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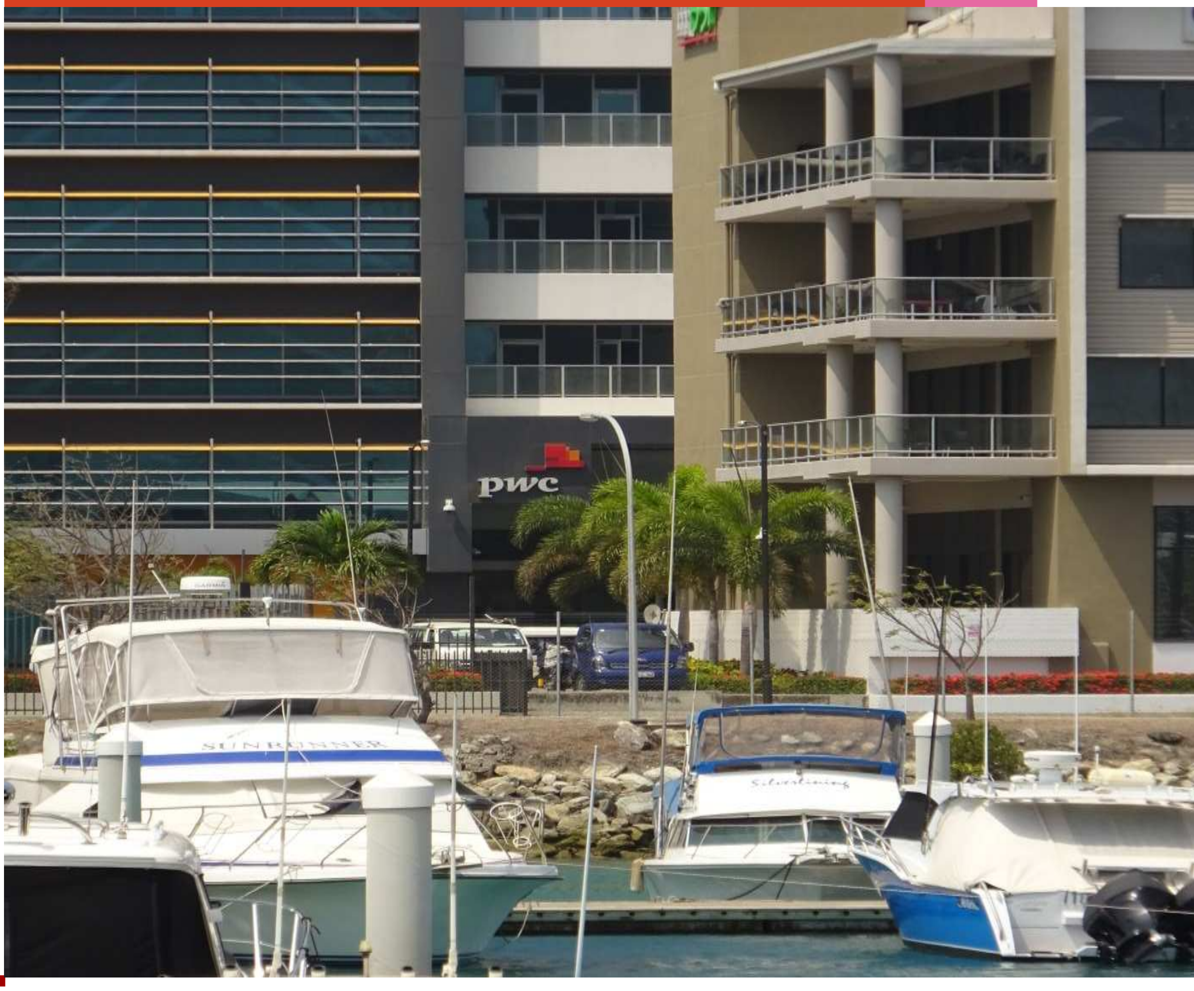
Shaping the Future of Tax Reform

Report of the Tax Review Committee

November 2015



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In October 2015, the Tax Review Committee presented its final report. The timing was significant in that it was released less than one week before the 2016 budget was handed down, but almost six months later than the original schedule. As a result, the committee's findings were almost without exception not incorporated within the budget.

