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Submission: Issues Paper No.4 – Taxing Capital Gains

Dear Sir / Madam

We write in response to the request for submissions on the Issues Paper No.4 – Taxing Capital Gains (the Paper) released by the Taxation Review Committee on 12 December 2014. PwC is pleased to present its submission on the matters raised in the Paper.

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

Yours sincerely

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Introduction

The Paper, and Issues Paper Nmber 3 – " Broad directions for tax reform" acknowledge that a capital gains tax should be a medium term priority for PNG, and not an immediate priority. PwC agrees with this view while there is not sufficient capacity and resources at the IRC to effectively administer a complicated new tax.

PwC believes that a capital gains tax should be, at least initially, as simple as possible and should have the following features:

- It should be limited to specified and prescribed assets – eg land – rather than applying to all assets with specified exclusions / exemptions

- If a capital gains tax applies to all assets with exemptions we believe there would need to be numerous exemptions – eg main residence, trading stroack, depreciable assets, personla use assets, currency (including foreign currency), at least. Accordingly, it would be simpler to prescribe the assets to which the tax will apply.

- If capital gains tax applies to intangible assets, rights (including contracual rights), insurance proceeds, proceeds from compulsory acquisition, etc it will be significantly complicated. Accordingly, we believe it is more appropriate to limit the application to specified assets.

- There should be a concessional rate of tax that applies to capital gains compared to the rate applying to income due to the additional level of risk associated with some capital investments compared to income. Nevertheless, there should be a reduction in income tax rates to compensate taxpayers for the broadening of the tax base to include capital gains.

- There should be an annual tax free threshhold for individual taxpayers.

- Capital gains tax should apply on a realisation basis only, and there must be a rollover on death to prevent the requirement for beneficiaries to dispose of wanted assets to pay a tax bill.

- Rollovers should be allowed to ensure that socially and economically desirable restructures, acquisitions etc are not discouraged by a capital gains tax liability.

- Existing assets should be quarantined from the capital gains tax – that is the first change in ownership after introduction of a capital gains tax will not be subject to tax.

In our view the above features will provide for a simple, manageable capital gains tax regime. We have expanded on these points below in responding to the specific queries raised by the TRC Paper.

Why tax capital gains?

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?

PwC supports broadening the tax base in exchange for lower tax rates to improve the efficiency and competitiveness of the PNG tax system.

We do not neceesarily concur with the views expressed in the Paper that the exclusion of capital gains from the tax system in PNG encourages the conversion of income gains to capital gains, or tax planning to implement structures or transactions to achieve this effect. For instance, the Paper notes that the current system encourages a sale of shares with undistributed profits, rather than distribution of the profits prior to sale (which would attract dividend withholding tax). In our experience purchasers in this scenario are sufficiently informed to take account of the future dividend withholding tax liability when determining the share pruchase price, and the vendor therefore achieves no "saving" from the strategy.

Nevetheless, we acknowledge the comments in the Paper about the efficiency of the tax system being potentially compromised by the exclusion of capital gains from the system and support a broadening of the tax system provided there is no increase in the overall tax burden – ie there must be corresponding concessions made to taxpayers through lowering of tax rates applying to income.

However, we caution that the introduction of a capital gains tax will necessarily add complextiy to the tax system for taxpayers and administrators. We believe the priority should be to improve revenue administration of the current laws, before any new taxes are added. Accordingly, in our view, a capital gains tax should not be a short term aspiration. New taxes introduced before the capacity exists for their administration will compromise efforts to improve administration of the existing laws, and defeat the effectiveness of new taxes that cannot be properly enforced.

Design issues for taxing capital gains

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?

As a matter of principle, yes, we agree that a capital gains tax should apply to both residents and non-residents.

We would recommend that listed shares be excluded from a capital gains tax applying to non-residents to mirror the current exemption for profit on disposal of listed shares by non-residents in section 36B. This is also consistent with the approach taken in other jurisdictions where non-residents are not taxed on listed investments. We believe there is merit in excluding shares listed on the Port Moresby Stock Exchange from a capital gains tax for both resident and non-residents to prevent adverse impacts on liquidity of the Exchange. This is discussed further below.

Otherwise we agree that applying a capital gains tax only to residents of PNG would be discriminatory and distortionary as taxpayers may seek to use offshore holding structures to prevent the application of capital gains tax.

