

Submissions to Review

A number of submissions in response to the Committee's "Blue Sky Consultation" process did raise the prospect of taxing capital gains in PNG. Noting the absence of such a tax in PNG, one submission noted that:

> *This is one income source that can be included to broaden the tax base for the country.*[7]

In its submission to the Review, PNG's National Research Institute (NRI) cautioned against moving towards implementing a capital gains tax too quickly, citing;-

> *Currently there is no capital gains tax in PNG, perhaps because the property (land and housing) and equity (shares and bonds) markets are relatively underdeveloped. The country is yet to unlock a significant part of its land for property development. When this eventuates, it is considered that the sale of personal residential property will normally be exempt from capital gains tax until the country's property market matures. It is also noted that a Securities Commission Bill, a Capital Market Bill, and a Central Depository Bill are currently under discussion and which, if collectively passed into law, would replace the Securities Act 1997. Again, until these significant developments eventuate, capital gains tax on sale of stocks, bonds, and shares is not currently*

[7] See Submission by J&J Associates, 2014, 'Submission to PNG Tax Review', 30 April 2014, available at www.taxreview.gov.pg/submissions. See also the submission from Mission Aviation Fellowship also available on the tax review's website.

recommended in order to allow a sustained interest and investment in the country's capital market.[8]

[8] See National Research Institute, 2014, 'Taxation Policies and Practices Affecting Businesses and Individuals in Papua New Guinea: Options for Reform", 14 October 2014, available at www.taxreview.gov.pg/submissions.

CHAPTER 2: WHY TAX CAPITAL GAINS?

As noted in Chapter 1, gains from the increase in asset values are not currently taxed in PNG except in very limited circumstances.

As a result of this treatment, there is a strong incentive for taxpayers to structure profits as tax-free capital gains. This was discussed in relation to business structuring in Issues Paper 2 on Corporate Income Tax released by the Committee.

Issues Paper No. 3 also considered that introducing a capital gains tax could be a medium term priority for PNG to make the system fairer and more efficient provided the administrative capacity of the IRC is improved/increased to enable implementation.

This Chapter further explores the case for taxing capital gains, measured against the five general principles for good tax policy set out in Issues Paper No. 3:

1. **Revenue**: A good tax system should raise sufficient revenue to ensure that the government can fund services that meet the community's needs.
2. **Competitiveness and efficiency**: A good tax system should promote economic growth and thus create more jobs, higher incomes, more services, lower prices and less poverty.
3. **Fairness**: A good tax system should be fair: it should create a level playing field for businesses and ensure that taxpayers each pay their fair share.
4. **Simplicity**: A good tax system should be simple enough for taxpayers to understand and meet their tax obligations. It should also minimise the administrative costs for government and for the taxpayer.
5. **Trust in and accountability of government**: A good tax system including a reliable tax administration should build trust and confidence in government and should be transparent and encourage greater government accountability and integrity.

Revenue

The lack of capital gains taxation means that certain forms of economic income are simply not taxed. It also provides an incentive to taxpayers to convert taxable income into untaxed capital gains[9]. The effect of this is clearly detrimental to PNG's revenue base.

However, it is often argued that the revenue from taxing capital gains will be minimal, and not enough to justify the additional administration and compliance costs associated with a capital gains tax.

While the revenue yields of taxing capital gains can be difficult to predict (due to the lack of data and need for assumptions about changes in asset values, turnover of assets and behavioral responses), international experience suggests that the revenue impact of including capital gains in the tax base often exceeds the predictions, and far exceeds administration costs[10].

The increased revenue is attributable not just to the direct collection of capital gains tax, but also to increased personal and corporate income tax on 'ordinary' income because the incentive to convert income to capital gains is reduced or removed. Furthermore, the positive broader revenue impact will increase over time, by reducing tax distortions and encouraging more productive investment.

One-off transactions can also generate significant gains, particularly where a country has a strong resource sector. For example, a single sale of mining interests in Mozambique in 2011 was valued at $4 billion. This case is also an example of ensuring that any regime for the taxation of capital gains captures the sale of indirect interests – in this case, the large transaction went untaxed because it involved the sale, on the Australian stock market of shares in the mining company holding interests in the project (rather than the direct sale of the assets themselves). This issue is discussed further in Chapter 3.

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[9] For example, owners of closely held (for example family owned) companies would seek to retain profits and realise more of their earnings as (tax-free) capital gains on the sale of shares, rather than receive (taxable) dividends.

[10] This underestimation can partly be attributed to tax authorities failing to realize the full extent of tax planning designed to convert fully taxable income into tax-free capital gains (Brooks 2001, p 20).

Taxing capital gains would strengthen revenue collections by expanding the tax base and reducing opportunities for income tax avoidance and planning. This would improve the sustainability of revenues, consistent with PNG's Medium Term Fiscal Strategy 2013-2017.

Ultimately, the revenue impacts of taxing capital gains would depend on key design issues, including the transitional issues discussed in Chapter 4. However, even a conservative system for taxing capital gains is likely to be significantly revenue positive.

Competitiveness and efficiency

Some argue that the taxation of capital gains can promote competitiveness and efficiency, thus is helping to drive economic growth. However, others argue that taxing capital gains can adversely affect an economy's competitiveness and efficiency as it discourages savings, reduced capital mobility, discourages entrepreneurial activity and risk taking and deters foreign investment.

The economic literature shows that the level of savings is generally unrelated to the rate of return on savings. International experience shows that the level of savings over time and across countries is much more stable than the rate of return on savings.

Furthermore, taxing different *forms* of saving and investment differently – such as fully taxing interest income but fully exempting capital gains – is likely to significantly distort investment behavior and capital flows, with the result that savings are directed at less productive but more favourably taxed investments.

For example, compare two (2) investment opportunities: an investment that is expected to generate income with a pre-tax return of 10 per cent versus and a second investment that does not generate any (taxable) income but is expected to grow in value by 8 per cent a year. Assuming a 30 percent tax rate, the investor could be choose the second investment, because the tax-free capital gain of 8 per cent is higher than the after-tax return of 7 per cent on the first investment opportunity, despite it being the less productive investment.

More generally, providing an equal treatment of different forms of *capital income* allows capital markets to work and allocate investment to the most productive activity.

