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Submission: Issues Paper No.5 – Tax incentives

Dear Sir / Madam

We write in response to the request for submissions on the Issues Paper No.4 – An examination of the advantages and disadvantages of tax incentives (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

Jason Ellis
Partner

Introduction

PwC believes that tax incentives can play an important role in the development of PNG and that the majority of the incentives currently available should be retained.

While we agree in theory with the view expressed in the TRC Paper that tax incentives contribute to complication of the tax system and it is therefore desirable for incentives to be removed - eg with a corresponding reduction in tax rates, we do not believe this is the appropriate practical approach for PNG. Tax incentives can be desirable and play an important role, for instance:

- Tax incentives can encourage investment in socially desirable projects and industries and we believe the removal of established incentives that are utilised by those industries will have a deleterious effect on investment in PNG.

- Tax incentives need to be offered to ensure investment in industries that rely on public infrastructure that is not provided by the State, and therefore must be provided by private industry. This is particularly the case for industries operating in remote locations – eg resources, agriculture, tourism, where public infrastructure does not exist.

- Incentives such as the infrastructure tax credit scheme are critical for the development of PNG, to meet gaps in the provision of infrastructure by the State, and should not be viewed as benefits to individual projects.

- Tax incentives geared toward individuals – eg for residential housing, education, training etc, are important social drivers of development in PNG.

- Tax incentives do influence behaviour, even if not always directly. For example, the availability of accelerated depreciation might not directly factor into a specific capital expenditure decision, but the resulting tax benefit enables the taxpayer to re-invest the cash tax saving in further capital expenditure. Removal of accelerated depreciation will affect the level of capital expenditure in PNG.

- While project specific concessions may not be theoretically desirable this needs to be weighed against the cost of a project not proceeding. If a particular tax concession can facilitate a project that would not otherwise proceed there are many other tax and non-tax benefits that will accrue.

Properly targeted tax incentives are a common feature of all tax systems and can operate to support PNG's development goals. PwC agrees with the TRC that greater transparency around tax concessions is necessary and we believe this will aid in better understanding of the role and extent of concessions being offered in PNG.

Overview of Tax Incentives Regime in PNG

1.1 are stakeholders aware of any other tax incentives not captured in the table?

1.2 do stakeholders agree with the stated purpose of each incentive, as provided for by the Review?

We believe the table captures all tax incentives in PNG, although we do not necessarily agree that all of these are accurately described as "incentives". For instance:

- Section 97 of the Income Tax Act – this provides a deduction for the cost of land preparation and planting for primary producers. In our view this is not "accelerated depreciation" and is not a tax incentive. The provision simply provides a deduction for an outgoing that might not fall under the ordinary deduction provision (eg because it is capital in nature) or the depreciation provisions (because it is not plant). It is appropriate that taxpayers receive tax relief for this expenditure and section 97 is no different to other specific deduction provisions – eg for bad debts, commission, borrowing costs etc.

- GST zero rating – the paper does note that this might not be appropriately described as a tax incentive. In our view it should not. For instance, the intention of zero-rating supplies to the resource industry is not to provide an incentive or concession to the resource industry, since any GST paid would be refundable in any event.

- Tax credit scheme – in our view the tax credit scheme is not a tax incentive, but merely a mechanism to facilitate spending on public infrastructure by the private sector. The scheme is critically important to development in PNG and should be extended, rather than scaled back. We have discussed this further below.

1.3 are relevant stakeholders able to indicate how individual incentives helped to achieve the stated policy goal?

We acknowledge the observation in the TRC paper that tax incentives do not drive decision making, and are instead a 'windfall' benefit to the taxpayer that would have undertaken the expenditure / project in any event, and we agree this is sometimes the case.

However, in many cases the windfall gain will contribute to future behaviours. An example is with accelerated depreciation: A taxpayer in, for instance, the primary production sector may not consider the 100% tax depreciation write-off each time they make a capital expenditure decision, but the 100% depreciation does provide a cash flow benefit that enables greater capital expenditure to be incurred in the following year(s) than would be the case had the tax write-off not been available. Accordingly, the incentive does achieve the goal of greater capital investment in PNG.

