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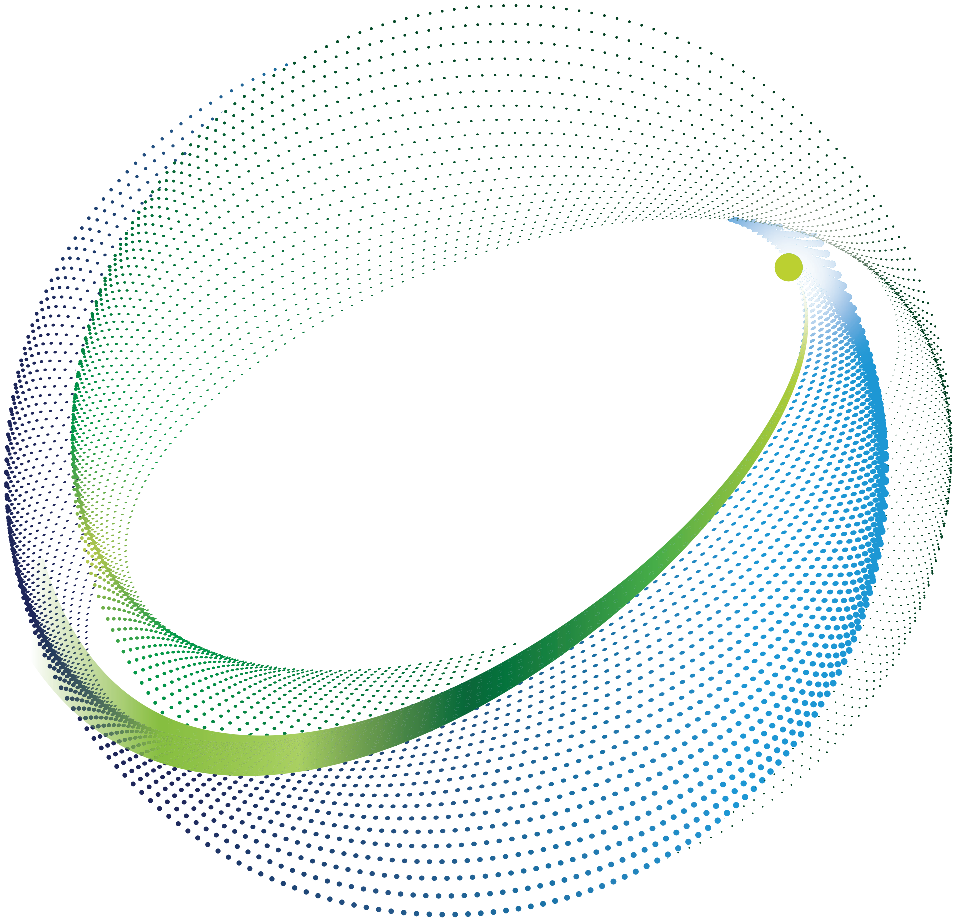

Papua New Guinea

Tax Alert

Income Tax Act Rewrite Series – Allowable Deductions

In this issue

The draft rewrite of the Income Tax Act (referred to as the new Act) contains many important implications to consider for taxpayers, including changes to what constitutes an allowable deduction. In this article, we summarise how the new Act has affected allowable deductions. 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 Jan 2024.

Allowable Deductions

Incurred Expenditure/ Loss

The base rule for deduction remains broadly the same as under the Income Tax Act 1959 ("current ITA"). Expenditure or loss to the extent incurred by the person during the year in deriving amounts included in assessable income are deductible, unless otherwise disallowed. The concepts of expenditure, loss and derivation all exist in the current ITA as does the concept of apportionment. Apportionment is specified to be on "…any reasonable basis, …".

In addition, whilst the expenditure has to be incurred in the current year the same requirement does not apply to assessable income. That is, an expense incurred today for earning income tomorrow should still be deductible (unless otherwise disallowed). The new Act specifically provides that a person "incurs expenditure when it is payable by the person". Thus, differentiating it from a mere provision for future expenditure. Consequently, the treatment of accruals versus provisions remains broadly the same with the exceptions outlined below.

On timing of the deduction, it is interesting to note that, other than bad debts (see further comment below), the current rules around long service leave and holiday pay are not specifically mentioned. However as discussed further below, such payments are subject to withholding tax and only deductible when the withholding tax is paid or earlier if paid when it was paid by the due date (or extended due date). This potentially is a significant change.

Prepayments, including for insurance, are covered under the business intangible rules as contractual rights. They are deductible in the year incurred provided they don't relate to a period of more than 1 year.

The business intangible rules also allow for deductions of business expenditure that may not otherwise be deductible, sometimes referred to as "black hole expenditure".

In addition, the business limb of the current ITA, (that is the limb which states that expenses "… necessarily incurred in carrying on a business…", is not replicated. Court cases over the years have indicated that this limb was unnecessary, and it is understood this is the reason for its exclusion.

Expenditure, including interest, incurred connection with construction or acquisition of a capital asset are not allowable deductions to the extent it is incurred prior to the later of the date on which a person first derives assessable income or first uses the capital asset for the purposes of producing assessable income. This non-allowable portion is treated as part of the cost of property.

The 9th draft also allows a deduction to resident companies for interest or other expenses incurred in deriving exempt dividends from another resident company.

Trading Stock

The cost of trading stock receives special mention. The cost of stock disposed is deductible. Closing stock is required to be valued at the lower of cost or fair market value, with the valuation method based on the "first in first out" or "weighted average" cost if the specific identification method is not readily identifiable.

This differs from the existing rules in terms of the valuation options.