Another issue when considering whether or not to tax capital gains relates to its impact on capital mobility. 'Capital mobility' is really just another name for the desire by investors to try and find the best investment and return around the world. A country like PNG, with limited sources of funds to draw upon to drive economic growth, needs to maximise this international investment.

A commonly used argument against taxing capital gains is that it can reduce capital mobility and the efficiency of capital markets, because of what is known as the 'lock-in effect' – where taxpayers are reluctant to pursue investments they believe will have a higher rate of return because selling existing investments to re-invest might trigger a taxable capital gain. (Stiglitz 1983, p 259).

While the taxation of capital gains may give rise to some 'lock-in', the empirical evidence indicates that the adverse effects on investment from 'are less serious than claimed, particularly when capital gains are taxed at concessional rates (Amatong 1968, Brooks 2001).[11]

Taxing capital gains can also counter the 'corporate lock-in' effect, where companies have an incentive to retain profits (where there is no CGT) rather than distribute them. This can have negative efficiency implications (OECD 2006, p 49).

The lock-in issue and possible ways to minimize the lock-in effect are discussed further in Chapter 3.

Another argument against taxing capital gains is that it would discourage entrepreneurship and risk taking. Encouraging new businesses and investment will be increasingly important for PNG in the coming years and decades.

The best way to support quality investment, including entrepreneurship and rational risk taking, is to allow capital markets to allocate investment to the most productive use by providing a more neutral tax treatment of different forms of investment.

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[11] To the extent that American literature finds evidence of lock-in effects, this partly reflects a particularly generous treatment of unrealised capital gains when a taxpayer dies. The US system effectively exempts the unrealised gain by providing a 'stepped up' market value cost base to the beneficiary. As a result, there is a strong incentive, particularly for older people, to hold onto assets with significant unrealised gains until death.

For example, in the absence of any tax on capital gains, there is a strong incentive to invest in assets that provide relatively predictable capital gains, despite lower yields – in particular, immovable property or unimproved land.

Taxing capital gains can *support* entrepreneurship and risk-taking.

Part and parcel of taxing capital gains is also recognizing capital losses. Currently, capital losses are not recognizable for tax purposes in PNG. This creates a disincentive to put capital at risk in an entrepreneurial activity that is expected to produce (taxable) income.

Recognizing capital losses and providing a more symmetric treatment of capital gains and losses can in fact encourage more appropriate risk-taking in entrepreneurial activity (OECD 2006). This will depend on how capital losses are treated, discussed further in Chapter 3.

The claim that taxing capital gains can discourage investment, particularly foreign investment – which PNG needs to support growth and create more jobs – is not supported in theory or by international evidence.

Indeed, exempting capital gains in PNG is therefore unlikely to lower the overall tax burden for foreign investors. This is because:

- in most countries, 'passive' investment (for example investment in a company that you do not control) is generally exempt from taxes on capital gains in the host country; and
- for foreign direct investors, or 'active' investment (for example, where a substantial or controlling interest in a company is taken), profits are normally in the form of ordinary business income, rather than capital gains. If foreign investors were to pay tax on capital gains in PNG, they will inevitably receive a credit for the tax paid in the parent entity's home country when profits are repatriated.

Moreover, tax rates on capital gains are unlikely to be a major determinant of foreign investment. Improving physical and social infrastructure – or lowering the corporate tax rate – is likely to attract substantially more foreign investment than not taxing capital gains.

Fairness

The main argument often advanced for taxing capital gains is to improve the fairness of the tax system, on the basis that capital gains are a form of income that increase a taxpayer's ability to consume – and their ability to pay tax (Brooks 2001). As Brooks notes, "the notion that two individuals with the same ability to pay should pay the same amount of tax provides the ethical justification for a tax on income."

Treating different forms of income differently, without sound and very clear policy reasons, not only undermines the fairness of the tax system but can challenge the legitimacy of the income tax system. It can also reduce overall support for and compliance with the tax system.

Taxing capital gains also supports the principle of vertical equity – the principle that those with greater means should contribute more. Wealthier people will generally make more capital gains over their lifetime, recognising that they have greater capital to invest.

This fairness argument supports the revenue and competitiveness and efficiency arguments above, both in terms of improving tax neutrality of different investments and protecting the income tax base by reducing the incentive to convert taxable income into tax-free capital gains.

Simplicity

A common argument against taxing capital gains is that doing so is often more complex than other taxes. This complexity can arise from the nature of the tax – one that is based on infrequent transactions, potentially many years after an asset in purchased and which requires taxpayers to keep records for long period of time. There is also the transitional complexity associated with introducing any new tax which can impact both the revenue administrator and taxpayer alike – this includes the need to introduce new systems and compliance costs associated with understanding and comply with new rules.

On the other hand, there are strong arguments that the **absence** of a capital gains tax actually increases complexity. This is particularly the case for businesses. Since the difference between 'ordinary' profit and capital gains is a legal distinction and not an economic one, providing different treatment of income and capital gains for businesses can increase the complexity of planning business transactions. Expensive legal and accounting advice is no doubt sought to re-structure income as capital gains, without changing the underlying substance of the transaction. This diverts the efforts of management (and the advisors) from improving the operation of the business.

Regarding concessional treatment provided to capital gains in the United States, a US commentator noted that this preferential treatment:

> *…is the single most important tax loophole that is responsible for turning a generation of dedicated law and accounting graduates into the greatest masters of needlepoint in the history of the law* (see Brooks 2001, p 8)

This tax planning is more likely in cases where the administrative capacity of the revenue authority is limited such as in PNG, as businesses can take an aggressive tax stance knowing the risk of audit is low, and even if an audit does occur, there is enough complexity and 'plausible deniability' to avoid penalties for tax evasion.

In practice, most tax systems that include capital gains in the tax base involve some degree of further complexity, including the requirement for some taxpayers to keep and submit more information to the revenue authority. In addition, as noted above, *transitioning* from PNG's current tax system to one that includes capital gains in the tax base will inevitably involve some complexity in order to avoid retrospective taxation on past gains.

However, this needs to be considered against the *ongoing* complexity (and resulting tax planning) that results from treating capital gains differently to other forms of (investment) income.

