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Submission: Issues Paper No.9 – Goods and Services Tax

Dear Sir / Madam

We write in response to the request for submissions on the Issues Paper No.9 – Goods and Services Tax (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

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Introduction

PwC agrees that GST is an important part of the revenue base in PNG and we acknowledge that the current rate of 10% is low compared to other developing nations.

However, in considering the merits of an increase in the GST rate it is important that proper consideration is given to who will be most affected. By its nature the GST is “regressive” in the sense that lower income earners will generally consume a higher proportion of their income, and therefore pay a higher effective GST rate (measured against income). Given the large informal sector in PNG it seems likely to us that a significant amount of the GST burden falls on the same group as are supporting the personal tax system – ie those in formal employment are likely to be paying a large proportion of the GST.

Accordingly, an increase in the GST rate and reduction in personal tax rates may have the effect only of shifting the tax from income to consumption of the same group of people, and not necessarily broadening the tax base. In an event it is critical that concessions - eg income tax reductions – will properly compensate for any increase in the GST.

On the other matters raised in the paper:

- PwC supports the introduction of a GST import deferral scheme in PNG.

- PwC does not agree with the suggestion that zero rating of supplies to resource companies should be removed. It is not clear to us that this measure will simplify compliance enforcement for the IRC, and in fact will increase the risk that refunds are issued to resource companies of GST that has not been paid by contractors.

- If zero rating of supplies to resource companies is removed we believe it is essential that this is done in conjunction with the introduction of an import deferral scheme and a formalised process for timely issue of GST refunds. If resource projects are required to pay GST on their imports this will affect investment decisions for future projects.

- PwC believes that the supply of education should be zero rated rather than exempt to improve the affordability of eduction in PNG.

We have addressed each of the matters raised in your issues paper below.

Maintain GST as an important part of PNG's revenue base

1.1 Do stakeholders agree that GST should continue to be an important part of PNG's revenue mix?

PwC agrees that GST is an important part of the revenue base in PNG and should continue to be so.

The Design of (the) GST System

2.1 Is the current scope of zero-rating appropriate? Is there any item which should be changed, deleted or added? Are there better ways of achieving the intended concessions?

PwC believes that education services should be classified as zero-rated supplies.

Educational services are currently treated as exempt supplies for GST purposes in accordance with Division 7 of the GST Act. Subsection 25(5) provides that:

The supply of educational services by an educational institution including –
(a) tuition; and
(b) boarding services provided by the educational institution pursuant to the provision of tuition; and
(c) text books, or writing materials; and
(d) other educational materials reasonably relevant to the purposes of education
is exempt from tax under this Act

An educational institution is defined in subsection 25(6), and includes, inter alia, a school, teachers college, technical college, vocational centre and a place of tertiary education.

The consequence of educational services being treated as exempt supplies is that:

1. The service is exempt from GST when supplied to the consumer (section 8 of the GST Act);

2. Educational institutions are unable to claim a deduction for input tax paid on the acquisition of supplies for the purpose of making the exempt supply (subsection 31(14) of the GST Act).

However, notwithstanding subsection 31(14), subsection 31(16) then goes on to allow a deduction for input taxes paid on the acquisition of "*... text books, writing materials and other education materials reasonably relevant for the purpose of education ...*".

It is submitted on behalf of the institutions we represent that the denial of input tax deductions to educational institutions is an unjustified cost imposed on the provision of education. It is a cost which is ultimately borne by the consumer of the education services, to the detriment of education in Papua New Guinea.

Accordingly, we believe that education services should be treated as zero-rated supplies in accordance with Division 6 of the GST Act. In the alternative, the scope of subsection 31(16) should be extended and clarified to provide greater meaning to the term "other educational materials"

There is a perception that an exempt supply, which is not expressly charged with GST is not "taxed", but in reality this is not the case. Because of the nature of the GST being levied at each stage of the supply process, and the denial of a deduction for input taxes paid by the provider of an exempt supply, the pricing of that supply is necessarily inclusive of the GST paid by the provider. Accordingly, the classification of education as an exempt supply in PNG means that education is taxed, and therefore this affects the affordability of education in PNG. Given the importance of education for the future of PNG we believe it is critical that education is made as affordable as possible, and assistance with this objective via tax policy is appropriate.

