OIL SEARCH LIMITED

Taxing Capital Gains

Oil Search Submission to the Tax Review Committee

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H E A D O F F I C E

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This paper contains the response from Oil Search Limited to the Papua New Guinea Taxation Review Issues Paper No.4: Taxing Capital Gains

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Section 1: Introduction

The introduction of a capital gains tax into PNG has been the subject of significant debate over a long period of time. International comparisons suggest that countries such as PNG that rely heavily upon exports of commodities for a substantial portion of their gross national income typically would have a capital gains tax in place to ensure that tax is collected by the Government on capital transactions involving resource assets. PNG's position as an exporter of commodities is in contrast to those countries which merely act as financial intermediaries in corporate holding structures and where typically capital gains tax is not applicable as the valuable underlying assets are not physically located in the jurisdiction.

However, the potential introduction of a capital gains tax needs to be finely balanced to ensure that it takes into account the nature and history of PNG. Customary land holding, strong family ties and poor historical documentary evidence of ownership of assets need to be considered so that any capital gains tax system which might be introduced meets the needs of the PNG people as well as those of the PNG Government. More importantly, before a capital gains tax can be implemented, PNG must ensure that it has a framework and the systems which would enable it to manage a capital gains tax. Without the necessary infrastructure to audit and enforce compliance with a capital gains tax, the implementation exercise would be in significant danger of being a waste of valuable Government resources and time.

Ultimately, the aim of any capital gains tax must be that entities pay their fair share of tax. A number of the issues in the Committee's report highlight that certain taxpayers may have historically restructured transactions so that that they are treated as being on capital account so as to avoid paying tax in PNG. Oil Search is fully supportive of any actions taken by the Committee to ensure that taxpayers who seek to artificially avoid tax that would otherwise be payable, are subject to tax on those gains. By ensuring that each industry makes a fair contribution by way of tax payments, this will allow the Government to utilise a greater proportion of the tax revenue it derives to build the necessary infrastructure to allow the PNG economy to flourish. It is only through this increased economic growth that the Vision 2050 development goals will be met.

This Oil Search submission addresses the issues contained in the Tax Review Committee's *Issues Paper No.4: Taxing Capital Gains* and also addresses several design issues not otherwise covered in the consultation paper. As PNG's largest listed company and long term contributor to the country's development, Oil Search has a strong commitment to working with all levels of Government and with the communities in which we operate to ensure the future prosperity of PNG. We look forward to continuing our work with the Tax Review Committee and exchanging views on potential reforms as part of developing a balanced taxation regime for PNG.

Section 2: Executive Summary

The continued refinement of the PNG tax system to ensure that it meets the needs of the PNG economy is an important part of the responsibilities of the PNG Government. To that end Oil Search considers that the current tax review vital to providing the platform for the next phase of economic growth in PNG.

This submission contains detailed explanations of our views on the potential introduction of a capital gains tax and also contains comments on other tax design and policy issues. Broadly, we support the consideration of the potential introduction of a capital gains tax in PNG, but caveat our comments by reinforcing the challenges that the introduction of a capital gains tax would present. The design process for a capital gains tax is critical and must meet the needs of the PNG people. Further, a capital gains tax should only be considered when PNG has the systems, controls and governance structure to effectively administer such a tax. In our view, PNG's systems and not yet sufficiently mature to allow a capital gains tax to be effectively administered and there is a significant danger that such a tax could be enforced in an ad hoc manner and that many taxpayers would be willing to accept detection risk in not disclosing taxable capital gains given the current state of the IRC administration.

Notwithstanding the above comments, if and when PNG is ready to implement a capital gains tax we consider that the essential design elements of an appropriate capital gains tax for PNG would consist of the following:

- A capital gains tax should only be introduced after all technical design issues have been rectified and a comprehensive education program has been completed. It is more important that PNG gets the capital gains tax design right upfront as opposed to implementing it in the near term as a revenue raising measure.
- The capital gains tax rate should be lower than the standard corporate tax rate to encourage saving and capital investment in the PNG economy. We suggest a rate of 10-15% apply to all classes of taxpayers.
- The capital gains tax should apply to all persons, but only in respect of their PNG assets. It should be assumed that PNG residents who hold foreign assets will pay tax in those foreign jurisdictions. Alternatively, if foreign gains are taxed, a full tax credit should be given for any foreign tax paid.
- The capital gains tax should cover all capital assets, with a set of exclusions. These exclusions should cover main residence, personal use assets, customary land and other like classes of assets.
- Capital losses must be allowed to offset capital gains and must be allowed to be carried forward.
- A capital gains tax system must only be introduced after a tax loss transfer system has been implemented. It would be inappropriate to not allow corporate groups to offset capital losses against capital gains between entities.

- Rollover relief must be provided to allow for corporate restructures and other involuntary disposal events whereby assets pass from one party to another where there is no intention to derive a gain (e.g. death).

