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Papua New Guinea

Tax Alert

Income Tax Act Rewrite Series – International Tax

International Tax Changes

The draft rewrite of the Income Tax Act (referred to as the new Act) contains many important implications to consider for taxpayers, including International Tax changes. In this article, we summarise how the new Act affects various aspects of international trade. This Alert is updated to the 9th draft of the new Act. It is expected that the new Act will be introduced to Parliament in late Nov 2022 and will come into effect from 1 January 2024.

In this Alert we cover the following:

- Foreign Tax Credits
- Indirect Foreign Tax Credits
- Foreign losses
- Concept of Permanent Establishment
- Transfer Pricing
- Anti-treaty shopping rules
- Use of Tax Havens
- Thin Capitalisation
- Capital Gains Tax; and
- Foreign currency exchange gain or loss.

The changes for Foreign Contractors, Withholding Taxes, and Trusts are the subject of separate alerts and therefore not repeated here.

Foreign Tax Credits

A resident taxpayer that derived assessable foreign income and paid tax on the foreign income is allowed a foreign tax credit equal to the lesser of:

- The foreign income tax paid; and
- The PNG income tax payable in respect of the assessable foreign income.

The foreign tax credit is calculated separately for assessable foreign business income (broadly defined but effectively includes income derived from business activities such as income derived from the investment of the capital of the business e.g. dividends and interest; net foreign currency exchange gains etc.) and foreign property income (dividend, interest etc. but does not include amounts that are included in business income). This creates two classes of foreign income with the tax credit limited to the PNG tax on that class.

The foreign tax credit is only allowed where the resident taxpayer has paid the foreign income tax within 2 years from the end of the tax year in which the foreign income was derived and the resident taxpayer can produce documents from the foreign tax authority evidencing the payment of the foreign income tax.

The foreign tax credit is non-refundable and is applied before any other tax credits. Any unapplied foreign tax credit in a respective tax year will be forfeited, i.e. a resident taxpayer is unable to carry back or carry forward the foreign tax credit.

Foreign losses

Resident taxpayers can deduct allowable deductions incurred to determine taxable foreign income. Separate calculations and apportionment of deductions are required for foreign business income and foreign property income. As in the case of foreign tax credits discussed above, this creates two classes of foreign income, with the losses of each class quarantined for use against future income only from that same class of income. If a foreign loss arises, the resident taxpayer is allowed to carry forward the foreign loss to be deducted against future assessable foreign income but only for 7 years after the year in which the loss was incurred.

Permanent Establishments (PEs)

The new Act's proposed definition of a PE appears to broaden its application, and influences whether non-residents pay tax based on net income (lodgement of a return) or are subject to withholding tax. See our alert on foreign contractors for more details.

The new Act also includes force of attraction rules for income of a similar kind to that of the PE. For example, any other business activity a non-resident conducts in PNG that is similar to the activities of their PE will be deemed to be income sourced in PNG (and thereby assessable). We strongly suggest that any non-resident doing business in PNG review the PE definition to ascertain if they have a PE in PNG, and what income may be attributed to it.

Transfer Pricing

The transfer pricing regime will be modernised to reflect current OECD trends, including requirements around the need for "Local files", "Master Files" and country by country reporting. The regime will be supplemented by Regulations (not yet available). For the purposes of the new rules a head office and its permanent establishment will be treated as separate and distinct (associated) persons. This applies unless the country of residence of the taxpayer does not apply the same rules and the Commissioner General chooses not to treat the head office and permanent establishment as separate persons.

Anti-treaty shopping rules

The new Act disallows the benefit of any treaty exemption, exclusion or reduction where 50% or more of the underlying ownership or control of the entity receiving the benefit is held by an individual/s who are not residents of the other contracting State for the purposes of the tax treaty. However, there are some important exceptions to the application of these rules within the new Act.

Use of Tax Havens

Where a resident taxpayer holds 50% or more interest (directly or indirectly) in a "tax haven entity", the assessable income of the resident taxpayer will include a portion of the property income (dividend, interest etc. but does not include an amount that is included in business income or otherwise taxed in PNG) equal to the percentage interest it holds in the "tax haven entity". The attributed income is reduced by foreign tax paid by the tax haven entity. The term "tax haven" is defined in the new Act.

Thin Capitalisation

A deduction for interest is disallowed to the extent the average debt to average equity ratio of a foreign controlled resident company is in excess of 2 to 1. A foreign controlled company is a company owned (50% or more) by a non-resident (alone or with associate/s).

The rules will apply to all interest incurred by a foreign controlled resident company. It is irrelevant if the interest is in respect of local or foreign debt or to whom it is paid (an associated person or otherwise).

The new definition of "interest" is also wide. Amounts not commonly contemplated as interest may be non-deductible if the thin capitalisation rules apply. For example, interest includes an amount deemed as interest under a finance lease. The definition may also have an impact on hybrid instruments where amounts are treated as interest for accounting purposes.

The new thin capitalisation rules contain a carve-out that applies if the non-resident lender is entitled to the benefit of the non-discrimination article in the relevant tax treaty. Foreign controlled financial institutions (as defined) are also excluded from the thin capitalisation rules.

The thin capitalisation rules also apply to the PEs of non-resident companies and is calculated with reference to the average debt and equity (as determined for financial reporting purposes) attributable to the operations conducted through the PE.

Technical/ Management Fees

The proposed section recreates the limits on deduction of technical fees including management fees paid by a resident taxpayer or the PE of a non-resident taxpayer (payer) to a non-resident associated person. The definition of technical fees differs slightly from the current definition.

The deduction is limited to the higher of-

- 2% of the total assessable income derived by the payer during the tax year; or
- 2% of the total allowable deductions (ignoring the management fees) for the tax year.

Capital Gains Tax (CGT)

Non-resident taxpayers may be liable for CGT in PNG if they dispose of –

- PNG real property;
- Membership interest in a property rich entity (i.e. an entity where more than 50% of the value of the interest is derived, directly or indirectly, from PNG real property (during the 365 days preceding the disposal));
- An option or right to acquire (a) or (b) above.

The CGT provisions including withholding tax rules are discussed in further detail in our Alert #10.

Implications for your business

The abovementioned changes to international tax are significant and taxpayers should take time to ensure they understand the implications. There are situations were non-resident persons doing business in PNG may now be regarded as having a PE due to the expanded definition. Furthermore, the thin capitalisation rules will potentially have a significant effect on non-residents PEs and foreign controlled businesses. Planning in advance of any changes is therefore recommended.

If you would like to discuss the draft changes, or their impact on your business please let us know.

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