Nevertheless, the system for taxing capital gains should be designed to minimize complexity and support the capacity of taxpayers and the IRC to comply and administer, drawing on existing information sources and efficient collection mechanisms wherever possible.

Trust in and accountability of government

Taxing capital gains on the basis of the principles outlined above can also help to build trust in Government and the tax system as a whole.

Why tax capital gains?

A tax system that is more equitable, and ensures that those with greater means are contributing their 'fair share' to the revenue base can help to strengthen confidence in the tax system, encouraging voluntary compliance.

In resource rich countries in particular, the non-taxation of certain sales of interests in extractive resources can be a significant source of political tension and broader public discontent. This was the case in Mozambique which recently took steps to tighten its capital gains tax regime in response to the non-taxation of large value transactions (Ernst & Young 2013).

Question 3.1- What are stakeholders' views about the case for taxing capital gains in PNG? Putting aside issues of when such a tax could be introduced, are there any other reasons why PNG should/should not consider taxing capital gains?

CHAPTER 3: DESIGN ISSUES FOR TAXING CAPITAL GAINS

Having looked at why tax capital gains in the previous chapter, this chapter looks at some aspects of the design of a capital gains tax:

1. **Who should be taxed on capital gains?** This section looks at the potentially different treatment of individuals and businesses, residents and non-residents.
2. **What assets should be covered?** This section looks at the scope of assets that should be covered.
3. **When should capital gains be taxed?** This section looks at the point in time at which capital gains should be taxed.
4. **At what rate should capital gains be taxed**? This section looks at the rate at which capital gains should be taxed
5. **How should capital losses be treated**? This section looks at how capital losses should be treated under a system that also taxes capital gains.

Of course, as with the design and implementation of any tax policy measure, the system should ultimately be considered as a whole. For example, different approaches to the *rate* at which capital gains are taxed could reduce the need for roll-overs or concessions.

Who should be subject to a tax on capital gains?

Broadly, all entities – including resident and non-resident individuals, companies and superannuation funds – which are liable to pay income tax would be subject to a tax on capital gains.

Resident taxpayers

Consistent with PNG's approach to taxing other income, resident taxpayers would generally be subject to tax on their worldwide capital gains. However, like other foreign source income derived by PNG residents, the taxation of gains arising from assets held outside of PNG may be subject to PNG's double tax agreements (DTAs).

Also where a PNG resident is taxable in the other country, the resident may be entitled to a credit for any tax paid to ensure that double taxation is avoided (Section 219, ITA).

Non-resident taxpayers

The objective of applying consistent treatment of capital gains with other income of non-residents would require non-residents to be subject to capital gains from all PNG assets. However, there can be practical difficulties collecting taxes on capital gains on some assets held by non-residents. This is particularly the case where the asset is an intangible asset and the non-resident does not have any connection to PNG other than the asset. Also the OECD Model tax convention, upon which many of PNG's double tax agreements (DTAs) are based, requires non-residents to be subject to tax on real property, including land and natural resources.

It should be noted that there is some debate as to the appropriateness of developing countries limiting their taxing rights to capital gains derived from this narrow class of assets. This is part of the broader debate about the allocation of taxation rights between 'source' and 'residence countries' (see Issues Paper 2 for some discussion of this). However, in reality, capital gains made by non-residents in PNG are more likely to be derived from real property, in particular natural resources so this may not present a significant policy issue in the PNG context.

There can be significant practical challenges in collecting tax on capital gains derived by non-residents. Notably, integrity rules would be required to prevent people avoiding tax by disposing of indirect interests (e.g. shares) in real property (land rich) assets.[12]

Question 4.1 – If PNG were to tax capital gains, do stakeholders agree such a system should apply to both resident and non-resident taxpayers?

[12] For example, see section 855.25 of the *Income Tax Assessment Act 1997* (Australia). For more of a discussion on these issues, including how to address them see Appendix VI to the IMF's Policy Paper on International Spillovers available at http://www.imf.org/external/np/pp/eng/2014/050914.pdf

What assets should be subject to a tax on capital gains?

Whilst a comprehensive income tax benchmark would support taxing all forms of capital gains equally, most capital gain tax systems around the world exclude certain classes of assets. However, as a general principle, these exemptions should be limited. Broad exemptions would be inconsistent with the general rationale for taxing capital gains and special treatment for certain types of assets maintains the tax distortion on different types of investment, reducing overall competiveness and efficiency.

Assets that are of largely personal use or the inclusion of which would overly complicate the system are often exempted. It is on this basis that an individual's **main residence** is usually exempted.

It is for similar reasons that **personal use assets**, such as motor vehicles, are often excluded from the capital gains tax regime (and generally, such assets other than collectables are unlikely to appreciate in value).

As noted above, an important consideration in the PNG context is the treatment of **customary land**. The Tax Review Committee is of the view that **any capital gains tax regime in PNG should include an appropriate exemption for customary land**.

Some countries also provide exemptions for other select assets, such as listed shares traded through the national stock exchange. This was the approach taken by Fiji in the context of its South Pacific Stock Exchange. This acts as a form of subsidy for investment in that type of asset. As noted above, the NRI has argued against taxing capital gains derived from **shares and bonds** until the capital market matures. However, as with other incentives provided through the tax system, providing an effective subsidy in this way should be avoided in favour of other alternative ways of achieving the same policy objective.

If exemptions are provided for select assets, then consideration could be given to introducing these exemptions with a sunset clause (say, five years) in order to ensure that the ongoing appropriateness of the exemption is assessed.

Question 4.2 – If PNG were to tax capital gains, which class of assets should not be included in such a regime? Why?

Depending on how a system for taxing capital gains was designed (see below), another way of thinking about this issue is to identify the class of assets that *should* be taxable if they generate capital gains. These assets can be identified having regard to their ability to generate revenues (i.e. their significance in a PNG context) and the complexity associated with collecting gains on their disposal. In the PNG context the following assets may be appropriate to include within a capital gains tax regime:

- Interests in mining, petroleum and gas projects or exploration licenses
- Shares in companies (private companies in particular), as well as interests in partnerships or trusts
- Properties (having regard to the exemptions usually provided in relation to main residences and the Committee's views on customary land)

Question 4.3 – If PNG were to tax capital gains, which class of assets should be included in such a regime?