Whilst it will be relatively easy for the Committee to recommend a capital gains tax to the Government, in our view the Committee needs to take additional steps and set out the steps that need to occur in the administration of the PNG tax and public records keeping systems before a capital gains tax could even be considered for implementation. Only once this exercise is complete, will PNG be ready to consider implementation of a capital gains tax.

Once the systems are in place to support the introduction of a capital gains tax, the Government needs to appoint a subsequent Committee to delineate the exact form and substance of the proposed capital gains tax. Whilst the current consultation paper discusses many issues, it is the detailed technical drafting that will underpin the feasibility of a capital gains tax. We envision that this subsequent Committee will need to undertake a substantial technical exercise before it makes a final recommendation supporting the tax to the Government.

Without a targeted development process that focuses on systems and readiness first and subsequently the detailed technical operation of the proposed law, any recommendation to introduce a capital gains tax by the Committee now is at significant risk of the current and any future PNG Governments continuing to defer the introduction of a capital gains tax on the basis that it is too difficult. When PNG's systems are sufficiently developed to support a new broad based tax such as a capital gains tax, the Government should ensure that a technical consultative committee made up of appropriately qualified persons from Treasury, the IRC, the tax profession and industry is established as part of the exercise of delineating the capital gains tax. Oil Search would be happy to assist in such a program should the Committee see fit to invite our participation.

Section 3: Taxation of Capital Gains in PNG

The lack of a capital gains tax system in PNG is an obvious deficiency in the PNG tax system in comparison to PNG's resource rich international peers. From an economic perspective, the failure to tax transactions on capital distorts behaviours as taxpayers will seek to maximise their post-tax return. For example, if a taxpayer can make a 10% return on a transaction but will be subject to tax, or can make an 8% return, but the transaction will be on capital account and non-taxable, the prudent taxpayer will opt for the latter option. In a pure tax system, the taxpayer would opt for the higher return as all transactions would be taxed on an equivalent basis. In a simple PNG example, a taxpayer may hold a property and is offered the option of selling the property or leasing it for a substantial period, say 30 years. The differential in economic return may be minimal but the tax outcomes would likely drive the investor to sell the property instead of accessing the taxable income stream. Hence, there is a case to be made for the future introduction of a capital gains tax, in some form, in PNG.

However, the Committee needs to counter-balance the economic merits of a capital gains tax with PNG's ability to actually implement and enforce a capital gains tax. The IRC is already understaffed and lacking in senior technical expertise and we have concerns about the record keeping of public institutions which would support the critical cost base elements of a capital gains tax. Without the appropriate systems in place to support a capital gains tax, it risks becoming an ad hoc tax that is only paid by large corporates who would not engage in tax avoidance schemes. Without the proper systems in place, there is a substantial risk that small to medium size taxpayers will accept a level of detection risk and not report capital gains to the IRC, as is currently the case with regard to GST remittances according to anecdotal evidence. PNG must ensure that is has the people, the data and the political will to implement a capital gains tax before it embarks on such an undertaking.

Notwithstanding our comments above in relation to PNG's readiness for a capital gains tax system, below we outline our analysis of a potential introduction of a capital gains tax by reference to the five general principles of good tax policy espoused by the Committee in the consultation paper.

Revenue

The introduction of a capital gains tax should support future growth of tax receipts in PNG. We acknowledge that depending on the design of a capital gains tax, there may be not be significant additional revenue immediately after its introduction. Notwithstanding that fact, as Oil Search has stated in previous submissions as part of this review, the Committee needs to take a long term view and create a tax system that will stand for the next decade-plus. Furthermore, any concerns about compliance and administration costs can be somewhat alleviated by the design of the capital gains tax system. As we detail later in this submission, we support a simple capital gains tax system which minimises the cost of education on and administration of the new tax.

As the PNG tax system currently stands, it encourages taxpayers to structure transactions in a manner which would give rise to a capital gain as opposed to a revenue gain. By ensuring relatively

consistent taxation of transactions on revenue and capital account, the PNG tax base should be expanded and it should result in fewer instances of taxpayers structuring transactions to avoid revenue account taxation.

We note the concerns regarding the potential for taxpayers to begin "off-shoring" transactions which would otherwise be subject to capital gains tax if executed in PNG as the underlying assets are located in PNG. This is a significant issue for all countries, particularly those that are resource rich. International law issues such as treaty obligations, extra-territoriality and enforcement are critical to the consideration of this potential concern and we have included detailed additional thoughts in Section 4 when discussing capital gains tax design issues.

Competitiveness and efficiency

As highlighted above, the absence of a capital gains tax in PNG distorts investment behaviours. From the perspective of pure economic efficiency, the introduction of a capital gains tax promotes efficiency as the driver for those distortions in behaviour is removed.

It is acknowledged that the introduction of a capital gains tax in PNG could result in an allocation of capital away from PNG for those who regularly trade capital assets. However, removal of speculative traders from the PNG dynamic, especially those that acquire mining and petroleum prospecting licences with little or no financial or technical capability to undertake an exploration program, would arguably be a positive for the PNG economy. These speculative investors have sought to drive up prices for licences in the secondary market and have added little or no value to the PNG economy. As is pointed out by the Committee in the consultation paper, improving physical and social infrastructure is more likely to be determinative of a foreign investor's likelihood to invest in PNG as opposed to whether or not a capital gains tax system is introduced.