Nevertheless, the 91 recommendations that form the heart of the report have the potential to significantly change the landscape of tax legislation over the coming years with a broad five year horizon for changes proposed by the review committee. The current review is the first significant and comprehensive review of the taxation system in PNG since 2000. The background for the review was an acknowledgement that the underlying economy has changed significantly in the intervening decade and a half and a review of the fiscal priorities and position of the Government of PNG was timely.

The terms of reference for the review noted that the growth in the economy generally is currently not sufficiently translating into a sufficient or appropriate fiscal yield and identifying mechanisms to rebalance fiscal contributions was a priority.

As the main driver of economic development in PNG, the resource sector was particularly in focus. The committee set out to examine whether the return from these non-renewable resources was sufficient, and concluded that more needed to be done to ensure that windfall gains are appropriately captured and leveraged for deployment in the medium and long term development of the country.

Other features of the review were an examination of the balance between direct and indirect taxation, the transparency associated with fiscal policy as well as the impact of the fiscal system on the government's priority policy objective of developing small and medium enterprises.

During the nearly two years that the committee was working, over 100 written submissions were received responding to the various issues papers presented by the committee. The committee also sought to have a wide ranging consultation process. Nevertheless, the underlying positions taken in the issues papers have effectively continued through to the content of the final recommendations. It is difficult to trace specific responses to issues or items raised as part of the consultation process through to the body of the final report.

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The Findings

Unsurprisingly, the review concludes that the tax regime lacks an overarching framework of policies to provide direction and guidance and is the result of years of evolution in an ad hoc manner. As such it has become alienated in a number of ways from the current realities of PNG society and the pace of change within the community has outstripped the capacity and effectiveness of the tax regime. Another conclusion was that the Revenue Administration operates under significant challenges relating to a lack the skills and funding to perform their duties. This has contributed to the low rates of revenue collection. There has been considerable under investment in improving and modernising the IRC and PNG Customs.

The balance of taxes collected relies too heavily on salary and wages tax. To provide context, the report notes that fewer than 400,000 individuals are taxpayers from a population of approximately 7.5 million. Consequently, high personal income tax rates provide a disincentive for people to enter formal employment.

PNG's corporate income tax rate is not regionally competitive. It remains at the higher end of corporate rates regionally and is high when compared to similar countries. However, it was noted that effective tax rates for some companies are low because of the use of tax incentives and the absence of a capital gains tax. The review concluded that PNG should enact reforms to enhance the fiscal returns from the resource sector. However, the review acknowledged that this should be accompanied by a reduction in state equity participation in projects in line with efforts to capture resource rents through fiscal measures.

Corporate and personal tax bases should be broadened to be able to reduce rates overall

The corporate and personal tax bases should be broadened to enable an overall reduction in rates overall and the mix of tax take between direct and indirect taxation should be rebalanced with a move to increase the take coming from indirect consumption taxes as a more stable alternative to direct taxation. It was noted that the GST rate was comparatively low.

The review concluded that tax incentives had been over used and are not well targeted. It was concluded that incentives had little or no effect and there is a lack of clarity around the cost of foregone revenue from incentives. Hence it is difficult to properly assess their merits. There is also a lack of clarity on the basis for introduction of the incentives and which industries should benefit. PNG's tax system is not well suited to the development of small business. Compliance obligations are complex and costly and they form a barrier to entering the formal business sector.

The Recommendations

The report presented by the Tax Review Committee includes 91 recommendations.
They were presented in a number of categories reflecting some of the broad themes of the review's structure. Some are quite specific and absolute, for example the abolition of the Training Levy – based on the conclusion of the committee that it has failed to achieve its aims. Other recommendations are more directional, for example "to strengthen and simplify transfer pricing rules".

The report presented by the Tax Review Committee includes 91 items

Importantly, the committee does emphasise that changes to the tax system should not be considered in isolation and the report cautions against cherry picking and implementation of individual recommendations in isolation. Nevertheless, there is the potential for significant changes to the fiscal environment for taxpayers in PNG over the coming years. If the majority of the recommendations are implemented, it seems likely that future resource projects will be required to bear a higher fiscal burden, whereas low to middle income salary and wage earners may have their share of the tax burden slightly reduced. A summary of some of the key items covered in the recommendations are covered in the paragraphs below, but all taxpayers current and prospective would be well advised to consider the implications to their operations.

Revenue Administration

There are 21 recommendations in this area, which makes it the single largest source of the report's recommendations. The items are grouped around three themes. There is a view that the Revenue Authorities need a better policy focus for their actions and this could be enhanced by the introduction of a Central Revenue Administration Board, which would act as a driver for change and development. The second theme is the need for additional skills, training and resources for the IRC and Customs. The view is that the current establishments are unable to properly execute their roles. Finally, the revenue should overhaul technology and look to modernise their tax filing and systems management.