In the event it is not considered appropriate to classify educational services as zero-rated supplies, we submit that the scope of subsection 31(16) be extended and clarified. Subsection 31(16) currently provides for educational institutions to claim deductions for input tax paid on:

- Text books;
- Writing materials; and
- Other educational materials reasonably relevant for the purpose of education.

The implication from the phrasing of section 31(16) may be that "other educational materials" would include classroom supplies and similar items, but would not extend to, for instance, the cost of renting premises in which educational services are provided. We note that a contrary interpretation of the law could quite reasonably be reached – ie that a classroom is itself an educational material which is as integral to the provision of education as a pen and paper. However, the scope of the law is not clear, and in particular it is uncertain what is meant by other educational material.

Not only does the current form of subsections 31 (14) and (16) result in the taxation of educational services, but they also add complexity and substantial compliance burden for educational institutions to identify relevant expenditure with differing tax treatments. It also seems likely that the uncertain scope of subsection 31(16) would results in differing treatment between institutions.

In any event, it is submitted that from a policy perspective there is no justification for arbitrarily separating the inputs into those which are more or less relevant to the provision of education. The classroom building itself is no less relevant to education than are text books and writing materials. Accordingly, we submit that subsection 31(16) should be amended to make it clear that an educational institution can claim a deduction for input tax paid on property costs, including rent / lease payments, electricity and water costs and telephone expenses.

2.2 Is the current scope of exempt supplies appropriate? Is there any item which should be changed, deleted or added? Are there better ways of achieving the intended concessions?

As noted above, and for the reasons discussed, we believe educational supplies should be treated as zero rated supplies rather than exempt supplies.

2.3 Is the current registration threshold of K250,000 too low or too high? Do stakeholders see a need to increase (or decrease) the threshold?

PwC believes the current threshold is appropriate.

2.4 Is the option for voluntary registration bringing in too many tax payers below the threshold into the GST system?

In our experience taxpayers below the threshold do not typically voluntarily register for GST.

Challenges for the GST

3.1 What would be the benefits and problems of changing the current arrangement so that only exports by resource companies are zero-rated? Would this improve compliance with the policy intent underlying the existing concession?

PwC does not support the removal of zero-rating classification for supplies to resource companies. While we acknowledge that the current arrangement may be unique to PNG, there are sound reasons for the current treatment. In particular:

- Notwithstanding the concerns around fraud and abuse under the current arrangement we believe the current arrangements were introduced, and continue to operate, as compliance enforcement and revenue protection measures.

  A large number of contractors to the resource sector are engaged on single contracts and have a short term presence in PNG. Zero-rating the supplies they make to their resource sector client means they will be in GST refund position and therefore encourage them to register as taxpayers in PNG to reclaim the GST input tax they pay. If they are required to charge GST they may be disincentivised to register as taxpayers in PNG.

  If the refunds are pushed from contractors to the resource companies there is a risk the IRC will be issuing refunds to the resource companies of GST that has not been collected from the contractors – ie because of poor compliance by the contractors. In our view changing the current arrangement will in fact require a greater level of compliance enforcement by the IRC at the contractor level to ensure revenue collection is not compromised.

- In the current environment where refunds are not made on a timely basis by the IRC the requirement for resource companies to pay GST on their acquisitions is likely to have a significant cash flow impact. While this is important for all resource companies it particularly important for projects in the stages of exploration and construction, while no revenue is derived, where cash flow is critical for continuing operation.

