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20 September 2015

Submission: Issues Paper No.8 – Personal Income Tax

Dear Sir / Madam

We write in response to the request for submissions on the Issues Paper No.8 – Personal and Retirement Income Taxation (the Paper) released by the Taxation Review Committee on 31 July 2015. 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

A handwritten signature in blue ink that reads 'Jason Ellis'.

Jason Ellis
Partner



Introduction

PwC believes that reform of personal income taxation is an important consideration as part of the Tax Reform process.

The TRC Paper has identified a number of broad areas for reform and we agree that these represent opportunities for re-aligning the current system of personal taxation towards a structure that will address a key conclusion of the Committee, namely that PNG needs to consider lowering its personal income tax rates.

However, in addressing this overall aim, PwC would like to highlight the following:

- We agree with the TRC paper's focus on the impacts of relatively high personal income tax rates on low income earners. However, we are of the view that the support for lower personal income tax rates needs to also address income levels that represent middle income earners. These salary and wage earners represent a growing proportion of individuals subject to relatively high marginal levels of personal income tax, while at the same time constituting a section of the population that is driving consumption in the economy.
- The impact of a change in tax rates will clearly need to be examined in the context of overall budget policy addressing the question of whether changes to personal income tax are to be revenue neutral. However, in considering the overall impact of a package of reforms (eg a lowering of personal income tax rates in exchange for an increase in GST for example), focus should remain on the impact on low and middle income earners, rather than low income earners alone.
- In the absence of a significant level of other social spending, support through the tax system for redundancy and workplace restructure would seem to be an appropriate aim and a valid target for reform.
- Implementing changes that simplify the tax system should be supported, assuming that the overall policy goals are achieved. In this context, reviewing the extent and availability of rebates and credits should therefore be part of this analysis.
- The taxation of retirement income is part of a very complex intersection of policies on social welfare, the encouragement of a financial investment sector as well as individual taxation. While taxation reform can be supportive in this regard, it should not be a substitute to an overarching policy in this area.

We have addressed these and other matters below, and have commented on each of the issues raised in Issues Paper No.8.



Options for Reform of the tax free threshold and personal income tax rates.

Question 4.1 - Do you agree that adjustment to the tax free threshold is the best mechanism to give tax relief? Do you have any views on whether adjustments to individual marginal tax rates could provide a similar level of relief? And if so, what changes could be made?

While we agree that an increase in the tax free threshold is appropriate, the practical problem with this approach is that the tax benefit flows to all individual taxpayers, not just lower income earners. Assuming an increase in the tax free threshold to K15,000 from the current K10,000, every individual taxpayer will receive a benefit of K1,000 (on the basis that this income is currently taxed at 20%).

The alternative is to provide some sort of rebate or credit (eg a “low income rebate” or similar) that is specifically targeted to people below a certain level of income. This would ensure the benefit is restricted to those lower income earners. However, we acknowledge that the introduction of new rebates, or other form or transfer payment, does add complexity to the tax system and this is at odds with the objective of simplification.

Most importantly, we believe that on its own the increase in the tax free threshold is not sufficient reform to the personal marginal tax rates and further changes to benefit middle income earners are required. We have discussed this further below.

Question 4.2 – What is your response to the Committee’s observation that the tax free threshold could be raised to at least K15,000 as part of a package of possible reforms that include reductions in concessions and removal of rebates and an increase in the GST?

Our principle concern with this suggestion is that the “package” is likely to discriminate against middle income earners and potentially makes them significantly worse off.

As we have noted above, the tax benefit of increasing the tax free threshold is K1,000. Someone claiming full entitlement to, for instance, the dependent rebate (3 or more dependents) can claim a rebate of up to K1,050 per year – accordingly, the removal of the dependent rebate will more than offset the benefit of the increase in the tax free threshold.

In addition, middle income earners will often spend a large proportion of their income on consumption that incurs GST. Accordingly, a package that consists of removal of rebates and an increase in the GST rate, to be offset by an increase in the tax free threshold, will make a large number of taxpayers considerably worse off. We believe that additional tax benefits – eg decrease in marginal tax rates – will also need to be included in the package.

