PAPUA NEW GUINEA

Value Added Tax to Be Implemented

Paul O'Brien and Rusty Donnell

Paul O'Brien is a Partner with the Tax and Legal Services Division of PricewaterhouseCoopers PNG, Port Moresby; fax: +675 321 1428. Mr O'Brien is responsible for all aspects of taxation such as corporate tax and indirect taxes (including VAT). He specializes in advising companies in the mining and petroleum industries.

Rusty Donnell, a Manager with the Tax and Legal Services Division of PricewaterhouseCoopers PNG, provides VAT training and business advisory assistance to companies.

This article is based on the law in force as at 1 January 1999 and represents a summary of the applicable legislation. It should not form the basis of specific decisions without references to the legislation itself and proper professional advice.

I. INTRODUCTION

As part of a major reform of the indirect taxation system, it was announced in November 1995 that Papua New Guinea ("PNG") would introduce a value added tax ("VAT"). The introduction of a VAT is intended to remove the requirement to use import duties as a revenue collection mechanism, and thereby to allow for a rationalization and reduction in tariff rates. Tax compliance benefits were also identified from the widening of the tax net in an economy where less than 10% of the population pay income tax.

VAT will be PNG's first comprehensive indirect tax. The VAT will replace all existing provincial sales taxes. It will be accompanied by:
- the removal of a 1.5% drought surcharge on imports; and
- the first stage of tariff rate reductions.

The standard VAT rate has initially been set at 10%. This rate is seen as sufficient to cover the loss of revenue from the tariff reform programme and the elimination of provincial sales taxes. Consideration was also given to this "simple number" assisting in the implementation and understanding of VAT.

II. IMPLEMENTATION

The Value Added Tax Act 1998 ("the VAT Act") will be implemented on 1 July 1999. The VAT Act, which is based upon the New Zealand Goods and Services Tax Act 1985, is accompanied by the Value Added Tax Revenue Distribution Act 1998 ("the Distribution Act"). It is anticipated that the regulations to these Acts will be finalized by June 1999.

Various transitional provisions exist from 1 January 1999 to 31 March 2000.[1]

III. BASIC CONCEPTS

The VAT Act, being fundamentally the same as the New Zealand legislation, has thus conformed to the general underlying principles of a value added taxation system. Certain changes to the legislation have been made to address specific areas and activities that are considered to be integral to the taxation framework in PNG.

The VAT is a broadly based consumption tax with input credits available to registered persons on any goods and services (including capital goods used for business purposes) provided that they are not utilized in the making of an exempt supply. By this credit offset system, only a net figure is "returned" by registered persons. The net figure is calculated by deducting the input VAT credits from the VAT (output VAT) charged on supplies made by the registered person.

The VAT Act affects:
- all goods and services,[2] which are supplied in PNG, on or after 1 July 1999; and
- any goods and services imported, on or after 1 July 1999.

Although the VAT will be generally levied at the standard 10% rate, some supplies have been identified as zero-rated and a small number are specifically exempt from VAT.

The VAT Act does not include any exemptions for basic food items but does attempt to address any regressive effects in the areas of public transport, health and education. Provision is also made for the Head of State to exempt any further items by notice in the National Gazette.

1. *Infra* XIV.
2. The definitions of goods and services are mutually exclusive but create an exclusion for money, which is also defined. Money is the only commodity to which the VAT Act does not apply.

The zero-rating provisions have been utilized to maintain the destination principle: exports are not taxed, imports are. This ensures that the VAT is levied on domestic consumption rather than production and that the VAT regime is effectively confined to PNG. Consistent with the zero-rating of exports, the international transport of goods from PNG is also zero-rated.

IV. EXEMPT GOODS

As in most VAT regimes, the supply of financial services will be exempt. This is consistent with the mutual exclusion of money from the definitions of goods and services and the exempt treatment of the monetary substitute, fine metals. A main reason for this treatment is the difficulty in determining the value added arising from transactions in the financial services sector. The exemption includes:
- normal banking transactions;
- life insurance transactions;
- superannuation transactions; and
- stock exchange transactions.

The health and education service sectors have also been exempted from VAT in an attempt to improve human capital in PNG.

The health sector includes doctors, dentists, hospitals, opticians and other registered medical practitioners who will therefore not be able to charge VAT on their services and are not able to recover VAT paid on their inputs. The potential increase in operating costs has been addressed to some degree by the treatment of prescription drugs, medical equipment and medical prostheses as zero-rated.

In a similar way, the potential cost increases to the education sector have been addressed by a specific ability to recover VAT input credits where these relate to text-books, writing materials and other educational materials that are not for the purpose of resale to those other than students of the education institute.

Further community assistance has been afforded with the exemption of:
- the retail supply of newspapers;
- the supply of postage stamps; and
- the supply of public road transport.

The restriction on public road transport operators has also been muted as a mechanism to bring this sector into the tax[3] net.

The exempt status has also been utilized to increase tax[4] collections on specific sectors by its application to:
- the supply of betting, lotteries and games of chance;
- the forestry industry;[5] and
- the provision of accommodation and housing to employees.