Personal Income Tax

The recommendations target a number of aspects of personal income tax namely, rates, rebates and taxable benefits.

In the area of rates, there is a proposal to increase the tax free threshold, initially to K15,000 and then to K20,000 and at the same time reduce the number of tax bands with the current 22% marginal rate being reduced to 20%; the top rate remains at 42%.

To offset the reduction in the tax collected, the review recommends the elimination of the rebate on education expenses, which would leave only education provided as an employee benefit by employers to enjoy concessional tax treatment. Another change proposed to benefits is to significantly increase the taxable value of accommodation benefits, from the current levels (a maximum of K700 per fortnight for high value accommodation in Zone 1) to 50% of the value of the housing costs being included as a taxable benefit in five years' time. Should this be introduced, it would have a significant impact on the tax costs of providing housing and it would be expected to have a flow on effect into the housing market at least in major centres.

The review also proposes a broadening and simplification of the treatment of redundancy payments. However, there are no recommendations covering retirement income and the treatment of superannuation, with this identified as worthy of a separate and comprehensive study in the future.

Corporate Income tax

The overall theme for corporate income tax proposed changes is to increase the overall tax burden on resource companies, with a reduction in the general corporate income tax rate. The recommendations also reflect an overarching theme for the report around eliminating tax incentives to produce a simpler, more transparent overall system. The recommendations in this sector of the report are potentially far reaching, however, there is acknowledgement that change would need to be carefully managed over the medium term to achieve the overall objectives.

Recommended changes include:

- A reduction in the corporate income tax rate to 25% for resident companies and aligning the rate for non-resident companies on a post dividend basis
- All dividends (including for resource companies) should be taxed at 15%, subject to treaty rates and this should be aligned with 15% withholding tax on interest
- The 2:1 debt to equity thin capitalisation ratio should be applied for all sectors, eliminating the higher ratio currently applicable to resource companies
- Training levy and the double deduction for training (apprentices) should be abolished
- Self-assessment should be introduced as soon as possible
- Accelerated depreciation should be abolished

There were other items that will be continued or streamlined including maintaining FCWT, simplifying and strengthening transfer pricing rules, and simplifying depreciation. In the light of the global BEPS review, it was also recommended that PNG put on hold the negotiation of any further tax treaties.

Mining and Petroleum Taxes

One of the strongest themes in the report is a view that the level of taxation on resource projects is insufficient to provide an adequate return for the government of PNG from projects exploiting non-renewable resources of the country.

However, coupled with the recommended changes to taxation is recognition that the equity participation by the state should be reformed. The review proposes a limit on state equity participation of 5% against the current level of 22.5% for petroleum projects and 30% for mining projects, shifting the government take from being through equity participation to a more direct taxation role. This would signify a major shift in policy. The nature of the tax changes recommended also reflects the change in emphasis to the collection of resource rents through the tax system.

Recommendations include;

- Alignment of the fiscal regime applying to the different sectors of the industry (mining, oil and gas) with a 25% income tax rate and 15% dividend withholding tax.
- Application of Additional Profits Tax on new projects in all resource sectors (oil, gas and mining) with a similar structure to that currently in place
- To remove the double deduction for exploration expenses for mining projects
- To remove the 10% annual cap on the deduction of exploration expenses
- To pro-rate the deduction for depreciation in the first year of operation rather than a full year being allowed
- Use a field gate valuation method to calculate royalties for oil and gas projects.
- To limit the government's ability to grant fiscal stability agreements, including preventing the use of "most favoured project" rules.

The overall trend towards reducing or eliminating special arrangements or contract specific provisions and policies is also echoed more generally when it comes to the recommendations around the availability and use of tax incentives, in particular the committee's stance on Infrastructure Tax credit programs (see below).

Tax Incentives

Generally, the view of the tax review committee is that the use of incentives has been widespread and largely ineffective at promoting favourable policy objectives. Rather, incentives are seen as distorting the tax system with a lack of transparency about the operation of the incentive and the value of any tax forgone.

Hence the recommendations are to significantly limit the role and scope of incentives.