Question 4.3 – What are your views on maintaining the progressivity of the existing marginal tax rates but with adjustments reflecting changes to the tax free threshold and the number of tax bands?

PwC agrees that progressivity of the personal marginal tax rates is generally appropriate. In our view, and as noted above, the change to the tax free threshold is not itself sufficient and further reform to assist middle income earners is also necessary– whether by changing the tax bands or reducing marginal tax rates.



Notwithstanding our conceptual support for progressive marginal tax rates, we do urge the Committee to explore all options and be as creative as possible in considering proposals to increase participation in the tax system. We refer to, for instance, the case where Russia (in 2001) introduced a flat personal tax rate of 13% to replace the previous progressive tax rates and encourage Russians to come into to the tax net and declare all their income. It is estimated that Russians had previously declared only 25% of the income they earned.

The move was a success as tax collections increased by more than 50% in the first year of the flat tax regime.

We do not necessarily endorse the introduction of a single personal tax rate in PNG, but make reference to the Russian example to illustrate that perhaps reform can be achieved through unconventional means. There are some parallels between the situation in Russia 15 years ago and in PNG today. There is clearly a belief in PNG that personal marginal tax rates are high, and we believe this provides a strong disincentive for people to participate in the tax system – whether by not declaring income, or simply choosing not to engage in formal employment.

Question 4.4 – What are your views on the Committee’s proposal that current top marginal tax rate be retained for the time being?

PwC agrees that a reduction in the top marginal tax rate is not an immediate priority. Although the current top marginal rate (42%) is high by international standards, we agree that reform targeting lower and middle income earners is more pressing than a reduction in the top marginal rate.

Nevertheless, as other countries move to reduce income taxes (corporate and personal) it is important that PNG makes a reduction in top marginal rate a medium term priority to ensure the country remains internationally competitive.

Question 4.5 – Do you agree with the proposal that future reductions in the top marginal tax rate be considered in conjunction with reductions to the corporate tax rate?

As we have noted above, we believe it is important PNG’s corporate and personal tax rates remain competitive with other jurisdictions.

We also believe it is generally desirable for the remitted corporate tax rate (ie including dividend withholding tax) to be equal to the top marginal tax rate to prevent any incentive for diversion of income through a corporate vehicle. Accordingly, reductions in corporate tax rate (and dividend withholding tax) should be matched with a reduction in the top marginal tax rate.

Question 4.6 - Do you have a view on whether the number of tax bands should be reduced in number? If so what tax bands are appropriate for PNG?

Question 4.7 – Do you have views on what the marginal tax bands should be and what income levels should they apply?

As we have noted above, we believe that a key priority should be reduction in the tax rates paid by middle income earners.

Without access to modelling of the cost impact of reform we are not in a position to comment on what rates and bands are likely to be feasible, and therefore have limited our comments to the general



observation that rates should be reduced, and it is critical that the reduction targets middle income earners in the K50,000 to K150,000 range. The people in this income range are the key demographic for future growth in employment in PNG – by income growth and workforce participation – and they need to be suitably incentivised.

To illustrate the high level of taxes paid by middle income earners in PNG we have compared the effective tax rates for selected incomes in PNG with the equivalent (in the home currency of each jurisdiction) in Australia, New Zealand and Fiji:

	Effective tax rate on income of 50,000	Effective tax rate on income of 100,000	Effective tax rate on income of 150,000
PNG (PGK)	26%	31%	34%
Australia (AUD)	17%	27%	31%
New Zealand (NZD)	17%	25%	28%
Fiji (FJD)	11%	15%	17%

The comparison jurisdictions selected above are not necessarily the most appropriate, but are provided for illustrative purposes. It is particularly interesting that the Fiji rates are much lower than PNG, and this reinforces the comments in your issues paper that PNG, as a developing economy, is over reliant on salary or wages tax.