- There is currently no GST import deferral scheme in PNG and the imposition of GST on the importation of high value equipment by resource companies – coupled with the inability of the IRC to make timely refunds – will have a significant adverse impact on projects. Unless this is properly addressed we believe the cash flow impact of a project being required to pay GST on importation of high value equipment during construction would affect the viability of future projects in PNG.

Accordingly, it is our view that the current treatment of supplies to the resource sector as zero rated should be retained. In the event that the treatment is changed, the following need to be implemented at the same time:

1. A statutory time frame for issuing refunds from the date of lodgement of GST returns – eg 14 days – with interest applied to the benefit of the taxpayer for late refunds.

2. The introduction of an import deferral scheme for GST. We have discussed this further below.

To the extent that it is believed the current system allows fraud and abuse we believe this should be tackled by better compliance enforcement by the IRC rather than simply pushing the compliance / cash flow burden onto resource projects.

3.2 Do stakeholders agree that the refund system is slow and open to abuse? Will making the system simpler and fraud-proof by reducing the number of taxpayers due for refund improve the system?

We agree that the process for the refund of GST is slow and causes cash flow difficulties for taxpayers. However, it is not clear to us that there is extensive fraud and abuse in the current system.

In any event, as we have noted above, moving the refunds to resource projects increases the risk that refunds of GST are provided to the projects for tax that is not paid into the system by non-compliant contractors. In either case the solution is better compliance enforcement by the IRC and changing the system will not, on its own, address the problem. In fact, it seems likely that, if zero-rating to resource companies is removed, even greater levels of compliance enforcement will be required at the contractor level to prevent loss of revenue to the State.

3.3 Do stakeholders agree that exemptions for schools under Section 31(16) of the GST Act be removed?

For the reasons we have discussed above we believe the scope of Section 31(16) should be expanded, rather than removing the input tax credits currently allowed to schools.

The fraudulent exploitation of Section 31(16) has not been substantiated in the Issue Paper and PwC is not aware of any instances of such fraud.

Possible Reform Directions

5.1 Would stakeholders support, in principle, an increase in GST to either 12.5% or 15%, as part of broader efforts to reduce PNG's reliance on income taxes (notably personal income taxes) and spread the tax burden so everyone pays their fair share? Who would be the most severely affected by an increase in the rate? How could these impacts be managed?

In principle PwC agrees that reliance on income taxes needs to be reduced. However, it is not clear to us that the tax base is broadened by an increase in the GST rate. Although we do not have access to statistics and modelling that would provide a clearer picture, it seems likely that GST is paid largely by those in formal employment, and those not in formal employment are more likely to acquire their consumption from unregistered suppliers (ie with turnover below the K250,000 threshold).

Accordingly, exchanging a reduction in income tax rates for an increase in the GST may have the effect of simply moving the tax burden from income to consumption of the same, small, group of taxpayers in PNG. While this may have some merit – eg in encouraging saving by taxing consumption instead of income, it is not clear to us that this will expand the tax base.

As we have discussed in the submission we made on the Personal Income Tax Issues Paper our principle concern with an increase in the GST rate is that those most affected will be middle income earners – for instance in the K50,000 to K150,000 range of annual income – who likely consume a large part of their income and are in the formal sector. If there is an increase in the GST rate it will be critical that this group is properly compensated via income tax rate reductions. A small increase in the tax free threshold will not be sufficient.

The focus of the GST and PIT issues papers seems to be on low income earners, and not on middle income earners. While it is of course important that low income earners are not disadvantaged, it seems likely to us that the lower the level of income, the more likely the person will be consuming outside of the registered, formal sector, and therefore not paying GST in any event. It is middle income earners that will consume a large proportion of their income in the formal sector and therefore will be most affected.

5.2 What are the benefits in implementing a flat rate GST system for small businesses? What problems might it arise?

PwC agrees that a simplified tax system, potentially including a flat rate GST, may be appropriate for small business. We would not support a flat rate GST as a more general proposition.

5.3 What would be the impact of changing the administration of zero-rating to bring it in line with the international best practice for GST?