This will be the case with many incentives. For instance, if the double deduction for apprentices was removed this may not immediately result in a reduction in the number of apprentices employed, but it will necessarily increase staff costs, and therefore affect future hiring decisions and employment in PNG.

The advantages and Disadvantages of Tax Incentives

2.1 what other advantages do tax incentives have, particularly in the PNG context?

While we agree with the view expressed in the Paper that tax holidays are generally not good policy, we note that it is already stated Government policy not to provide project specific concessions, and there are in fact fewer project concessions provided than is perceived. We are aware of only one 'tax holiday' currently provided as a project concession (ie outside of frameworks available in the law – eg pioneer industries etc).

Nevertheless, we believe it is important to acknowledge that project specific concessions can play a role in the investment decision for a project, and that income tax is only one of the benefits that might flow to the State and the community from a project.

For instance, a project with an income tax holiday will still employ people and pay salary or wages tax. It will engage contractors that will pay income tax and, themselves, employ people and pay salary or wages tax. In the case of a resource project royalties and other benefits will be paid to the State and communities even if income tax is not paid.

As is noted in the TRC Paper, in many cases the income tax holiday afforded to a project may not be of any substantial value if the project is not taxable in any event. On the other hand, other taxes and benefits paid to the State and communities will be paid and there needs to be recognition that if a project does not proceed these other benefits are forgone. This might be the case with any tax concession – not just tax holidays. Whether a concession is provided always needs to be considered against the alternative that a project, an asset purchase, an expenditure decision, and employment decision, etc may not otherwise proceed.

In our view much of the debate about tax concessions has resulted from the lack of transparency around tax holidays, and a belief in the community that many more concessions are being provided than is in fact the case. We agree that better administration of tax incentives is desirable, and we believe that greater transparency will assist the community to understand the benefits of tax concessions.

2.2 what other disadvantages do tax incentives have, particularly in the PNG context?

2.3 do stakeholders have any other views about the merits of particular types of tax incentives?

PwC does not support the removal of any tax incentives contained with the Income Tax Act. We have commented below on some specific incentives that we believe are most important.

<u>Infrastructure tax credit scheme</u>

Infrastructure levels in PNG are at crisis levels, with basic infrastructure not being provided to large parts of regional PNG. In our view the government needs to leverage the private sector to provide this infrastructure. In many cases the private sector is able to provide greater quality infrastructure, and at less cost, than otherwise would be provided if managed by the government.

The ITC scheme recognises that Provincial and National Governments have insufficient planning, engineering or construction capacity in isolated regions to undertake infrastructure developments. The types of community infrastructure projects that can be undertaken are specified under the Department of National Planning and Monitoring (DNPM) Guidelines which were last updated in 2001.

Given the major role the ITC scheme has to play in this service delivery function we believe it needs to be expanded. By increasing or removing the credit limit the private sector will be able to better play their part in developing the infrastructure required in regional PNG and make an invaluable contribution to the PNG economy.

It is widely considered that the economic and social development of PNG is dependent upon: -

- focus upon priority recurrent and development expenditure, including particularly infrastructure development and maintenance, and increased health, education and justice related services, and

- the efficient use of current and prospective revenues in addressing priorities, including the long-standing decline in national and local infrastructure, and building up a sense of ownership of public goods and services.

We believe an expanded ITC scheme will help these objectives be achieved. The Government is encouraging public-private sector partnership as one of the most efficient and assured methods of delivering rural services in accordance with the District Plans. Expansion of the ITC scheme will enable these objectives to be achieved.

The ITC scheme is a well-established, cost effective State-industry partnership that has a proven track record of efficient delivery of infrastructure and services to rural communities.

The TRC Paper implies there are private benefits derived by participants in the ITC scheme. In our view any private benefits should be viewed as purely incidental and not a distortion of the scheme. The planning and approval process is in place to ensure that only suitable public benefit projects qualify for the scheme – if this is not happening it is the planning and approval process that needs to be reviewed, not the scheme itself.