V. ZERO-RATED GOODS

In addition to the encouragement given to the export sector, the tourism industry has also been promoted: goods purchased from duty-free shops, and the international transport of passengers to and from PNG, are zero-rated.

Also zero-rated are:
- temporary imports;[6]
- prescription drugs;
- medical equipment;
- the sale of going concern businesses;
- supplies to a prescribed foreign aid provider; and
- the mining industry.[7]

VI. ACCOUNTING

Taxpayers will generally be required to file VAT returns on a monthly basis with the returns and payment due by the 21st day of the following month or by the next succeeding working day. The Commissioner of the Internal Revenue Commission ("IRC") is given certain powers to extend the taxable period to a period not exceeding six months where the taxpayer's turnover does not, or is not expected to, exceed PGK 250,000 in a 12-month period.

The accounting basis for VAT has been predominantly set as the invoice basis, where the supply will occur on the earlier of the issuance of the invoice or payment. Taxpayers may apply to use the payments basis; at the discretion of the IRC, this is only available where:
- turnover does not, or is not expected to, exceed PGK 500,000 in a 12-month period; and
- the taxpayer is a local authority or non-profit body.

VII. REGISTRATION

All those who know, or ought to know, that their turnover will exceed the registration threshold at 31 March 1999 will be required to register for VAT by 30 April 1999.

The registration threshold has been set at an amount of PGK 100,000 p.a. which, by PNG standards, is sufficient to exclude many small owner-operated businesses and cottage industries. The legislation also allows that one-off capital purchases or permanent reductions in trading capacity do not need to be taken into account in the threshold figure.

Voluntary registration is available for those persons who do not come strictly within the scope of the VAT regime by virtue of Section 42(5) VAT Act. This enables a person who wishes to enter the regime to do so. The following factors determine the viability of a particular course of action:
- whether most of the person's customers are registered or not;
- the extent of compliance costs; and
- the proportion of sales to exempt institutions.

Once a person is registered for VAT, he is subject to a number of legal obligations including the requirement to charge and account for VAT and to issue a tax invoice within 28 days of supply. The tax invoice is the key docu-

3. The reference is to the overall taxation system, not just VAT.
4. Id.
5. *Infra* XII.
6. I.e. items that are effectively exported immediately in an unchanged state.
7. *Infra* XI.

ment on which the VAT regime rests; without an invoice, VAT input credits are effectively denied where the total consideration involved exceeds PGK 50.

VIII. IMPORTS AND PLACE OF SUPPLY

Section 6 VAT Act stipulates the value of imports as being the aggregate of:
- the value determined by the Customs Department;
- all import duties; and
- all transport and insurance costs relating to the importation.

VAT is payable in conjunction with import duties at the time the goods are entered for home consumption[8] into PNG. For imported goods, the customs documentation is treated as a tax invoice.

To ensure that imported services are also subject to VAT, Section 14 VAT Act requires a registered PNG recipient to self-assess VAT on these services. The PNG recipient will thus effectively act as an agent for the overseas supplier and will increase the amount charged by the VAT component. This amount would then be accounted for to the IRC by the PNG recipient. To the extent that the services relate to a taxable supply, an input VAT credit will accrue to the recipient in the same taxable period and will therefore ensure that no additional direct costs are incurred.

The diplomatic community is excluded from the payment of VAT on imports as are any goods which are declared exempt by the VAT Act.

Where a supplier is resident in PNG, goods or services supplied are deemed to be supplied in PNG and thus are subject to VAT. Where the supplier is not resident in PNG, the supply is deemed to be in PNG where:
- the goods are in PNG at the time of supply;
- the services are physically performed in PNG; or
- the services are physically performed outside PNG for the use or benefit of a person resident in PNG.

These provisions will therefore cover the activities of temporary contractors or service providers, and will necessitate registration for these parties where the registration threshold of PGK 100,000 p.a. is exceeded.

Where registration is necessitated or voluntarily made, these parties will be required to charge and account for VAT on a similar basis to resident contractors. In instances where non-residents will be purchasing local inputs, registration will allow the recovery of input VAT credits.

IX. ADMINISTRATION

PNG has 21 provinces which are controlled by provincial governments. These provinces directly control the imposition and administration of the present provincial sales taxes with varying rates throughout the country ranging from zero to 4%. Following the implementation of VAT, these provincial sales taxes will be abolished and the provinces given an entitlement to a share of the VAT funds.

The original intention was that all VAT funds were initially to be collected centrally by the IRC. Subsequently, the provincial allocations would be made on a regular basis after the settlement of any refunds due. This led to concerns being raised by the provincial governments over the loss of control of a large portion of their income. In an effort to negate this problem, the government introduced the Distribution Act.

Administration will now be a dual function of the provincial governments and the IRC with the primary responsibility and authority vesting with the IRC. Each provincial government will now operate a VAT trust account and will collect VAT on supplies made in that Province. VAT refunds will continue to be made from the central IRC trust account which will receive all VAT from imports and will debit individual provincial trust accounts for their share of the refunds.