Albeit without any data to cost a reduction in tax rates, we believe, conceptually, that a range of 15% - 25% as an effective tax rate for income between K50,000 and K150,000 (compared to the current 26% - 34%) would be more appropriate.

We also recommend that the tax rates / tax bands are either indexed or regularly reviewed to ensure that the benefits of reduced rates are not quickly offset by bracket creep as PNG develops and wages increase.

Question 4.8 – To what extent are non-resident salaries likely to be grossed up?

In our view the gross up of salary for non-residents (or residents) is generally tax (revenue) neutral. Assuming the employee is on the highest marginal tax rate, the additional deduction for the employer of grossing up the income is tax deductible at the same rate (including dividend withholding tax) as the additional salary or wages tax. Accordingly, there is no additional cost of employment that results from the grossing up of the salary, and there is no additional (or lost) revenue to the State.

Question 4.9 – Do you agree with the Committee’s recommendation that resident and non-resident tax rates and threshold be harmonised?

In our view this would have very little impact on revenue collection in PNG as there are a limited number of taxpayers working in PNG on the non-resident rates. A “resident” includes a person present in PNG for more than one-half the year of income and this captures the majority of salary or wage earners in PNG.

In our experience those employees on the non-resident rates (eg because they are present in PNG for less than one-half of the year of income) are likely to be tax equalised (or “grossed up”) for PNG taxes and, as we have discussed above, this results in a revenue neutral outcome for PNG.



Options for Reform of the Tax on Termination Payments

Question 5.1 – Should the taxation of redundancy payments in cases of medically caused retirements be taxed more lightly? What do you think the policy rationale should be for reducing tax on redundancy payments in this situation?

PwC has previously made submissions to Treasury in support of a tax concession for early retirement schemes and we believe this type of scheme could be designed to cover a medically caused retirement.

We believe the objectives of assisting retiring employees with retirement savings, assisting businesses to smoothly restructure their workforce, and providing opportunities to younger Papua New Guineans are matters of benefit to PNG, and therefore justifiably supported through the tax system. We also believe that a tax concession for retirement termination payments is consistent with the current policy of providing tax concessions for superannuation, and that policy to provide financial assistance to Papua New Guineans in retirement is fundamentally sound.

Question 5.2 – Should Section 46CA be amended to remove the 30 person redundancy requirement as discussed? If so what integrity measures should be applied to ensure only genuine redundancy is covered?

PwC believes the 30 person requirement should be removed. It unfairly discriminates against employees of small businesses, or cases where less than 30 people are made redundant. It is not clear to us what the policy justification is for providing a tax benefit to an employee as part of a 30+ person redundancy, but not to an employee who is genuinely redundant but whose employer does not qualify.

We also believe the requirement for a redundancy scheme to be approved by the IRC in advance should be removed. In our experience the time taken to obtain approval of a redundancy scheme often makes it impossible to access the tax benefit. In many cases employers want to move quickly with a redundancy program and are not in a position to wait for approval. The requirement that approval be obtained in advance of making any payments under the scheme simply makes the tax concession unavailable.

We acknowledge that both of our suggestions on this point will present integrity issues. In our view this needs to be dealt with via compliance enforcement by the IRC (ie audit), while allowing employers to “self-assess” the availability of a tax concession. We would be receptive to some form of notification requirement – whereby an employer is required to give notice to the IRC but not obtain approval in advance of the payment. This would give the IRC sufficient information to appropriately direct their compliance enforcement resources.

Question 5.3 – If concessions are to remain should Section 46CA be replaced by a simple Kina cap on the amount of termination payments subject to the concession?

PwC supports simplification of the tax concession provided the simplification does not result in a reduction in the tax benefit that is available.

In our view a redundancy (and early retirement) tax concession is an important feature of the tax law in PNG. PNG does not provide a social welfare safety net – eg support during unemployment or retirement – and it is appropriate that tax law assist employees with a tax concession in the case where they are made redundant or retired.