We also note the TRC Paper refers to the fact that projects need not be provided in the area where the taxpayer is operating as an extension of the scheme beyond its original policy intent. In our view this should be evidence of the success of the scheme – a taxpayer cannot benefit where the expenditure is in another geographic region, but they are nevertheless prepared to fund projects anyway. The Highlands Highway tax credit is an example of an extension to the project that worked – it was not just the users of the Highlands Highway that contributed to the expenditure on that infrastructure. Since the Highlands Highway scheme was discontinued (and then reintroduced in a restricted form) the infrastructure has suffered.

PwC does not have any objection to an independent audit of the scheme, and we would caution against any contraction of the scheme before further proper consideration is given to its effectiveness.

<u>Accelerated depreciation</u>

Accelerated depreciation – particularly for the manufacturing and primary production industries – is an important driver of capital expenditure in PNG. As we have noted above, even if not a direct factor in each capital expenditure decision, the 100% write-off does provide a cash flow benefit that facilitates a greater level of future capital expenditure. Removal of accelerated depreciation incentives would, in our view, have a significant adverse impact on capital expenditure and investment in PNG.

We note that other jurisdictions typically offer incentives for capital expenditure – for example, Australia reintroduced the investment allowance during the recent global financial crisis – and in our view PNG should continue to offer this incentive to targeted industries to encourage investment in those industries. Manufacturing and primary production are considered critical to the development of PNG and investment in these industries needs to be encouraged.

Staff training double deduction - apprentices

We believe the double deduction available for the salary cost of apprentices is an important driver of employment opportunities for apprentices, and that removal of the tax incentive would result in a (potentially significant) fall in apprentice hires in PNG.

Tourism related incentives

As noted in the Issues Paper there are a number of incentives available to tourism operators – eg. 20% income tax rate, 55% accelerated depreciation, a double deduction for staff training costs.

For a country with an abundance of natural beauty, PNG's tourism industry lags behind many of its Pacific Islander neighbours. The lack of infrastructure and the perception of high crime are factors in the industry's performance and need to be overcome by tourist operators looking to enter the PNG market. The removal of these tax incentives would therefore negatively impact on investment in PNG's tourism industry. It is no co-incidence that leading tourist destinations such as Hawaii in the US and Queensland in Australia have incentives in place for tourism operators, despite having highly developed infrastructure and a perception they are relatively safe destinations.

The TRC Issues Paper notes that the tax system is not the reason tourists do not choose PNG as a holiday destination. This, on its own, is of course true, but the TRC notes that the reasons for lack of tourism are more likely to be matters such as law and order and cost. It is the failure of the State to provide basic infrastructure and services that requires the private tourism sector to fund additional security, infrastructure etc itself and that leads to the greater cost. To foster a tourism industry it is necessary for operators to receive some relief – via the tax system or otherwise – for the additional costs it is required to incur.

The expansion of PNG's tourism industry is a policy objective of the government and it is important the tax incentives are maintained.

Personal tax exemptions

In our view personal tax exemptions – eg for housing and education – are an important feature of the PNG tax regime.

Home ownership is a key characteristic of developed economies. However, affordability of housing in PNG has meant that home ownership has become unattainable for many Papua New Guineans, including those in full time employment. A tax concession to encourage home ownership is entirely consistent with PNG's development goals.

Similarly, education is a key priority for Papua New Guinea. The future prosperity of the nation depends on education being available and affordable to all and it is appropriate for a tax concession to support this.

We also believe retention of the section 40AA leave fare exemption is important, because:

- leave fares are common feature in the PNG public service. A tax concession for a leave fare in the public service is of no real benefit since the tax is paid to the State. If the concession was removed it would place the private sector at a competitive disadvantage to the public sector.

- an exemption for workers travelling frequently to and from remote locations is common in most jurisdictions. If this concession is removed it places remote PNG projects at a competitive disadvantage with projects in other countries.