The potential for capital gains tax to 'lock-in' investors who do not wish to sell to avoid the capital gains tax impost is high. Ultimately tax is only one factor to consider in an investment decision and if the ultimate post-tax rate of return is increased by investing in a new asset, sensible taxpayers will look to divest existing assets regardless of whether it triggers an immediate capital gains tax liability.

Fairness

From an economic standpoint, there should be no differentiation on the taxation of an income flow depending on whether it is deemed to be on revenue or capital account and we support the concept of tax neutrality. As mentioned above, the differentiation in the way tax is applied distorts behaviours and results in taxpayers seeking to avoid taxes through reconstruction of transactions to obtain a more favourable tax outcome. Hence, having revenue and capital account transactions taxed on a relatively similar basis promotes fairness in the tax system.

Simplicity

A capital gains tax is not inherently complex, rather it is the design of certain capital gains tax systems in place in developed countries which have led to significant complexity and much jurisprudence. Like any new tax there is a transition period whereby taxpayers will need to adapt to the new requirements and adjust their behaviours accordingly. By adopting a simple transition mechanism and a comprehensive education plan, the relative pain of that transition can be minimised. We deal with this issue in further detail in Section 4.

Trust in and accountability of Government

The public's sentiment towards the taxation of capital gains and by extension its trust in Government will be largely determined by the design of the capital gains tax system as opposed to any notional fairness or equity that the introduction of a capital gains tax system brings with it. Citizens of PNG will likely support the tax is it is designed to tax non-residents who would not otherwise pay tax in PNG such as in the Mozambique example used by the Committee in the Consultation Paper. However, if the capital gains tax extends to such assets as the family home, then one potential outcome is that the introduction of a capital gains tax may actually heighten Government distrust as it often does where new taxes are introduced without appropriate offsetting decreases in existing taxes. The Government also needs to consider whether the introduction of a capital gains tax could damage the aspirational goals of the PNG middle class. For the first time in PNG's history, that middle class is beginning to develop wealth and has used that wealth to invest in capital assets. To a degree, taxing those capital assets could be seen as targeting that middle class and could act as a disincentive to further wealth accretion.

Responses to Tax Committee's Questions

Consultation Questions	Responses
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?	In our view, PNG does not yet have the systems and governance processes necessary for the introduction of a capital gains tax.

Section 4: Design Issues for Taxing Capital Gains

Who should be subject to capital gains tax?

To be an effective and fair capital gains tax system, the capital gains tax should apply to all taxpayers. This would include residents and non-residents, individuals, companies, trusts and superannuation funds.

One of the critical issues to consider is the breadth of the capital gains tax, i.e. should it apply to PNG residents deriving foreign sourced capital gains? If PNG adopts a source rule, then these gains should not be subject to tax. This approach would be predicated on the assumption that the gain should only be taxed in the country in which it arose. Such an approach is also aligned with international thinking arising out of the Base Erosion and Profit Shifting ("BEPS") work being undertaken by the OECD and the G20, that is, tax should be paid in the country in which the profit arose.

The alternative option for the Committee to consider is taxing PNG residents on their worldwide capital gains, with an exemption where the gain has been subject to tax in a foreign jurisdiction, or a full income tax credit equal to the foreign tax paid which would offset any PNG capital gains tax which may have arisen. Calculating the PNG tax or the applicable credit can be quite complex due to foreign exchange issues and hence we recommend that the capital gains tax is limited only to PNG sourced gains in the interests of simplicity.

To the extent that the Committee did recommend that PNG residents be subject to PNG capital gains tax on foreign sourced gains, we also encourage the committee to consider providing exemptions from PNG capital gains tax where the seller is a PNG corporate and the underlying asset that is disposed of is a controlled foreign company and the underlying assets of the company are active (i.e. not passive assets that derive interest, dividends and rents). Adopting this approach would ensure a consistent outcome from a PNG perspective when compared to the situation where the controlled foreign company sold the underlying assets directly. In that circumstance, no PNG tax would arise and any dividend paid back to PNG by the controlled foreign company from the proceeds of sale would be rebated and hence effectively not subject to PNG tax.