How to identify assets subject to a tax on capital gains

Depending on the feedback from the questions raised above, there are conceptually two ways that assets could be identified as being subject to a tax on capital gains. These are:

- Prima facie include all assets, then specifically exclude certain assets

- Identify certain asset types that are included in the regime and by implication exclude all other assets

The first approach is more consistent with the five (5) principles for good tax policy and the comprehensive income tax benchmark. It also ensures more conscious consideration of exemptions, including their ongoing appropriateness.

If a 'carve-in' approach is taken, to minimise any tax planning opportunities it should cover any derivative of assets that are taxable. For example, the recently introduced Fiji system lists the type of assets that are subject to the CGT regime and also includes "an option, right or other interest in an asset referred to in the foregoing paragraphs, other than an asset that is trading stock"[13].

Question 4.4 – If PNG were to tax capital gains, should it do so through identifying a specific class of assets or should it have a 'catch all' rule subject to specific exemptions?

When should capital gains be taxed?

There are two (2) basic approaches to when capital gains should be taxed – on accrual or on realization.

Accrual

Under the accrual approach a capital gain becomes taxable as it accrues over time. While under the realization approach the gain is taxed when the asset is disposed of.

The accruals approach has substantial theoretical support as it is arguably more consistent with the concept of economic income and the comprehensive income tax benchmark, allows for more symmetrical treatment of different types of gains and losses and prevents any lock-in effect[14]

However, it has found little support in practice largely because it is complex and difficult to administer, particularly as it requires annual valuations of assets. Moreover, taxing unrealized gains can present liquidity problems where taxpayers are unable to meet the tax liability without selling capital assets.[15]

Realization

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[13] See Section 2 of the *Capital Gains Tax Decree 2011* (Fiji)

[14] The lock-in effect is, the incentive for taxpayers to hold onto the asset rather than dispose of it to delay the tax liability that would arise. The lock-in effect can reduce capital mobility and the efficiency of capital markets – where taxpayers are reluctant to pursue investments they believe will have a higher rate of return because selling existing investments to re-invest might trigger a taxable capital gain.

[15] Although people can borrow to fund liability. However, can create a distortion in favour of more liquid assets and assets that produce a steady stream of income, rather than riskier or longer term assets.

Most countries therefore take a 'realization' approach to taxing capital gains.

Theoretically, a realization or taxing point should arise whenever there is a change in economic ownership of an asset.

The most common form of change in ownership is a disposal – in particular, selling an asset. Other examples of disposal include gifting an asset (giving an asset to someone is economically no different to selling it to a third party (which would be taxable) and gifting the proceeds instead).

A number of jurisdictions also seek to recognize capital gains or losses when an asset that is outside the tax system is brought into the system or vice versa. This could occur, for example, when a non-resident taxpayer becomes a resident taxpayer. Developing comprehensive 'deemed disposal' rules can add significant levels of complexity to a system for taxing capital gains and are not recommended for developing countries (Burns and Krever 1998, p 49).

Question 4.5 – If PNG were to tax capital gains, do stakeholders agree capital gains and losses should be recognized on a realization basis, in particular where the asset is disposed of?

Roll-overs

If capital gains were to be taxed on a realisation basis, it may be appropriate in some circumstances, where a taxpayer has realized a gain or loss on the disposal of an asset, to defer (or "roll-over") the recognition (and therefore the tax consequence) of that gain or loss until some later event.

While roll-overs should be limited because they increase potential tax deferral advantages and can make worse the lock-in effect, in some circumstances they can be justified on efficiency and/or fairness grounds. This includes where:

- There is a technical (legal) change of ownership but where there is **no change in economic ownership**. This would include for example, where a company decides to undertake a share split or consolidation (i.e. where the company increases or reduces the number of shares without changing the proportion of equity held by each shareholder).

- Where an **involuntary disposal** takes place such as the compulsory acquisitions of property, or the loss or destruction of the asset and the taxpayer purchases a (similar) replacement asset.

- Where a transfer of asset takes place on the **breakdown of a relationship such as a marriage**.

It may also be appropriate to provide a rollover where there is a change in ownership because of the death of the owner of the asset.

Providing a roll-over on the death of the owner can significantly increase the lock-in effect and reduce the efficiency benefits of introducing a tax on capital gains – particularly where the unrealised gain is exempted (as is the case in the US system). Nevertheless, many countries do not treat death as a taxing point because of the obvious sensitivities associated.

At a minimum, the gain should not be disregarded, but rolled over to the recipient of the asset and taxed on the next (voluntary) realisation.

Question 4.6 – Should a roll-over be provided where a disposal occurs because of the death of the owner of the asset?

Question 4.7 – Are there other roll-overs that should be provided, even where there is a voluntary change in economic ownership? If so, why?

At what rate should capital gains be taxed?

The broad principle should be that all forms of capital income are taxed at the same rate. This ensures that the tax system, to the extent possible, is not distorting investment decisions.[16]

Calculating the capital gain

The basic principle is that the capital gain should be calculated on the basis of proceeds from the sale of the asset less the cost of the asset.

Proceeds include all forms of compensation, including cash or value of any assets received in return for the asset.

[16] This principle – that all forms of capital taxation are taxed the same – does not address the question as to whether capital and labour income should be taxed at the same rate. There may be a case for taxing capital income less than labour income (ideally in a neutral fashion across different types of investment).

Where the asset is a gift or where it is disposed of to a related third party, proceeds should be based on the market value of the asset.

Costs of the asset include acquisition costs, improvement costs and costs directly related to preserving the value of the asset, excluding anything that can be deducted against other taxable income.

For assets that are created, such as intellectual property, the cost is the spending directly associated with creating the asset.

It is often argued that only the 'real' capital gain (that is, the gain above inflation) should be taxable. However, there are serious theoretical and practical problems with this approach.

While it is true that inflation affects the measurement of real gains, this is also true for the tax system as a whole. Lenders are taxed on the full nominal interest they receive, and borrowers can deduct the full nominal interest they pay. Other forms of return, such as rental income, are also taxed in nominal terms.

Very few countries have attempted to convert the *entire* tax system to a 'real' or inflation-adjusted base, and none has done so without extreme complexity.