We believe a review of personal tax incentives should be considered in conjunction with a review of personal taxation in PNG more generally.

Tax Incentives in PNG – Possible Directions for Reform

4.1 do stakeholders agree that PNG should focus on creating a tax system that is overall simpler, fairer and more competitive?

4.2 would stakeholders agree to a trade-off between removing existing incentives with other reforms that focused on making the tax system simpler, and more competitive overall?

In principle, yes, we support a simpler, fairer and more competitive tax system. However, we do not necessarily agree that this is achieved by removal tax of tax incentives. Tax incentives – whether or not theoretically desirable – are a feature of all tax systems and removal of incentives could be uncompetitive. For instance:

- It is common for tax exemptions to be provided to workers in the aid sector. It would not be appropriate for this concession to be removed in PNG.

- Tax exemptions for charities, sporting clubs etc are common. It is not clear how removal of these concessions in PNG would improve fairness.

- The deduction available for off-licence exploration expenditure for resource projects is noted as a tax incentive in the TRC paper, but is not even the most favourable incentive for exploration in the region. Australia allows a full deduction for exploration expenditure at the time it is incurred.

- Certain industries need specific incentives in order to develop, eg. agriculture, resource projects and tourism. A fairer and simpler tax regime may not result in any increased investment in these areas due to industry specific issues not relevant to the wider business community.

We believe that misconceptions about tax incentives can be better dealt with by improving the administration and transparency of incentives, rather than removing the incentives.

4.3 do stakeholders agree that there is a need for a framework to guide the granting and management of tax incentives?

4.4 should PNG consider formalizing the process for the granting of tax incentives, similar to the process adopted recently in the Solomon Islands?

4.5 do stakeholders consider that there is a need to create a new body for the carriage and formulation of National Strategic Economic Development Plans in PNG, with part of its role being to ensure that consideration of targeted interventions using the tax system are placed in a broader economic context?

4.6 what stakeholder's views on the proposed principles to guide the award of tax incentives in PNG? Are there any other principles that should be included?

4.7 do stakeholders consider that there is any merit in amalgamating existing incentives into a single piece of legislation or into a part of existing legislation, such as the income tax act?

4.8 which Government portfolio is best placed to have ultimate responsibility for tax incentives?

4.9 do stakeholders agree that the tax incentive report should be given greater prominence in the annual Budget, and include the policy rationale for each inventive? Should a separate report be prepared?

4.10 how can PNG most simply estimate the value of the tax incentives if provided?

4.11 do stakeholders agree that the annual report on the value of the tax incentives should include the value of any taxpayer of project specific incentive?

4.12 do stakeholders agree that there needs to be some effort in evaluating the ongoing value of revenue incentives provided in PNG? Which incentives are most in critical need of evaluation?

PwC supports a formalisation of tax incentives, reporting on the value of incentives, etc. We agree it is preferable to codify tax incentives into the Income Tax Act (for income tax incentives – other incentives could be included in the appropriate revenue law) rather than have a raft of different legislative instruments and private agreements.

In particular, private project agreements contribute to the lack of transparency and understanding of tax incentives in PNG. We favour industry wide concessions, rather than concessions for specific taxpayers, and this is already Government policy in PNG.

If project specific concessions are granted we believe these can be included in the appropriate revenue law (eg Income Tax Act). This is already the case, for example, with the GST concession granted to the Ramu Nickel Project, which is included in the GST Act, and the import duty concessions for the Ramu Nickel Project and the PNG LNG Project, which are included in the Customs and Excise Acts.

Other Issues

5.1 do stakeholders agree that, before any decision is taken to substantially change the ITC scheme (including guidelines) an independent, third-party audit of the scheme is required?

Yes, as discussed above, we believe it is critical that proper consideration is given to the effectiveness of the scheme before making any decision on its repeal or contraction.

5.2 for firms that have utilised the enhanced deduction for R&D that was previously available, how did the incentive promote investment in research and development that would not have otherwise occurred? What broader benefits to PNG and the PNG economy did that research and development produce? How might a future R&D concession be frames differently?