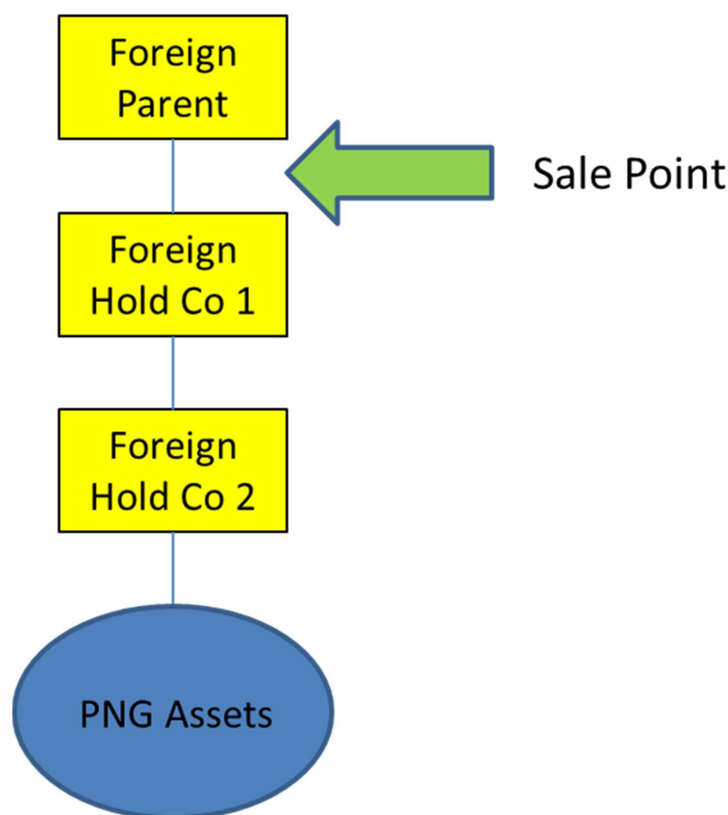
For non-resident taxpayers, several technical issues could limit the ability of PNG to effectively impose capital gains tax. Notionally non-residents should be subject to PNG capital gains tax on any PNG sourced capital gains. This would include sales of shares in PNG companies and sale of land located in PNG. Difficulties start to arise where the relevant disposal is of a non-resident entity, executed outside of PNG but where the entity that is sold has underlying PNG assets. In that scenario, the disposal has no nexus with PNG and hence PNG has no taxing rights. To that end, we outline below some of the key considerations regarding the taxation of non-residents.

Double Tax Agreements

Currently PNG has nine double tax agreements in place. The majority of PNG's double tax agreements contain either a Capital Gains article or an Alienation of Property article which reserve the rights of PNG to tax dispositions of real property and also dispositions of entities whose assets consist wholly or principally of real property.

For those treaties that do not contain such an article (e.g. the UK treaty), one may look to the Business Profits to determine the taxing rights. Pursuant to the Business Profits articles contained in those treaties, the right to tax business profits is reserved to the country of residence unless the non-resident company has a PNG permanent establishment. Hence where a non-resident of a treaty country realises a business profit, PNG would not have a right to tax the gain. However, many people would argue that the Business Profits article does not cover capital gains and that PNG should have the right to tax the gain, especially where the tax has only been introduced post entry into the relevant double tax agreement.

Where the non-resident entity divesting a PNG asset is not resident in a treaty country, PNG will need to rely on its domestic laws to assert taxing rights. Similarly, where the non-resident is a resident in a treaty country but the transaction occurs outside of PNG, PNG will need to assert that it has domestic taxing rights. For example, the following sale would be outside the scope of the Alienation of Property article in PNG's treaties as the sale occurs further up the ownership chain such that the entity that is sold only holds PNG assets indirectly.



Extra-territoriality

The above example of an offshore sale up the ownership chain to avoid potential domestic and treaty taxing rights creates issues for enforcement and recovery of taxes. Arguable the hardest challenge for a revenue authority is being aware that the transaction has even occurred so that they can ensure compliance with PNG's tax laws. In the mining and petroleum context it may only be when the new owner seeks to register a change in beneficial ownership of the underlying tenement that the revenue authorities become aware of the transaction.

Seeking to tax offshore sales is a quandary and raises the question of whether PNG is seeking to impose tax extra-territorially. This same issue arose in Australia with regards to the introduction of the Taxable Australian Real Property ("TARP") provisions which trace the underlying assets of the offshore sale and imposes tax where, broadly speaking, the majority of the underlying assets are Australian real property interests. PNG should strongly consider introducing similar rules otherwise it runs the risk of non-residents engineering their structures to achieve offshore sales to avoid PNG capital gains tax. If the introduction of a TARP equivalent regime is too complex for PNG given the current state of its tax administration, the drafters of the relevant capital gains tax provisions need to ensure that any provisions that allow capital gains tax rollover relief do not allow non-residents to move PNG assets into a structure which would allow an offshore sale. Further, the drafters could also consider imposing a withholding obligation on buyers of certain classes of assets to ensure that sellers pay the correct amount of PNG tax on exit.

Foreign Exchange

One of the issues not covered in the consultation paper is the potential impact of foreign exchange both in the domestic context and the foreign context. As it currently stands, the IRC allows taxpayers to prepare their accounts, tax returns and also make tax payments in a foreign currency, typically USD. To the extent that a capital gains tax applies, it is assumed that taxpayers who have made the election to produce accounts in USD would be able to calculate their capital gains in USD. The larger challenge arises if PNG seeks to tax foreign source capital gains of PNG residents where those gains are denominated in foreign currency. This will require FX translation rules to be included in the capital gains tax provisions and will add to the overall complexity of the system. Such complexity is potentially another reason why the capital gains tax should not extent to foreign source gains of PNG residents.