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The Paper notes that an objective of a capital gains tax regime would be to ensure non-residents are taxed on indirect gains on PNG real property (eg on sale of shares in a company not resident in PNG). Care would need to be taken with drafting such provisions to prevent unintended consequences. Compatibility with PNG's double tax agreements will also need to be considered and we note that in some cases planning activity may be directed to selection of holding structures and jurisdictions to avoid the imposition of capital gains tax in PNG. It will also be important that a PNG tax on indirect disposals does not have the effect of distorting decision making – eg preventing global transactions from proceeding because of a capital gains tax liability in PNG on an indirect disposal. This would have the effect of discouraging foreign investment in PNG.

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

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

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?

In our view a capital gains tax should be as simple as possible. We favour an approach similar to the Malaysian system whereby:

- The assets included in the system are prescribed; and
- The number and type of assets is limited

PwC believes a simple system will aid in administration of the system and better facilitate transition. A comprehensive capital gains tax will result in complexities and unintended consequences – many of which cannot be foreseen – which will compromise the effectiveness of the tax.

The experience in Australia – with a catch all rule subject to exemptions – is that assets not specifically exempted, but not necessarily foreseen as being taxable, are where much of the complication in a capital gains tax can arise. This is particularly the case with intangible assets, rights, contractual restrictions etc. It is not possible to include all these possibilities in an exhaustive list of exemptions.

In the PNG context a catch all regime with exemptions would either need to provide for quite extensive exemptions, or otherwise deal with rules for the following types of assets:

- Personal use assets incuding cars
- Main residence
- Depreciable assets
- Trading stock
- Intangible property
- Rights and options
- Contractual rights and restrictions
- Foreign exchange
- Customary land
- Leases
- Resource interests
- Compensation and insurance receipts
- Proceeds from compulsory acquisition of assets

In the ordinary course at least some of these asset categories will be excluded from a capital gains tax (eg main residence). In our view there are potentially significant complications that can arise from having to design a regime that appropriately deals with each of the above – and the list is not intended to be exhaustive – such that consideration should be given to exclusions for all of these. This being the case, rather than having a long list of exclusions and rollovers, we prefer an approach of prescribing explicitly the assets that are subject to capital gains tax.

We recommend that, at least initially, the assets included in the regime are limited to perhaps real property (other than main residence) and unlisted shares.

Consideration should be given to excluding listed compay shares from a capital gains tax in PNG because:

- There is already a significant lack of liquidity in the Port Moresby Stock exchange, and imposing a tax on disposal of listed shares would likely hinder liquidity further as it acts as a deterrent to people disposing of shares and triggering a taxable gain. In this respect we agree with the view of the National Research Institute that the taxation of listed shares should be deferred until PNG capital markets have sufficiently matured.

- The majority of salary or wage earners in PNG do not lodge an income tax return even if they own some listed shares, since the dividends on the shares are exempt from tax. Making the capital profit on disposal of the shares subject to tax would result in an increase in the number of returns required to be lodged, and an increase in tax compliance requirements for salary or wage earners.

- If non-residents continue to be exempt from tax on gains on listed shares in PNG (ie section 36B) a tax on residents is discriminatory.

If listed company shares are included in a capital gains tax regime we recommend that a tax free threshhold / allowances be prescribed for individuals so that small profits on – for instance – listed company shares are not taxed.

We also believe consideration should be given to excluding resource interests from a capital gains tax regime, particularly exploration licences. Movements in interests in exploration projects are common as explorers search for development partners and funding. If the sale of an interest in an exploration licence is taxable this will discourage such transactions and therefore affect the ability to get projects developed.

While the sale of interests in developed projects is less common, and therefore application of capital gains tax to such a transaction likely to be less of a discouragement to project development, careful consideration would need to be given to how capital gains tax rules would interact with the existing capital allowance rules in Division 10. In particular, whether a purchaser would obtain any tax relief for the amount paid to acquire an interest in a project.

If a vendor is subject to capital gains tax on disposal of a resource interest we would strongly recommend the existing rule in section 156B for "additional allowable capital expenditure" for mining licences be retained, and expanded to apply to exploration licences and petroleum and gas interests. Current opposition to section 156B is largely based on the premise that the vendor is not taxed on the capital gain on the 'premium', and therefore it is not appropriate for a purchaser to obtain tax

deductions for the same amount. While under a capital gains tax, presumably, the purchaser would get "cost base" for capital gains tax purposes for the premium paid this would not in our view be sufficient. For example, a single project operated to completion would never obtain any tax relief for the amount paid.

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

Yes, PwC agrees that a capital gains tax should apply only to realised gains and losses. The difficulty in funding tax on an unrealised gain would make such a system unworkable.