5.3 what value, if any, do the existing research and development incentives (available under section 95) continue to provide?

The key feature of R&D is to encourage innovation. A function of removing the R&D tax concession, while neighbouring jurisdictions – eg Australia – have an R&D tax concession, is that taxpayers are encouraged to conduct their innovation overseas rather than in PNG.

PNG has a number of unique challenges that lend themselves to innovation. Innovation is the reason we have resource projects in remote locations with adverse weather conditions and no public infrastructure. It is important to encourage innovation so that the next projects – whether resource projects or otherwise – can be developed in PNG. As we have noted previously in this submission, the direct cost to the State of a tax incentive needs to be weighed against the benefits that flow when projects proceed, where they otherwise would not.

We note also the recent comments by Jamie Graham, General Manager of Ramu Agri Industries Ltd, that the cost of production of sugar and beef are much higher in PNG than competitors overseas (*The National*, February 19 2015). Mr Graham makes the following comments:

> *"Unlike our overseas competitors, we have to provide our own research into plant and animal health protection, breeding and agronomic improvements.*
>
> *There is no support from government in getting access to new breeding materials and animal genetics both of which we have to acquire from overseas at great expense"*

The objective should be for PNG companies to conduct this research themselves, in PNG, rather than acquiring the information from overseas. While other jurisdictions offer a tax incentive for R&D, and PNG does not, this will always place PNG companies – in the agricultural industry and others – at a competitive disadvantage.

5.4 do stakeholders agree that reform of the corporate income tax, with a view to making PNG more attractive to international investment, should focus on a reduction in overall rates rather than the provision of targeted tax holidays to specific sectors?

As a general proposition PwC agrees that project specific tax holidays are not the most desirable approach and we support a reduction in tax rates in preference to ad hoc tax holidays.

5.5 on what basis should consideration be given to providing exemptions/reductions to GST/Import Duties/ Excise?

PwC has made submissions to Treasury for a number of years suggesting the introduction of a GST import deferral scheme similar to that operated in Australia. In our view one of the key impediments to doing business in PNG is the cash flow cost associated with payment of refundable GST on importation of equipment into PNG, particularly given the usual time taken to obtain a refund of GST from the IRC. A GST deferral scheme is not specifically an incentive, but we believe this should be considered as part of the review of the GST in PNG and we will provide a specific submission in this matter at the appropriate time.

For import duties it is important for PNG to consider whether these are intended to be revenue raising or local trade protection measures. There is a general movement around the world toward lowering and removing import duties – eg via domestic policy, free trade agreements (including the Melanesian Spearhead Group) and PNG needs to remain competitive with other jurisdictions.

5.6 is there value in clarifying, in law, the limitation on tax exemptions available to aid organisations (for example, in clarifying that exemptions apply to the organization and its employees only)?

We agree it would be beneficial if tax exemptions for aid organisations were included in the appropriate revenue law (eg Income Tax Act) for the purposes of both transparency and certainty. There is currently some uncertainty about the scope of aid organisation tax concessions – ie which bodies and employees are eligible for concessions – particularly in the context of subcontractors to the industry. A codified set of rules in the Income Tax Act would introduce greater certainty and simplicity, and assist organisations to comply with the tax obligations in PNG.

5.7 what are the stakeholder's views about the value of GST exemptions provided for individuals employed in relation to aid projects?

PwC agrees that GST exemptions to individuals is not justified and could be repealed.

5.8 should project agreements *not* include a reference to incentives already available in legislation?

In our view a reference in a project agreement to a tax concession that is available in the law is of no particular consequence. While we agree the reference in the project agreement may be of no legal effect, it is not clear why restatement of the law would cause confusion or any other difficulty.

5.9 do stakeholders agree that any provisions in a project agreement purporting to provide tax treatment not generally available under the tax law should be published?

As we have noted above, we believe that any project specific concessions can be incorporated into the applicable revenue law and therefore will be publically available information.