What assets should be subject to capital gains tax?

In our view, a PNG capital gains tax should apply to all assets, other than certain identified exclusions. We recommend this approach as opposed to specifying a class of assets that are subject to the capital gains tax. The latter approach can lead to taxpayers adopting financial engineering to ensure assets fall outside the scope of the CGT. In relation to the assets that should be excluded, we outline below a number of areas that require detailed consideration.

Main residence

International capital gains tax systems generally exempt the main residence of a taxpayer from capital gains tax. In order to obtain widespread public support for the introduction of a capital gains tax in PNG, it is likely to be necessary to offer a similar exemption, particularly given some substantial increases in the value of property in areas of PNG over the past 10 years. The Committee will need to consider appropriate anti-avoidance mechanisms to mitigate the risk of taxpayers utilising family members to minimise any potential future capital gains tax liability. For example, a husband and wife may only be able to nominate one main residence jointly as opposed to each spouse nominating a separate main residence. Similarly, minors holding property may not be entitled to access the main residence exemption.

Personal use assets

For the reasons outlined by the Committee in the consultation paper we agree that personal use assets should also be excluded from the application of the capital gains tax. To include personal use assets in the regime makes the capital gains tax draconian and unnecessarily complex.

Customary Land

It is our understanding that generally speaking Customary Land cannot be sold. Hence, it would be difficult to see how a capital gains tax trigger could eventuate in relation to Customary Land. That said, we understand that in certain circumstances, Customary Land can be the subject of long term leases. There is some jurisprudence that supports the notion that a long term lease (e.g. 99 years) is an effective disposal for tax purposes. In that scenario, we support the exemption of Customary Land from PNG capital gains tax.

Listed shares and bonds

We noted with interest that Fijian exclusion for capital gains derived in relation to listed shares discussed in the consultation paper as well as the comments from the NRI in relation to shares and bonds. We disagree with those approaches and are of the view that capital gains tax should apply to these classes of assets. There would appear to be little sense from an economic perspective in excluding potentially two of the largest classes of capital investments from the capital gains tax.

Timing of Taxation of Capital Gains

It is impractical to impose a capital gains tax on any basis other than realisation. In most circumstances taxpayers will simply not have the cash to pay tax on any unrealised gain on an asset. This will force taxpayers to realise their asset, which is not recommended or sustainable.

In relation to circumstances where assets are brought into or out of the PNG tax system, we favour an approach that gives a taxpayer a market value cost base when the asset is brought into the system. For example, if a non-resident holds shares in foreign companies and then moves their domicile to PNG, they should obtain a market value basis in those shares on the day the domicile changes. Similarly, when an asset leaves the PNG tax net, this should result in a deemed disposal, although the Committee should consider whether to allow the taxpayer to make an election to defer the gain until such time as the gain is realised. Allowing a deferral does carry additional recovery risk and will be largely reliant on good administrative and enforcement practices within the IRC.

We acknowledge the argument that capital gains tax should only be payable on real economic gains as opposed to nominal gains, in practice this is difficult to administer given the complexity around the capital/revenue dichotomy. If an inflation-linked capital gains tax was introduced, then we would recommend that a relatively higher capital gains taxation rate should be utilised. In the absence of an inflation-linked system, then a lower rate is the preferred option. This is discussed in greater detail below.

Rollovers

The ability to access CGT rollovers is an important part of any CGT system. Broadly these should cover events where there has been no change in beneficial ownership or where there has been an involuntary disposal of an asset without an intention by the owner to have divested the asset (e.g. replacement asset rollover when previous asset is destroyed by fire). Below is a table listing the critical CGT rollovers that should be included in the PNG CGT system. This list is not exhaustive and

there are several other rollovers the Committee may wish to consider including rollovers to deal with the reconfiguration of holding structures for CGT assets.

Event	Description
Death	Where a taxpayer dies and assets which are subject to capital gains tax pass to the beneficiaries of the deceased's estate, this should not trigger a capital gain for the deceased. However, the acquirer should only obtain a cost base equal to the deceased's cost base to ensure that the appropriate tax is payable when the asset is realised.
Marriage/Relationship breakdown	Where as part of a property settlement between two parties as part of a marriage or relationship breakdown, no CGT event should occur where property is transferred between those two parties.
Asset is subject to compulsory acquisition or is otherwise destroyed or lost	Any gain where the asset is acquired by the State or where it is destroyed or lost and insurance proceeds result in a gain, this should be able to be deferred pending the acquisition of a substantially similar replacement asset within a 12 month period. The most common example here is where an asset might be destroyed by fire or flood.
Exercise of options	Where a taxpayer exercises an option to acquire a share in a company, any notional gain should be deferred and the tax taxpayer should have a cost base in the newly acquired share equivalent to the cost base the taxpayer had in the option.
Related company transfers	Where two PNG resident companies are part of the same wholly owned group, they should be entitled to transfer CGT assets between themselves without triggering a gain.
Amalgamations	The PNG tax law already provides a mechanism for company amalgamations. Specific rollover relief should be granted where such an amalgamation occurs.