Adjusting for inflation in one part of the tax system but not others is inconsistent with the policy principles for a good tax system. Furthermore, there is even less justification for recognizing the effects of inflation for capital gains compared with other forms of income, because capital gains (if taxed under a realization based system) would benefit from tax deferral. (Brooks 2001, OECD 2006).

In practical terms, applying indexation to reduce capital gains is invariably complex and difficult to administer, a particularly important consideration for PNG.

If the objective is to reduce the effective tax rate on capital gains, the simpler and more efficient way to do this is to provide a lower statutory rate or directly exclude part of the (nominal) gain from the tax base.

There are a range of options available in setting the rate that should apply to capital gains. Again, the model chosen would depend on a range of factors including:

- the need to make the system as simple as possible;
- the goal of equalizing the tax rates applying on different forms of capital; and
- the degree of concessionality desired as compared to other forms of income, such as labour income.

Examples of how other countries have approached these issues, and the relative weight they have placed on the factors above, is outlined in Attachment B.

As can be seen, some countries take an approach focussed on simplicity, by taxing capital gains in relation to all types of taxpayers (e.g. companies, individuals) at a flat set rate. This is true of the recently introduced CGT in Fiji which applies a set 10% rate. However, there should be caution in overemphasising the simplicity of such approaches. As noted above, taking such a blanket approach that retains significant inconsistencies in the treatment of different forms of capital income maintains the incentive for a taxpayer to engage in complex tax planning.

Other countries, placing more emphasis on reducing opportunities for tax planning, try to ensure that capital gains are taxable at similar rates as other forms of capital for that entity.

For example, capital gains of **companies** could be treated the same as other profits, and taxed at the prevailing company tax rate (30% in the PNG context). This could be justified in particular if the introduction of a capital gains tax regime was used to fund a reduction in the corporate tax rate.

For **individuals** a similar approach could be taken, with individuals taxable on gains at their prevailing marginal rate. To ensure some element of concessionality relative to labour income, only a portion of the gain could be made taxable. This is the approach taken in Australia, where individuals are generally only taxable on half of the gain.

An alternative approach would be to tax individuals under a separate system. Under such a system, capital gains could be taxable at a set rate which reflects (as close as possible) the effective rates applying to other forms of capital income. Similar to the tax free threshold available to individuals on salary and wage income, smaller amounts of capital gains could be exempted from the system. Fiji takes this approach. It exempts capital gains less than 20,000 Fijian dollars (K26,000) earned by a resident or Fijian citizen.

Such a system would also need to account for other entities such as superannuation funds and non-residents. Superannuation funds, consistent with their general taxation treatment, could be taxed at concessional rates whilst non-resident entities could be taxed at rates similar to other forms of investment income such as dividends and interest.

Question 4.8 – What rate or rates should apply to the taxation of capital gains in PNG?

Question 4.9 - Should the tax system seek to broadly align the tax on all forms of capital income, with different rates applying to different types of entities?

Question 4.10 – Is there value in PNG considering a capital gains tax system that applies a set rate to all capital gains? What issues could arise with this approach?

How should capital losses be treated?

Broadly, a capital loss arises when the proceeds from the disposal of an asset is less than the cost. Countries which tax capital gains usually provide some relief for capital losses. However, how that relief is provided varies around the world.

In theory, the best approach is to provide symmetrical treatment of gains and losses – in this way, if gains are fully taxable (i.e. taxable in the same way as any other form of income) then capital losses should be treated like any other loss (that is, be able to offset any other income).

However, in reality, many systems 'quarantine' capital losses – that is, they ensure that such losses can only offset capital gains (and not other forms of income). This is because as capital gains are taxed on a realization basis, in the absence of quarantining, taxpayers can accelerate the recognition of losses while deferring the recognition of gains (Burns & Krever 1998).

Under most systems that quarantine capital losses, any excess losses are typically carried forward, either for a limited period of time or indefinitely.

Some systems allow partial carry-back of losses in order to provide more symmetric treatment of gains and losses. However, carry back of losses results in increased complexity and administrative demands, including potentially the question of refunds. It could also be expected to increase volatility of revenue collections.

Overall, unlimited carry forward of capital losses (without indexation), quarantined for use against future capital gains, may provide an appropriate balance of simplicity and efficiency considerations in a PNG context.

Question 4.11 – Do stakeholders agree that the best approach for the treatment of capital losses in PNG would be for these to be quarantined and carried forward against future capital gains?

Question 4.12 – How else could capital losses be treated, in a way that supports the five (5) policy principles?

Chapter 4: Transitional Issues

If a decision is ultimately taken to introduce a system for the taxation of capital gains in PNG then one of the most significant issues is how a country fairly transitions its tax system to one that captures capital gains.

As a general principle of good tax policy, retrospective taxation should be avoided. If taxation is applied retrospectively, then this weakens the investment climate, undermines confidence in the tax system and also reduces trust and confidence in the Government more broadly.

In recognition of this, there are two (2) common approaches to excluding from tax the gains made on assets prior to the introduction of a tax on capital gains: excluding gains made prior to introduction, or excluding gains derived from assets held prior to introduction.

In considering these transitional issues, the objective should be to maximize the long-term efficiency, fairness and simplicity of the tax system, while minimizing the short-term complexity and administrative challenges.

Providing excessively generous transitional approaches would also reduce revenues, particularly in the short term, limiting the ability to use the revenue from broadening the tax base to lower tax rates, such as the corporate tax rate.

First possible approach: excluding pre-CGT gains

The most comprehensive transitional approach is to include all *gains* made from the introduction of taxing capital gains, regardless of when the asset was acquired. Gains accrued prior to its introduction would be exempt.

Some people argue that this approach retains an element of retrospectivity, because when people purchased capital assets there was no requirement or expectation at the time that capital gains on the asset would ever be taxable.

However, the legal definition of retrospectivity refers to a law that takes effect before it is introduced. As the purpose of this approach is only to take effect and tax capital gains that accrue from the date of introduction, it should be considered to be prospective.

Similarly, changing tax rates on future incomes, such as personal or corporate income tax rates, is rarely argued to be 'retrospective', notwithstanding that the new rates will apply to future incomes from existing assets (including human capital and physical capital).