Bad Debts

In line with the current ITA, the rules require the debt be written off in the financial statements but now go further by requiring the person to have "… taken reasonable steps to collect the debt but the debt is irrecoverable" The onus will be on the taxpayer to demonstrate that the debt was irrecoverable at the time the bad debt was written off. The deduction must also not exceed the amount of the debt written off as bad in the person's financial accounts for that year.

Charitable Donations

A deduction is allowed for cash donations made to either a charitable body or the Government in certain instances (emergency calls). However, the donation must exceed PGK50 and is limited to 10% of assessable income (excluding employment income).

The 9th draft now allows for a deduction for donation of property. The amount of donation is limited to the lesser of the person's cost in acquiring the property or the fair market value of the property at the time of the donation.

This draft defines "charitable body" as a company or irrevocable trust approved as a non-profit body that is established for charitable purposes.

Scientific Research

A 100% deduction is allowed for expenditure on scientific research as defined.

Fixed Assets/ Depreciation/ Finance Leases

Rules on the calculation of small assets write off, depreciation and losses on sale of fixed assets are dealt with in our rewrite series Alert # 2. If you require a copy, please contact us or check our website.

As noted, in that Alert, the deemed interest component of finance lease charges, as calculated for IFRS purposes, is deductible but subject to limitations under the thin capitalisation regime (see also our Alert on International Tax (Alert #7).

Profit Making Schemes/ Ventures or Concerns

A special rule has been introduced relating to a loss on a venture or concern in the nature of a trade, a profit-making undertaking or scheme, or the disposal of an asset otherwise held on revenue account. The profits on such transactions are taxable. However, a loss is only deductible if the Commissioner General has been notified with 10 days of commencement of the arrangement or acquisition of the asset.

In addition, the loss is calculated by deducting the expenditure from the "gross proceeds" derived by the person from the venture, concern, undertaking or scheme.

Industry Specific Rules

Special rules apply to Insurance Companies, Superannuation, Agriculture, Timber and Resource sectors. These are not dealt with here.

Withholding Payments

Where a withholding payment such as salaries and wages tax or interest is due and payable, the deduction for the expenditure is only allowed in the year the withholding tax is paid to the IRC unless it is paid by the due date or the extended due date for payment of the withholding tax. This may create timing issues for salaries and wages, interest, technical fees (including management fees), prescribed royalties and royalties and business income accrued at year end or expenses where withholding tax has inadvertently not been paid to IRC.

Non-Deductible Expenditure

Non-deductible expenditure includes the following:

- Domestic or private expenditure.
- Expenses incurred to earn employment income.
- Dividends
- Expenses or losses of a capital nature.
- Provisions for expenditure not yet incurred.
- Expenditure recoverable under a policy of insurance or otherwise recoverable.
- Taxes, other than GST irrecoverable on expenses otherwise deductible.
- Penalties or fines for violating laws.
- Bribes, Kickbacks etc. paid to Government Officials (whether in PNG or otherwise).

Entertainment

Expenditure for food, drink or recreation is non-deductible except to the extent it relates to travel for employment or business or is in furtherance of the persons core business (e.g. hospitality).

Management/ Technical Fees

The definition of "technical fee" has been broadened and includes management fees. The definition is as follows:

"technical fee" means a fee for administrative, management, technical, professional, or consultancy services, including a fee for the supply of administrative, management, technical, or other personnel, but does not include employment income ".

A deduction for technical fees paid to a non-resident associate are limited to the higher of 2% of assessable income or 2% of allowable deductions (excluding the technical fee). This limitation differs slightly from the existing rules. In particular, it only applies if the fee exceeds an arm's length amount.

Superannuation

A deduction is only allowed where a contribution is paid by an employer to an approved superannuation fund. The deduction is limited to 15% of the taxed employment income of the employee for the tax year.

Tax Agents Fees

Tax Agents fees are deductible, but only if paid to a "registered tax agent".

Losses

The existing loss carried forward rules are generally preserved. However, the time limit for all taxpayers has been limited to 7 years, including primary sector. In the 9th draft of the new Act the resource sector is excluded with the result that losses can be carried forward without time limitation.

Foreign Exchange losses

The proposed quarantining of foreign exchange losses has now been omitted from the 9th draft.

Transactions with Associates

A loss on disposal of a business asset to an associate is non-deductible. However, the associate is deemed to take over the written down value of the asset at the time of disposal. This would include trading stock as well as fixed assets or other business assets.

In addition, an amount paid to an associate, other than an amount included in assessable income or subject to salary and wages tax or non-resident withholding tax, is non-deductible. A further exception to the non-deductible rule applies if the amount is excluded from PNG tax due to the operation of a provision in a Tax Treaty. This would appear to include payments to offshore associates for the purchase of trading stock or payments unless relieved from tax due to the operation of a Double Tax Agreement.

Impact on business

The abovementioned changes are potentially significant and taxpayers should take time to ensure they understand the implications.

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

For more details please contact your key Deloitte contacts or any of the following:

Leadership Contacts

Andrew Harris
Partner
Tax & Business Services
Tel/Direct: +675 308 7010
andrewharris@deloitte.com.pg

Sanchika Sutharshan
Partner
Tax & Business Services
Tel/Direct: +675 308 7160
ssutharshan@deloitte.com.pg

Maygen Turliu
Director
Tax & Business Services
Tel/Direct: +675 308 7017
mturliu@deloitte.com.pg

Declan Mordaunt
Senior Counsel
Tax & Business Services
Tel/Direct: +675 308 7037
dmordaunt@deloitte.com.pg

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