Rates of CGT

In theory, for a CGT to be as efficient as possible there should be no difference between the rate of CGT and individual and corporate tax rates. When all rates are aligned, there is no incentive to structure transactions to access the lowest possible tax rate. In reality, this is impractical from a PNG perspective given that individuals are subject to a progressive rates system and corporate can be subject to tax at 30%, 45% or 50%. Further, some corporates may also subject to Additional Profits Tax.

The rate of CGT should ultimately be determined by deciding what behaviours the Committee wants to incentivize. If it is trying to create an incentive for individuals to invest in capital assets, then a

lower rate or alternatively a discount on the amount of the gain that is included in assessable income are the two options. Similarly, if the Committee wanted to incentivize foreign investment, then a lower rate for corporates might be appropriate. Further, the Committee will also need to consider whether any concessions should be available for both domestic and foreign superannuation/pension funds.

If the Committee sought to have one rate applied in the calculation of all gains, we would recommend that this be either 10% (in line with Fiji) or 15% (half the corporate tax rate). Imposing a rate in this range would introduce a capital gains tax, but not at so high a rate compared to PNG's international peers so as to dissuade foreign investors from committing to PNG. Further, a rate in this range should also be amenable for PNG residents, as opposed to being subject to tax at their marginal rate. Given the majority of PNG resident investors who would be subject to capital gains tax are probably at the top marginal tax rate of 42%, a rate of 10-15% should not be perceived as a prohibitive impost, especially if the introduction of a capital gains tax coincides with other individual tax reform measures. Further, we note that the existing operation of stamp duty already acts as a de facto GST on certain transactions. This assumes that a buyer of an asset calculates what they are prepared to pay on a stamp duty inclusive basis and hence the presence of a stamp duty reduces net proceeds to a seller. The continued operation of stamp duties in PNG therefore supports a lower rate of CGT than the standard company rate, especially given stamp duty is applied against the value of the asset transferred and not the gain made.

We note the Committee considered in the consultation paper whether the capital gains tax rate for companies should be aligned with the company tax rate in return for an overall reduction in the company tax rate. In a period where the PNG budget is under a degree of stress due to low commodity prices we would caution this approach without a significant understanding of the likely capital gains tax receipts that might flow from corporate entities. Based on the Committee's *Consultation Paper No.3*, it seems that an introduction of a capital gains tax system would likely be implemented over the medium term. Depending on the overall level of activity in the PNG economy and the recovery in commodity prices, it may be that the PNG budget can provide for corporate tax cuts at the time of commencement of the capital gains tax regime, but we would recommend that any cuts be introduced in a phased approach. For example, if the rate was to be cut to 25% from 30%, then in Year 1 it could move from 30% to 28%, then to 26% in Year 2 then 25% in Year 3. By adopting a conservative approach, the Government can ensure that the policy still fits within the fiscal limitations of the PNG economy and budget given that the PNG economy's performance has historically been dynamic.

Cost base

As part of creating the capital gains tax system, the Committee will also need to ensure that it introduces robust tax cost base provisions. These will need to cover issues surrounding dealings with related parties, improvements and whether they constitute separate assets as well as defining the cost base of assets held at the time of commencement of the capital gains regime. The Committee needs to ensure that the cost base provisions contain sufficient controls so that the capital gains system is not open to abuse through manipulation of tax cost bases.

Capital Losses

The principle of fairness demands that capital losses be recognised in the same manner that capital gains would be under any capital gains system. At its simplest, any capital loss which is incurred by a taxpayer should be available to offset any taxable income derived in the same income year. However, in an economy which is facing difficulty, the ability to use capital losses to offset taxable income can be open to abuse. In a simple example, capital assets can be subject to a 'bed and breakfast' series of trades whereby a taxpayer sells the asset on Day 1 to realise the asset, then buys the same asset back the next day. This is a common occurrence in funds management leading up to year end and depending on how asset values in PNG have moved, could be undertaken by taxpayers in PNG to minimise their taxable income on their wages.

The solution to such an exposure is to adopt the Australian methodology which is to limit the use of capital losses so that they can only be used to offset capital gains. If such a method was adopted, there must be rules providing for a substantial carry forward period for unused capital losses. We would recommend at least 20 years and would urge the Committee to consider providing for unlimited carry forward.

Some countries also adopt loss carry-back systems. For example, a capital loss incurred in the current income year could be carried back to offset a capital gain that was subject to tax in the previous five income years. Loss carry-back systems are however difficult to administer and hence do not meet the overall desire to adopt a system that is as simple as possible. Further, they can be a significant threat to the revenue in times where asset values have decreased sharply and as such we would not recommend the adoption of such rules.