In the current environment, with slow processing of GST refunds and no import GST deferral scheme a likely impact is that proposed resource projects in PNG will not proceed.

We do not agree with the assertion in the Issues Paper (page 37) that *"… while these cash flow impacts are real they are proportionately small …"*. The impacts may be proportionately small in the context of the overall tax system, but are not small in the context of any single project. If GST is required to be paid on importation of equipment for construction of new projects we believe this will have a direct impact on investment decisions for the projects.

5.4 Is a deferral scheme useful in PNG? What safeguards would be required to implement such an arrangement?

The requirement for taxpayers (importers) to pay GST on importation and subsequently seek to have the same GST refunded by the Internal Revenue Commission (IRC) presents a number of practical issues for taxpayers and the IRC, including:

- The need for taxpayers to fund the additional cost of GST advanced to the IRC on importation – even if only until lodgement of a GST return– is an additional cost of carrying on business in PNG, and decreases the attractiveness of PNG for international investment. This cost can be potentially significant if the goods imported are of high value.

- The IRC and Customs are required to manage the administration and collection of GST, only to refund the same GST to the taxpayer. Accordingly, a considerable amount of IRC and Customs resources are being directed toward management of a tax that results in no revenue being collected by the IRC.

- The administration required from the IRC often results in considerable delays in refunding GST owing to taxpayers – sometimes over many months or years – and therefore the cost of funding this GST for taxpayers is increased.

- One of the fundamental characteristics of a GST is that the tax should not be a cost to business. However, the cost of funding import GST is a significant cost to taxpayers that comply with the law.

With the increase in economic activity and foreign investment in PNG we are frequently seeing that funding GST on importation is not only a project cost, but a potential barrier to entry into PNG for our clients and prospective clients. Given that GST collected on importation is refundable, and therefore results in no net revenue to the IRC, this seems to be an undesirable outcome.

In our view there is no reason that a GST import deferral scheme should present any risk to the revenue. In Australia, where a GST import deferral scheme is operated, participation in the scheme is subject to an application and approval process conducted by the Australian Taxation Office (ATO). The approval can be refused or revoked at any time by the ATO due to poor tax compliance by the taxpayer with other tax obligations. A similar approval system could be operated in PNG so the IRC will retain control over who can participate in the scheme, and they can revoke approval where, for instance, a taxpayer fails to adequately comply with the requirements of any other tax law.

The introduction of a GST deferral scheme will be revenue neutral, will facilitate investment in PNG, and will relieve the IRC of a significant administrative burden that currently generates no net revenue.

The introduction of an import deferral scheme is even more critical if zero rating of supplies to resource companies is to be removed. Resource projects are one of the largest importers of goods and equipment into PNG and the value of their imports – particularly during construction – is very high. If GST is imposed on the importation of this equipment, without a deferral scheme, it will add a significant funding cost to a resource project in PNG and will affect future project investment decisions. As a result we would expect future projects would then seek specific exemption from import GST in their project agreements which we understand is not the preferred approach to dealing with fiscal terms for major resource projects.

5.5 What further organisational arrangements would facilitate improved cooperation between IRC and PNGCS?

This is a question that needs to be addressed by the IRC and PNGCS to ensure that GST is refunded on a timely basis. From our perspective it clear that suitable arrangements are not currently in place.

We underdstand that collection of import GST is a performance metric on which PNGCS is currently assessed. Given that import GST is prima facie refundable, and is therefore not revenue for the State, it does not seem appropriate to us that the amount collected should be a performance metric.

It is also apparent that the separation of the IRC and PNGCS, and lack of accountability for the GST collected by PNGCS, makes the funding of GST refunds by the IRC problematic. If an import deferral scheme is not introducd we recommend that the process by which import GST is collected, recorded, and refunded be reviewed and revised. In particular, GST collected by PNGCS should be specifically directed to the IRC for refund to taxpayers and not taken to consolidated revenue.