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

Yes, for the same reason as above at 4.5, there should be rollover of a capital gain on death of the owner of an asset. To impose tax where there is not an actual realisation of the asset requires the estate (beneficiary) to either fund the tax liability from other sources or to sell the asset. In many cases the forced sale of the asset to fund a tax liability is neither economically or socially desirable. For example the case where the asset is a privately held business there may be a desire to continue to operate the business within the family group, and forced sale may not be an economically sound decision for the business.

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

To prevent a capital gains tax from discouraging otherwise productive transactions we believe there are a number of circumstances for which rollover should be provided, for example:

- On marriage or relationship breakdown
- On share for share exchange on takeover
- On share for share exchange on a demerger
- On various restructures, eg the interposition of a new company, and on transfer of an asset between wholly owned companies
- On exercise of rights / options to acquire an asset (eg shares)

The extent to which rollovers are required will depend to some degree on the scope of the capital gains tax. If the tax is comprehensive and applies to a broad range of assets it is desirable to have a wider range of rollovers apply. If the scope is limited – and for instance excludes listed shares and provides a small gain exemption to individuals – there will be less need for complicated rollovers.

Rollovers are important because, as above, there are cirumstances where legitimate and desirable transactions are otherwise not undertaken because the tax liability is a deterrent, or in some cases fatal, due to an inability to fund the tax where there is no monetary realisation of the asset. In our view it is important that a capital gains tax does not act as a deterrent to productive transactions.

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

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)?

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?

PwC believes that a lower rate of tax should apply to capital gains to reflect the additional level of risk associated with capital investment compared to income. A capital gains tax will operate as a deterrent – compared to the current situation – to capital investment, and it is important that this deterrent is minimised.

In the interests of simplicity PwC would favour a lower rate applying to capital gains, rather than the Australian approach of subjecting a part (half) of the gain to tax. Something similar to the Fiji 10% flat rate of tax on capital gains would, in our view, be appropriate.

As noted previously, we would encourage the adoption of a tax free annual gain being prescribed for individuals. This could be a particular concession applied to individuals and not available to corporate taxpayers.

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?

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

On the basis that a different rate of tax should apply to capital gains than to other income, we believe it is appropriate for capital losses to be quarantined against capital gains. If the same rate of tax applies to all income – ie capital gains are taxed in a company at the standard company tax rate and at an individual's marginal tax rate – there is no reason that capital losses should not be offset against other income.

Transitional issues

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

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

PwC believes that the most appropriate transition to a capital gains tax system is to grandfather "pre-CGT" assets. While we acknowledge that this can have an adverse impact on revenue collection from a capital gains tax, and can add complexity in the longer term, we believe it is most appropriate because:

- It is the most equitable means for dealing with assets acquired before the introduction of a capital gains tax; and

- It provides short term simplicity in the system

In our view a system requiring valuation of assets at a given date will be extremely complicated and difficult to administer. While it is conceptually simple to obtain valuations of assets, some relevant considerations and complications will be:

- While some assets are relatively simple to value – eg listed company shares, many assets are inherrently difficult to value – eg shares in private companies, intangibles, rights and options.

- In many cases the necessary expertise to value specific assets (eg intangibles) will be either in short supply or not available in PNG. This will make obtaining a valuation a complicated and expensive exercise for taxpayers.

- There is a question as to how formal a valuation would need to be to satisfy the legal / IRC requirements. For example, whether an independent valuation is required, or a directors valuation is sufficient.

- Regardless of the nature of a valuation there is a risk of dispute with the revenue authority over the accuracy of any valuation. It is not desirable to have a dispute over a valuation, particularly where a formal valuation has been obtained, but in many cases it is possible for a different value to be ascribed to an asset by a different valuer.

- One means of mitigating valuation dispute would be to prescribe certain valuations that can be relied upon by a taxpayer – eg a valuation by a member of the PNG Valuer Registration Board but, as noted above, it is not clear there will be sufficient capacity or expertise to cover all the possible valuations that might be required.

- Another means of mitigating dispute is to require valuations to be lodged with the IRC for approval. This would provide certainty to taxpayers that their valuation is acceptable, but would require an enormous amount of work by an already undr-resourced revenue authority.

In our view the potential complications arising immediately from a valuation requirement, while there is not the capacity to manage the requirement, outweigh the future complications that arise from quarantining pre CGT assets. It is expected that future capacity in the IRC will be better placed to deal with the technical complications of a capital gains tax than is currently the case.