South Africa, UK and Canada all adopted the approach of taxing gains that accrue on existing assets after introduction. South Africa's capital gains tax regime was developed after an extensive consideration of other international regimes (a number of the sources cited in this issues paper are from this process).

Determining the value of assets at introduction

In order to exclude gains that accrued before the introduction of taxing capital gains, the initial value or acquisition cost of the asset should be its market value at the time the reform is introduced.

While simple in theory, this can create significant administration problems and increase compliance costs for taxpayers, due to the need to keep records for potentially long periods of time.

Where the market value of assets is generally available information, such as for listed shares, the IRC could publish these 'official' values as at the valuation day.

This 'published value' approach could include assets where public information can closely approximate the market price, even if the precise value is not easily calculated. This could include publishing growth factors to apply to previously known prices where data on average price growth is available.

The potentially massive simplicity benefits of these additions could outweigh concerns about imprecision or individual variation in growth rates. Furthermore, any resulting difference in tax liability is often going to be less than the cost of individuals obtaining a valuation, and limit the need for expensive auditing to ensure that valuations are fair.

Nevertheless, there are likely to be many assets where information is not generally available and/or assets are not easily valuable by the IRC.

For significant assets, such as private businesses or large property developments, taxpayer could provide a professional valuation to the IRC.

The cost of obtaining a valuation would be recognised in the overall acquisition cost of the asset.

There would be particular challenges in obtaining accurate valuations (particularly for smaller assets across PNG)

Alternative Approaches

Where market values are not readily available – and it is not feasible or practical to 'construct' realistic values – the most common alternative method is apportionment of gains and losses based on length of holding the asset.

For example, if an asset is held for 6 years before the introduction of a system for the taxation of capital gains and 4 years after, only 4/10$^{\text{ths}}$ of the gain is taxable.

This nevertheless requires information about the date of purchase, purchase price and other significant costs of holding the asset. Given that at the time there was no requirement to keep records of these costs for tax purposes, many taxpayers may not have these records – particularly for holding costs. To address this, allowances could be made for reasonable holding costs.

As a final fall back in the absence of any information (e.g. purchase price) it could be possible to deem capital gains as a small proportion of proceeds from disposal, having regard to the period of time the asset was held. This was one approach that was adopted in South Africa (which provided a range of valuation methods available to the taxpayer).

Question 5.1 – What class of capital assets in PNG would pose challenges in determining an appropriate market value?

Second possible approach: excluding pre-CGT assets

A second transitional approach to avoid retrospective taxation of past gains is to exclude (for all time) assets held at the time of introduction. Under this approach, such assets are commonly known as 'pre-CGT assets'.

This approach avoids the need for valuing assets at the time of introduction.

However, providing an ongoing exemption for pre-CGT assets can significantly reduce the short term revenue benefits of bringing capital gains into the tax system.

Equally important, an ongoing exemption for pre-CGT assets can reduce the efficiency benefits of taxing capital gains:

- It dampens the general effect of encouraging better quality investment and more risk taking, as described in Chapter 3.
- It exacerbates the lock-in effect. Taxpayers that hold pre-CGT assets have a strong incentive to hold on to these assets, even if they could achieve better pre-tax returns elsewhere.
- It creates potential tax planning opportunities, because taxpayers have an incentive to ensure that gains are attributed to the disposal of pre-CGT assets.

The pre-CGT asset approach also violates the principles of horizontal and vertical equity, as existing owners of assets have an ongoing tax exemption, whereas new owners and future generations are subject to tax on equivalent (or even identical) assets.

Finally, while excluding pre-CGT assets from the tax base can reduce transitional costs in the short term, such as avoiding the need for valuations or apportionment rules, the simplicity benefits can be short lived.

In particular, integrity rules are generally required to prevent what are effectively post-CGT gains being attributed to pre-CGT assets. This can include, for instance, where there is significant additional investment into a existing pre-CGT asset. There may also be issues associated with the indirect holding of pre-CGT assets. For example, where an entity holds a pre-CGT asset and the ownership of the entity changes substantially. Had the original interest holders owned the assets directly, the change of ownership would have brought the asset into the tax net.

More generally, the need for ongoing recognition of pre-CGT assets increases the ongoing cost of administration. It also increases the complexity of the tax law and the costs of legislative 'care and maintenance'.

For example, Australia is approaching the 30th anniversary of the introduction of its tax on capital gains in 1985, and continues to have integrity rules issues relating to pre-CGT assets. Policy changes to the CGT provisions in Australia also need to accommodate pre-CGT assets.

Ultimately, from a policy perspective, deciding which of the two (2) approaches described is appropriate in PNG, may reflect not only the substantial revenue considerations but also a trade-off between short and long term complexity.

Question 5.2 – Putting aside the revenue considerations how could PNG best transition to a system that taxes capital gains?

ATTACHMENT A: WHAT ARE CAPITAL GAINS?

In simple terms, a person or business makes a capital gain when they sell an asset (other than trading stock) for a profit – such as property, financial assets (e.g. bonds or shares), mining and petroleum tenements, or intangible assets (e.g. a trademark or goodwill).

As noted in Chapter 1, this type of profit is not currently taxed in PNG, unless the taxpayer acquired the asset for a profit-making purpose – in which case the profit is taxed as ordinary income. In practice, very few profits on asset sales are treated as ordinary income. Given the different tax treatment, there is a strong incentive for taxpayers to treat profits as tax-free capital gains. This very issue was discussed in relation to business structuring in the Committee's Issues Paper 2 on Corporate Tax.

When an individual or business sells an asset for a profit, their ability to consume (or invest in other assets) increases in the same way as a person who earns other forms of income, such as wages, interest income or trading profits.

This reflects a 'comprehensive' view of income, also known as Haig-Simons income after two American economists in the early 20th Century, Robert Haig and Henry Simons.[17] Most tax systems in the world use this concept of comprehensive income as the 'ideal' benchmark, although very few tax systems are fully comprehensive.

The analogy of the Fruit and the Tree

A common analogy to explain the difference between 'income' and 'capital' is that of the fruit and the tree. A productive mango tree is long-lived and can continue to produce fruit year after year. In this case, the mango fruit is 'income' that flows from holding the 'capital' – the mango tree.