Tax Loss Grouping/Transfers

Following on from the discussion above which illustrates the need to have capital losses offset capital gains in the calculation of a taxpayer's assessable income, it follows that the implementation of a capital gains tax must be accompanied by tax loss grouping or tax loss transfer rules. Capital gains and losses by their nature are often irregular one-off events and in large corporate groups, tend to be spread across a number of entities as each undertakes a separate project. These issues are even more pronounced in the Petroleum industry where each licence is ring-fenced, notwithstanding that the same legal entity may operate each licence. It would inequitable to not allow grouping of capital gains and losses in a corporate group and would be akin to outright denying an offset for any capital losses incurred. The reality of large corporate groups with joint liability issues and limited recourse funding arrangements is that corporates use separate companies for individual projects. To create a capital gains tax which does not allow for these modern corporate structures would be a fundamental design failure. The broader question would be that if a capital loss transfer system is implemented, how could this occur without having a similar set of rules for revenue losses? As outlined in our previous submission to this review, we are strongly in favour of such a system and believe that it supports the notions of equity and fairness than underpin this review.

Responses to Tax Committee's Questions

Consultation Questions	Responses
Question 4.1 – If PNG were tax capital gains, do stakeholders agree that a system for taxing	Yes, CGT should apply to both residents and non-residents.

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?	A taxpayer's main residence, personal use assets and Customary Land should be excluded from the operation of the CGT for the reasons described above.
Question 4.3 – If PNG were to tax capital gains, which class of assets should be included in such a regime?	Apart from the exclusions noted above, all assets should be subject to the CGT 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?	We prefer a 'catch-all' CGT which provides for specific exclusions to maximise simplicity.
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?	We agree that capital gains and losses should only be recognised on a realisation basis.
Question 4.6 – Should a roll-over be provided where a disposal occurs because of the death of the owner of the asset?	Yes, a rollover should be provided.
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?	We have provided a preliminary list of rollovers that should be included in the CGT provisions above.
Question 4.8 – What rate/s should apply to the taxation of capital gains in PNG?	We consider that a rate of 10-15% would be in line with international standards and should not be a significant disincentive to domestic and foreign investment.
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)?	We favour a capital gains tax system that applies to all classes of taxpayers and which is applicable at the same rate.
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?	We favour this approach. The risk is that parties may continue to seek to re-characterise revenue account transactions as capital account transactions to access the presumably lower capital gains tax rate.
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?	We agree that capital losses should be quarantined such that they only offset future capital gains, but this needs to be coupled with a tax loss transfer system as discussed above.
Question 4.12 – How else could capital losses be treated, in a way that supports the five policy principles?	As we have discussed above, capital losses could be available to offset ordinary income or could have carryback rules. To achieve simplicity and to protect the revenue we do not favour this approach.

Section 5: Transitional Issues

Pre-CGT assets

The Committee's consultation paper canvasses two potential options for dealing with assets held at the date of commencement of the CGT regime: excluding gains made prior to introduction or excluding gains made from assets held prior to the introduction. Due to the complexity associated with tracking pre-CGT assets post commencement of the CGT regime, we favour a scheme which excludes gains made prior to commencement. Broadly this should occur by way of taxpayers obtaining a market value cost base as at the commencement date for any CGT assets they hold.

Determining the value of assets at introduction

We support the proposals by the Committee whereby a taxpayer has the option to seek an independent valuation from an appropriately qualified valuer or rely on available market data to support the market value cost base. As the Committee correctly points out, the challenges arise in relation to assets such as businesses or land where historic cost base data may be difficult to obtain. We note the simplified approach of apportioning a gain based on length of holding, but again this relies on the taxpayer having accurate cost base records from the time of acquisition. In a developing country, accessing these types of records could be a significant challenge and is one of the key reasons why Oil Search believes PNG is not yet ready for the introduction of a capital gains tax.

Another alternative methodology that the Committee may wish to consider is to use reverse indexation to calculate the taxable gain. For example, assume that a taxpayer holds an investment property as at 1 January 2016 (assumed commencement date of the CGT regime for current purposes) and then sells that asset on 1 January 2019 for $100. They will need to refer back to a published indexation table to calculate the cost base of their asset as the commencement date and therefore the gain that is subject to tax. If we assume that the index is set at 100 at the time of commencement and has increased to 125 as at 1 January 2019, then the cost base at commencement will be:

$$\$100 \times \frac{100}{125} = 80$$

The gain on sale is therefore $20, being $100, less the cost base of $80.

The above methodology deals with the situation where information about the cost base is not easily obtainable. If in the index is linked back to only movements in inflation, then the result is that this methodology will only tax inflationary gains, not real gains and hence could be seen as concessionary and should only be available as a methodology of last resort.

Consultation on the design of a capital gains tax

As flagged earlier in this paper, we consider that if the Committee intends to support the introduction of a capital gains tax, there must be a multi-step process that follows. Firstly, PNG must

invest in its people and its systems to ensure that it can actually administer a capital gains tax. At its simplest, can the IRC easily access Government data sources and see historical data on acquisition values of real estate, shares and bonds? Without a way to verify capital gains tax calculations, the system would simply be relying on the honesty of the public to accurately report gains. As has been discussed by the Committee in previous papers, there is not a unifying principle amongst the people of PNG that they should all pay their fair share of tax. Because of PNG's history of large proportions of the population living on a subsistence basis, tax is not seen as a moral obligation. This is one of the fundamental reasons that GST collections in certain parts of the country are significantly less than was anticipated. Whilst a capital gains tax should notionally not be as difficult to track it still faces enormous challenges given PNG is still a developing economy with an under-resourced IRC lacking in technical expertise.