Question 5.4 – Should the taxation of termination payments be determined according to the length of service an employee has with his/her employer? Should the age of an employee be another consideration in the provision of tax concessions?

Conceptually, we do not support the determination of the amount of the tax benefit by reference to length of service with a particular employer. This discriminates against people that have recently changed jobs. For example, if two people with the same job description in the same office, on the same salary, and of the same age, are both made redundant they should enjoy the same tax concession. There should not be a different outcome because one joined the employer more recently (perhaps after many years of service with another employer – ie they are penalised only because they recently changed jobs).

We do agree that age should be a factor as it will generally be more difficult for older people to find alternative employment and they should therefore be entitled to greater “public” support via the tax system.

Question 5.5 – Should long service leave be included in any new arrangements or should it continue to be taxed under the existing tax rules?

PwC believes that the calculation of the concessional amount in section 46CA is overly complicated, and unreasonably restricts the benefit available, and it would be appropriate for all amounts paid on termination of employment (including accrued leave, ex gratia amounts, etc) to be eligible to be taxed concessionaly.

Reform of Rebates and Credits

Question 6.1 – For the purpose of simplifying the system for PIT and business, should the dependants rebate be abolished and folded into the standard tax rates?

Question 6.2 – What are your views on removing school fee rebate and rolling the savings into lower tax rates?

Question 6.3 – Do you support the removal of the salary and wage expenses rebate and rolling the savings into lower tax rates?

Question 6.4 – Do you agree with the Committee’s reasoning that the election expenses rebate be retained?

Question 6.5 – Do you support the removal of the rebate on non-salary and wage loss?

PwC does not have any conceptual objection to abolition of the dependent rebate provided affected taxpayers are suitably compensated via reduction in standard tax rates. In our experience the dependent rebate is widely used by people in formal employment in PNG and its removal will cause hardship if proper compensation is not provided. As we have noted above, a small increase in the tax free threshold will not be adequate compensation.

We believe that education is a key priority for PNG. While school fees paid by an employer are exempt from tax, not all employers are prepared to offer remuneration packaging options that allow employees to take advantage of the exemption, and these employees may rely on the school fee rebate. It is important that tax reform measures do not reduce the access to education in PNG



Question 6.6 – Do you support the current arrangements in the Income Tax Act for the relief of double tax?

PwC believes it is important that the tax law provides for relief of double taxation and the current rules should be retained. We are not aware of any significant issues with the current rules that would require reform.

The Taxation of Fringe Benefits

Question 7.1 – The Committee welcomes stakeholder comments on the taxation of non-cash benefits including suggestions for changes to the existing taxation of benefits that would improve the overall fairness and administration of PNG’s personal income tax system.

Question 7.2 – Do you agree that the taxable value of the housing allowance should be adjusted to take account of changes in house values and rentals in PNG?

PwC believes that housing affordability is a key challenge in PNG and we do not support an increase in the prescribed deemed values of housing. In our view this will serve to increase the cost of housing to employees (via a higher tax cost) and further marginalise the ability of employees to secure suitable, affordable housing.

In Issues Paper No.8 the TRC has raised the question of whether the current prescribed taxable values for housing should be increased because they do not properly reflect the value of the benefit. The Paper justifies this (in part) with the implication that the below market prescribed values encourage the selection of rental accommodation over home ownership.

The Issues Paper does not explain the view that the prescribed values encourage people to choose rental accommodation instead of home ownership and we do not believe this is the case. The application of the prescribed values can be secured either for rented or owned properties (via a housing allowance variation) and the tax treatment is the same in both cases.

Again, we are particularly concerned about the impact that removal of the housing tax concession will have on middle income earners. Removal of the housing tax benefit, increasing the GST rate, and removing the dependent rebate, will directly affect this group. Unless they are provided with significant reductions in tax rates they are likely to be considerably worse off under the package of reforms that it being discussed.