They recommend the establishment of an Economic Development Board to provide oversight and transparency over the grant of incentives. The board should also have the role of evaluating and monitoring the use of tax and other incentives and the publication of a list of those benefitting from any incentives in order to aid transparency. A specific recommendation was for the suspension of the infrastructure tax credit scheme for new projects.

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Finally, the tax review committee recommended that any and all incentives be consolidated into the tax law to ensure the legal basis is clear.

Capital Gains tax

The importance of the introduction of a capital gains tax was addressed by the tax review committee during the consultation period. However, ultimately, the recommendations of the committee with respect to capital gains taxation represent a relatively cautious approach to the area and acknowledge sthe significant challenge in introducing these reforms.

They recommend:

- The capital gains tax initially only apply to real property and disposal of mining or petroleum entities and licences
- It should apply to all taxpayers, entities and individuals on PNG sourced gains
- The rate should be 15%
- Rollover relief should be available in certain circumstances such as distribution after a death or for an intra-group transfer
- Capital gains and losses should be quarantined
- Capital gains and losses should be taxed on a realisation basis and the impact should be prospective and relate to gains relating to the period after the commencement of the provisions

Goods and Services Tax

The headline recommendation is the rate of GST should be 15%

The headline recommendation is the rate of GST should be 15%. This is aimed at reducing the reliance on direct taxation, in particular from salary and wages tax and to broaden the base for taxation including an effort to tax consumption in the informal sector.

Another significant recommendation is to change the way in which GST applies to the resource sector. Rather than continuing to treat supplies to resources companies as zero rated, the recommendation is to remove the provision. The recommendation is to shift the onus to the participants in the resource sectors. A similar change is proposed for those operating in the charitable sector.

The implication would be a smaller number of entities likely to be in a GST refund position; however, the scale of the refund entitlement for each of these taxpayers is likely to be significant. Unless the practical mechanisms for the IRC and Customs to process refunds regularly this will have a major impact on resource projects in particular.

Educational institutions are also singled out for a change with the recommendation to repeal the concession allowing the claiming of input credits on some supplies.

The GST area also includes the only recommendation that saw its way through to the 2016 budget papers. The committee promoted the implementation of a GST deferral scheme for imports. Nevertheless, although this was provided for in the budget – there was no detail around the exact nature of workings of the potential scheme.

Other Aspects of the Economy

The report also contains recommendations around excise, small business and the informal sector, other taxes and the current revenue sharing mechanisms between national and provincial levels of government. The recommendations are at times broad, and they also highlight the limitations of the review committee's work. The later issues papers covering a number of these areas of taxation gained significantly less attention than earlier papers and the report reflects the reduced momentum and pressure for the committee to finalise its work in the latter part of 2015.

Recommendations were broad and included;

- The abolishment of stamp duty
- The launch of a further review into the taxation of land and property generally
- Suspension of the tariff reduction program until its potential benefits can be more properly ascertained
- The introduction of simplified accounting rules for small businesses
- Develop a flat tax or alternative presumptive tax model for small businesses (although new small business rules would not apply to "companies and professionals")
- A study of tax morale in PNG should be undertaken
- A further study should consider the revenue sharing mechanisms with provinces, including the Autonomous Region of Bouganville

Where to From Here?

Although the report was made available shortly before the 2016 budget, only one recommendation (GST import deferral mechanism) was adopted by the Treasurer for next year. The remainder of the recommendations are therefore available for future consideration by the government.

In arriving at their framework for the future, the Taxation Review Committee has proposed a staged introduction of the reforms over a five year period. However, it is clearly uncertain at this time which, if any, of the recommendations will garner sufficient support to be considered for legislative changes. Also missing is sufficient detail in many aspects to be able to gauge the impact on the fiscal landscape. In fact, the committee noted that the lack of reliable data within the IRC creates challenges when looking at providing support for policy changes.

As with any tax reform process, the way ahead is sure to be complex as many of the proposed recommendations are inter linked. Nevertheless, despite the potential challenges with the contents of the tax review committee's report, it plants a flag on the field of fiscal policy for PNG. The themes raised will likely find some support from politicians in the coming months and years and may yet find their way into law.

In the meantime, it is up to taxpayers to assess and understand the potential impact on their operations and be prepared to take action. The review is clear that extensive further consultation in relation to the specific recommendations is anticipated and encouraged. Industry bodies, taxpayers groups and others will have the chance to continue to contribute to the process of reform. At PwC, we will continue to be engaged at all levels of the on-going debate and will be part of the conversation.

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