[17] It is also sometimes referred to as Schanz–Haig–Simons income, including reference to the German legal scholar Georg von Schanz who wrote about this concept of income in 1896. This definition of income includes consumption plus any change in *net worth*.

Similarly, a capital asset can provide an ongoing stream of income to its owner. The following table shows several examples of income streams (fruit) that flow from different capital assets (trees).

Table 1: Examples of income streams and related capital

The 'fruit' or income	The 'tree' or capital
Dividends	Shares
Interest	Bond or loan principal
Rent	Property
Royalties	Intellectual Property
Annuities	Lump sum

In a famous tax case in the United States, *Eisner v. Macomber* 252 U.S. 189 (1920) the taxpayer used the fruit and tree analogy to argue that only the 'fruit' was income for tax purposes.

The U.S. Supreme Court agreed with the fruit and tree analogy. However, the Supreme Court also noted that when you sell the tree for a profit, that gain is also income for tax purposes:

> *Income may be defined as the gain derived from capital, from labor, or from both combined," **provided it be understood to include profit gained through a sale or conversion of capital assets**… (emphasis added)*

The historical/legal view: The capital/income distinction

The origin of the legal distinction between 'income' and 'capital' goes back to the Middle Ages in England, and originally had nothing to do with tax. Instead, it related to the inheritance of property, which was restricted to males.

The ecclesiastic courts of England developed the notion of a "trust" to recognize that the legal owner of a property might have a moral obligation to hold property on behalf of, and for the benefit of, another person. In this trust law, an important distinction arose between the 'life' interest and the 'remainder' interest. A man could decide to provide for his wife in the event that he died first by leaving his property in trust, with the income of the trust going to support his wife for the rest of her life, after which the property then passes to his eldest son. The life interest became known as the 'income interest' (because the life interest was entitled to the income of the trust during their lifetime) and the remainder became known as the 'capital interest'.

To resolve disputes over which beneficiary was entitled to certain gains made by the trust – in particular, gains such as those made on the sale of all or part of the capital of the trust – the ecclesiastical courts developed tests to determine whether a gain was an 'income gain' or a 'capital gain'.

In the late 19th century, following the combination of the ecclesiastical and ordinary courts, judges in the U.K. imported the trust law concepts of income to help define and interpret what 'income' meant in the income tax law.

Applying these concepts, forms of periodic revenue such as wages, interest, rent, ordinary business profits or dividends – all examples of 'fruit' using the analogy above – are 'income', and typically taxable unless a special exemption applies.

In contrast, gains that would flow to the capital beneficiary (that is, capital gains) – profits from selling the tree – were generally excluded from the meaning of 'income' for tax law purposes unless the legislation specifically included the amount as income.

The economic/source view: labour vs capital income

Another way of categorizing income is to look at its underlying *source*, rather than the way it is paid or who is entitled to receive it. In economic jargon, income comes from a payment to use or employ a factor of production.[18]

Labour income is the payment that a person receives for providing their skills and effort. This is most commonly in the form of salary or wages, including any in-kind benefits and bonuses, but also conceptually includes the return to

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[18] Factors of production are the inputs used in the production process to produce goods and services. The three basic factors of production are land (including natural resources), labour and capital – although land is sometimes treated as a subset of capital. Time, energy and entrepreneurship are sometimes treated as separate factors of production.

a sole trader that is attributable to their work effort, regardless of whether they pay themselves a salary or take it as 'profits'.

Capital income is the payment that an owner receives for the hire or use of various forms of capital (including cash), such as the price of hiring physical equipment, renting land or buildings, payments for using a brand or trademark, interest on loans or returns to shareholders – broadly speaking, the return on investment.

Importantly, capital income could be in the form of regular payments (consistent with the *legal* definition of income), or one off payments such as a capital return or profit on the sale of the asset (consistent with the *legal* definition of a capital gain). As noted above, it is the *source* of the income that matters, not the legal form.

Under this approach, the tax treatment of capital gains (that is, the profit from disposing of an asset) should be broadly equal to the tax treatment of other forms of capital income such as interest income, dividends or rent.

Taxation on other forms of capital income (investment)

In PNG, other forms of capital income are subject to tax in different ways.

For businesses, tax on their various investments and projects generally applies at the corporate income tax rate of 30 per cent. The investment income of superannuation funds is taxed at 25 per cent, with a rebate for tax payable on dividend income.

The treatment of other forms of capital income is described below. The treatment generally depends on the form of investment, and also whether the payment is to a resident or non-resident.

Interest on Savings

Interest on savings of individuals is ultimately subject to personal income tax at progressive rates. As a collection mechanism, interest payments made from financial institutions are subject to a non-final interest withholding tax (IWT) at 15 per cent. For non-resident taxpayers, the 15 per cent IWT is a final tax.

Rental Income

In PNG's tax system, rental income received by an individual is included in their assessable income and subject to personal income tax at progressive rates. For individuals with large property holdings or significant other income, this income would generally be subject to the top marginal rate of personal income tax at 42 per cent.

Similarly, landlord companies are required to include rental income in their assessable income which is subject to the statutory corporate tax rate of 30%.

Direct investment in equity (dividends)

Dividends are generally subject to a Dividend Withholding Tax (DWT) of 17 per cent, with a 10 per cent rate applying to dividends from mining companies and no DWT applying to gas or petroleum income. A lower DWT rate may apply to non-residents under tax treaties.

DWT on dividends paid to non-residents, resident individuals and resident trust estates is a final tax. For resident companies the dividend withholding tax provides a tax credit, which may be offset against a liability to deduct this tax when the company pays a dividend itself.

Including the tax on business profits at the corporate tax rate of 30 per cent, the normal effective tax rate for individuals on dividends is 41.9 per cent, almost the same as the top marginal rate of personal income tax (42 per cent). For dividends from mining companies, the effective tax rate is 37 per cent.