The issues paper also notes that an increase in the taxable value of housing may discourage mobile labour to PNG and we agree with this concern. Affected people do not view the value of the accommodation benefit they receive as being equal to the actual cost of the benefit (given the high cost of housing in PNG)– the value of the benefit to them is based on the equivalent housing in their home jurisdiction. Or in fact may be nil, because the accommodation serves no purpose other than a “place to stay” while in PNG, and they maintain a home at their own cost in their own jurisdiction. In practice, taxation of the PNG benefit at actual cost would require additional compensation from employers, and therefore increase the cost of labour in PNG.



Taxation of Investment Income

Question 8.1 – Do you have any comments on the taxation of investment income?

PwC has previously submitted that the dividend withholding tax rate in PNG is too high and should be reduced. We have also suggested that the incidence of dividend withholding tax could be altered so it applies when a dividend leaves a wholly owned group (or PNG) rather than applying to the first dividend paid within a group of companies.

Taxation of Retirement Benefits

Question 9.1 - Do you have any comments on the taxation of contributions to Superannuation Funds?

Question 9.2 – What transitional rules do you think would be required if the mandatory employee contributions of 6 per cent were made tax free?

PwC agrees with the suggestion in the Issues Paper that the current compulsory 6% employee contribution could instead be made from pre-tax earnings. In our view this will assist employees to make a greater contribution to their retirement savings and will make the taxation administration of superannuation simpler.

We agree with the point made in the issues paper that voluntary additional pre-tax contributions are not currently common. However, we still believe that the current 15% “cap” on pre-tax contributions should be increased. This will become increasingly important if the mandatory pre-tax contribution is increased to 14.6% to provide flexibility for employees to make additional contributions to suit their circumstances. While this may option may not often be taken now, we expect it will become more desirable as the current generation of employees begin to plan for their retirement. On the basis that the ability to made additional contributions is not commonly taken up there is no revenue cost of increasing the limit, and we believe this opportunity to make the amendment should be taken up now.

Question 9.3 – What are the consequences on superfunds of current earnings tax?

Question 9.4 – Do you have any examples of the taxation retirement benefit withdrawals where there are inequitable outcomes for retirees?

Question 9.5 – How can RSAs be made more attractive for retirees as a way to manage their income during their retirement?

Question 9.6 – What tax changes could be introduced to encourage the take up of pensions in PNG? What features or aspects should pension accounts have and which are not already available in RSAs? How could or should market risks be managed?

If there is a reduction in the current 30% corporate tax rate (e.g. to 25%) we believe there should also be a reduction in the tax rate applying to superannuation funds to preserve the concessional tax treatment of contributions to funds.



Other Issues

Question 10.1 – Should the definition of residence for tax purposes be revised? Are there any issues associated with using the 183 day rule discussed above?

PwC does not believe any particular issues are presented by the current definition of resident in section 4 of the *Income Tax Act*. This definition already has the effect of deeming a person who is in PNG for more than one-half of a year of income to be a resident and in our view amendment to the definition is not a priority.

Question 10.2 – Withholding tax regimes need careful analysis, taking into account PNG circumstances. In particular, are the incentives for tenants to comply with these rules greater than those landlords to comply with the existing rules including potential TIN matching?

Question 10.3 – What would be the issues associated with the developing a rate that would collect a suitable amount of tax while limiting the need for the extensive issue of refunds?

We concur with the concern that many landlords are not declaring rental income and are not in the tax system. In our view the amendments in the 2015 National Budget to require landlords to provide a TIN before a lease agreement can be stamped are unlikely to have any impact on compliance – it seems unlikely that non-compliant landlords will seek to have agreements stamped.

We do not believe that imposing a broad withholding requirement on tenants will be practical. While corporate tenants may be in a position to understand and comply with such a requirement, it seems unlikely that individual tenants will have the desire or capability to register as withholders and make regular remittances to the IRC.

PwC believes this matter is more appropriately dealt with by IRC compliance enforcement activity directed at landlords. Shifting the tax burden to tenants is likely, in our view, to result only in non-compliance by tenants and require even greater levels of compliance enforcement by the IRC.