Assuming the readiness issues can be rectified over time, the next step in the potential implementation of a capital gains tax is that a new committee needs to be formed that can develop the vast majority of the technical detail that will form the capital gains tax. This will go beyond the current macro level design considerations and should be examining the nuances of a capital gains tax and turning that into draft legislation for public comment. We recommend that this future technical committee consist of a wide ranging group of experts. In particular we consider that appropriately qualified persons from Treasury, the IRC, the tax profession and industry should form part of this group, along with representation from the existing Tax Review Committee.

The output from the technical committee on the design of the capital gains tax should also outline a preferred strategy and timeline for the introduction of a capital gains tax. It would be short-sighted to quickly introduce a capital gains tax before all of the systems and technical issues have been fully resolved or before a comprehensive education program has been implemented. The introduction of a capital gains tax will be the biggest change in PNG tax law since the introduction of the GST and it is imperative that there is an appropriate lead time before the law becomes operational. This will allow taxpayers time to gather historical cost base data and learn what their new compliance obligations are.

We acknowledge that our proposed delays in implementation could lead to some taxpayers exiting assets ahead of the tax being applied, but this will always occur ahead of a new tax being introduced. PNG needs to take a long-term view and ensure that the system design is optimised from the outset and that the people and the IRC are ready for the transition to a new paradigm in PNG tax.

Responses to Tax Committee's Questions

Consultation Questions	Responses
Question 5.1 – What class of capital assets in PNG would pose challenges in determining an appropriate market value?	The largest challenges in terms of determining market values will generally be private businesses as these are not readily tradeable.
Question 5.2 – Putting aside the revenue considerations how could PNG best transition to a system that taxes capital gains?	As outlined above we favour a multi-step process which concentrates on readiness for a capital gains tax in terms of systems and people as a first step. From there detailed technical drafting should occur, followed by a final decision on whether or not to implement the

	capital gains tax. From there, an education program of not less than 12 months is needed to ensure a smooth transition at the chosen start date.

Section 11: Conclusion

The challenge with introducing a comprehensive new tax such as the capital gains tax is substantial. Notwithstanding the fact that the absence of a capital gains tax is unusual in a resource rich, developing country like PNG, there is likely to be significant pushback from taxpayers who will be concerned about the potential additional impost in an environment where economic growth has slowed post the commencement of PNG LNG and is arguably yet to feel the full brunt of lower commodity prices, in particular lower oil and gas prices. Further, there are significant doubts that PNG can implement and enforce a capital gains tax without first undertaking a comprehensive capacity building exercise. At this stage, we do not believe PNG is ready for the introduction of a capital gains tax because of the lack of systems and people required to support the enforcement of the tax.

Taking into account this environment, it is essential that any capital gains tax balances the needs of the PNG people with the economic challenges of the nation. Whilst Oil Search indicatively supports the introduction of a capital gains tax at some point in the future, it is critical that the design takes into account the challenges that have been discussed in this submission. We reiterate what we consider to the essential elements of a capital gains tax in PNG:

- A capital gains tax should only be introduced in the medium to long term after all technical design issues have been rectified and a comprehensive education program has been completed.
- The capital gains tax rate should be lower than the standard corporate tax rate to encourage saving and capital investment in the PNG economy. We suggest a rate of 10-15% apply to all classes of taxpayers.
- The capital gains tax should apply to all persons, but only in respect of their PNG assets. Alternatively, if foreign gains are taxed, a full tax credit should be given for any foreign tax paid.
- The capital gains tax should cover all capital assets, with a set of exclusions. These exclusions should cover main residence, personal use assets, customary land and other like classes of assets.
- Capital losses must be allowed to offset capital gains and must be allowed to be carried forward.
- A capital gains tax system must only be introduced after a tax loss transfer system has been implemented.
- Rollover relief must be provided to allow for corporate restructures and other involuntary disposal events whereby assets pass from one party to another where there is no intention to derive a gain (e.g. death).

As PNG's largest company, Oil Search sees itself as more than just a taxpayer in PNG. We consider ourselves an important development partner with our nation. It is our corporate priority to partner with the State in delivering meaningful projects across the nation for sustained long term development in the furtherance of the State's development goals. This includes working with the

State in relation to the tax reform agenda and we would welcome the opportunity to further contribute to the consultation process on the introduction of a capital gains tax. As highlighted above, in order for a capital gains tax to have a chance at being successful, it will be critical for the Tax Review Committee to deliver a comprehensive road map for the potential implementation of a capital gains tax including resolution of all key systems, capacity and technical issues. We would urge the Tax Review Committee and the Government to take their time and ensure an orderly and well planned introduction of any future capital gains tax. It is imperative that any such tax is supported by a strong administration by the IRC and that the public is well informed and educated about the new tax and their obligations that arise under it.

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