Attachment B: Summary of Key Features of Regimes for the Taxation of Capital Gains

Country	Key Features
Fiji	**Transition/Application** - Applies to all gains arising on the disposal of a relevant asset after 1 May 2011. **Class of Assets -** Applicable to ships (over 100 tonnes), land or improvements on land, yachts, shares (and the like), intangible assets, interests in a partnership or trust, aircraft or derivatives of these assets. Special rules for non-residents apply. Does not include capital gains under $20,000 (Fijian), main residence, shares in the South Pacific Stock Exchange, assets solely used to derive assessable income. **Rates** - A flat 10% rate on all gains, regardless of entity. **References** - See the Fiji *Capital Gains Tax Decree 2011*, *Practice Statement No. 34* (14 June 2011)
Australia	**Transition/Application** - Applies to gains arising from the disposal (or other event) of a relevant asset acquired after 19 September 1985 **Class of Assets** - Broad class of capital assets are caught by the regime subject to certain exceptions – this includes main residence, certain personal use assets (such as a cars) and assets used to produce exempt income. **Rates -** 50% of the gain is included in a resident individual's assessable income and assessed at their marginal rate (for assets held for more than one year). For superannuation funds only one-third is included. No discount is available to

	companies which are assessed on the full value of the gain at the corporate tax rate (30%). **References** - Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*
South Africa	**Transition/Application** - Applies to all gains from the sale, scrapping, exchange, loss, destruction, forfeiture or abandonment of any asset on 1 October 2001. **Class of Assets** – applies to assets broadly, with 'assets' also defined broadly. **Rates** – similar to Australia, it is different for different entities. For each type of entity, a set proportion of the gain is taxed at that entity's prevailing rate (for example, for individuals only 25% of the gain is taxable and for companies 50% of the gain is included). **References** – *Income Tax Act 58 of 1962*
Samoa	**Transition/Application -** Applies to sale, exchange, transfer, distribution, cancellation, destruction of capital asset excluding exempt capital gain or loss gained on disposal of a capital asset acquired on or before 31 December 1989; capital gain or loss made on disposal of individual principal place of residence; capital gain or loss made on an asset held more than 3 years. **Class of Assets -** Any assets including foreign currency exchange gains and foreign capital gains. **Rates -** The rate of capital gains tax is 27% regardless of the ownership. **References -** Parts 4,5,7 Division 3,Schedule 1(8) *Samoa Income Tax Act 2012*
Malaysia	Malaysia has no capital gains tax. Instead it has Real Property Gains Tax (RPGT). RPGT applies to disposal of real property such as land and building including disposal of shares in real property income. The RPGT applies to both

	individuals and companies. There are three separate tier group effective 1 January 2014. The groups are Malaysian Citizen and Permanent Resident individuals, Companies and Non- Citizen or Non-Permanent Resident. The rates are dependent on the entity and the holding period. Citizen or permanent residents do not pay RPGT when they dispose of the property held beyond 5 years. Exemption from RPGT can be obtained for the following: • Disposal of one residential property once in a life time • Transfer as gifts in between family members. This exemption is only applicable for transfers in between husband and wife, parent and child, grandparent and grandchild. Transfer in between sibling, brothers and sisters are not applicable • Waiver exemption equivalent to 10% of chargeable gains or RM10,000 whichever is higher is not taxable. Prior to 1 January 2010, the exemption was equal to RM5,000 or 10% of the chargeable gain, whichever was greater. **Class of Assets -** Land, buildings and shares in real property company (RPC). An RPC is a company holding real property or shares in another RPC with value not less than 75% of the value of the company's total tangible assets. **Rates -** Effective 1st January 2014, the rate is from 0% to 30%. The reason for the increase is to curb property speculation & sudden surge in property price, which affect the affordability of people to buy a property. **References -** http://www.hasilnet.org.my/real-property-gains-tax-2014/
Mongolia	The capital gains are included in corporate profits and taxed. As such there is no capital gains tax. The law governing the imposition of corporate income tax in Mongolia is the Economic Entity Income Tax Law (EEITL), which is effective from 1 January 2007.

Mozambique	Applies to companies on voluntary gains (disposal of fixed assets or the apportionment of fixed assets not related to the business) and involuntary gains (from damages arising from disaster or theft or positive changes in the equity which are not reflected in the taxable profit). For individuals applies to disposals immovable of Capital gains is included in business taxable income for companies and individuals and taxed. **Class of Assets** Different classes of assets apply for companies and individuals. For companies on voluntary and involuntary gains from the disposal of fixed assets or the apportionment of fixed assets not related to the business(voluntary) and gains from damages arising from disaster or theft or positive changes in equity which are not reflected in the taxable profit(involuntary gains). Effective 1 January 2004, marketable securities will be subject to 32% CGT. For individuals on the disposal of immovable property and shares and other rights and securities, other intellectual and industrial property or knowhow, leasehold or other rights in respect of immovable property, and transactions involving financial derivatives instruments **Rates -** 32% for Corporate entities and individuals 50% of the capital gain is included and taxed at individual rates which are progressive rate commencing at 10% and ending at 32%. **References -** https://www.kpmg.com/Africa/en/KPMG-in-Africa/Documents/2014%20Fiscal%20Guides/Fiscal%20Guide%20Mozambique.pdf
Zimbabwe	**Transition/Application** Where a specified asset was acquired prior to 1st of February 2009, is disposed off after that date, the rate of CGT applicable is 5% on the selling price, **Class of Assets -** Assets subject to CGT are specified assets being immovable property and marketable security. Examples of immovable property are land and buildings and marketable security is defined as debentures, shares,

unit trusts, bonds and stock. Exceptions to these are transfers of specified assets between spouses, transfers in a scheme of reconstruction/merger or the like that is approved by the Commissioner General of Zimbabwe Revenue Authority, transfer of business used for the purpose of trade by an individual to a company under his control used for the purpose of trade. And where a person aged 55 or above sold his or her principal private residence (PPR). Capital gain on disposal of principal private residences do not attract CGT if one elects for roll –over by spending all proceeds on the purchase or construction of new PPR. CGT will apply on the balance if all proceeds on the disposal of PPR is not fully extended.

Rates - The rate of capital gains tax is 20%. For unlisted securities the rate is 5%. For listed marketable securities (e.g listed shares), the rate is 1% of the price at which the security was sold.

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Abbreviations

CGT	Capital Gains Tax
CIT	Corporate Income Tax
DTA	Double Taxation Agreement
DWT	Dividend Withholding Tax
IRC	Internal Revenue Commission
ITA	Income Tax Act 1959
IWT	Interest Withholding Tax
OECD	Organisation for Economic Cooperation and Development
PIT	Personal Income Tax