Provinces will have their VAT entitlement set by reference to their previous year's collections. They will be entitled to utilize funds to that level from their VAT trust accounts after any debits for refunds have been settled. Any surplus funds in the provincial trust accounts will then be forwarded to the central IRC-controlled trust account for utilization by the government. "Top-ups" will be made to any provinces with insufficient funds to meet their allocations.

The IRC is currently considering submissions from interested parties on how VAT will be administered where a taxpayer operates in more than one Province. Initial indications suggest that in some instances, multiple VAT registrations and returns may be required. This matter is likely to be addressed by the regulations when issued later in 1999.

X. REFUNDS, PENALTIES, ASSESSMENTS AND APPEALS

Where, in any taxable period, a registered person's total input VAT credits exceeds their total output VAT charged, a refund is receivable. As noted before, it is the intention that all such refunds will be made from the central IRC-controlled trust account and entitled parties are granted a first charge over this account. Whilst this effectively ensures that a right to a refund does exist, the cash flow and opportunity cost considerations are not supported by any requirement for that refund to be issued within a specified time-frame or by any entitlement for interest to be paid on refunds.

In contrast, where a VAT payment is made late, an immediate flat penalty of 10% is imposed on the VAT due. In addition, interest at the rate of 20% p.a. is payable on the outstanding amount, including penalties, until paid.

8. Includes domestic and commercial consumption.

XI. MINING AND PETROLEUM INDUSTRY

Given the mineral rich environment of PNG and the established large-scale mining operations, the mining and petroleum sector represents a large source of taxation receipts for PNG. Thus, in a policy decision made by the PNG Government, it was established that the industry should not be allowed to obtain a windfall gain that would otherwise have arisen from the average 11 percentage points lowering of the tariff rates and the removal of provincial sales taxes.

During the passage of the VAT Act through the parliament, the provisions dealing with the mining and petroleum industry were the subject of detailed debate with numerous submissions presented by the Chamber of Mines and Petroleum and industry participants.

The VAT Act has confirmed the position of exports by the industry as zero-rated, with any domestic supplies being taxable at the standard rate of 10%.[9]

The government's fiscal concerns over the windfall gain have instead been addressed by the introduction of a turnover tax at the level of 4%, based on gross assessable income and imposed as an additional income tax under the Income Tax Act 1959, as amended, payable on a monthly basis. However, this only applies to the mining, but not to the petroleum, industry. Negotiations are continuing over the level and imposition of the turnover tax.

XII. FORESTRY INDUSTRY

Forestry and timber processors also come under specific attention from the VAT Act with both the local and export sales of unprocessed logs being treated as exempt supplies.

As this industry has been identified as dependent on imported capital equipment and inputs, these measures are seen as compensatory for the windfall gains which would otherwise have been obtained from the tariff reductions and the removal of provincial sales taxes. Local conversion of logs appears to be encouraged by allowing input VAT credits on all but the logging ("unprocessed") stages.

Due to the exempt status, input credits will not be allowed for any VAT paid on goods and services purchased for the purpose of making these exempt supplies. The VAT therefore becomes a cost to the companies involved. The forestry industry believes they will be significantly worse off under the VAT regime and are still lobbying for similar treatment accorded to the mining industry.

XIII. PRIMARY PRODUCERS

Another significant industry sector specifically addressed by the VAT Act is primary production, which does not include those involved in the production of timber.

While sales of such products by registered persons will be subject to VAT at the standard rate, the purchasers of goods from unregistered producers have been granted an entitlement to claim input VAT credits. This entitlement acknowledges the number of such producers that would not, or will not, be required to register for VAT.

These credits, which are yet to be established by regulation, are limited by the VAT Act to an amount not exceeding the tax fraction of the consideration paid for the supply (one eleventh of the consideration).

XIV. TRANSITIONAL ISSUES

Various transitional provisions have been included in the VAT Act to encourage consistent economic consumption and to assist in establishing the financial reserves of the regime.

Notional input VAT credits have been made available for qualifying trading stock and capital items on hand at 30 June 1999. These credits have been implemented to compensate for the higher levels of duty applicable prior to 1 July 1999 and thus to encourage a smooth consumption of goods by the economy.

"Qualifying trading stock" has been defined in Section 116 VAT Act and specifically excludes:
- land and buildings;
- goods held on hire;
- goods subject to excise tariffs;
- second-hand goods;
- primary products; and
- goods held for export.

Notional input VAT credits will be available at the rate of one eleventh of the value of the qualifying goods on hand as at 30 June 1999, with this amount claimable evenly over a ten-month period.

Qualifying capital goods have been defined as those purchased and installed ready for use, in the six-month period immediately prior to implementation.[10] Notional input VAT credits will be available at the level of one eleventh of the written-down value of these goods at 30 June 1999, with this amount claimable evenly over a twenty-month period.

Restrictions will apply on the availability of input credits for purchases of capital goods purchased in the first nine months of the VAT regime:[11]

(1) During the period 1 July to 30 September 1999, only 25% of the input VAT credits will be allowed.
(2) During the period 1 October to 31 December 1999: 50%.
(3) During the period 1 January to 31 March 2000: 75%.

Where the input VAT credits are not claimable, they will be treated as part of the cost price of the goods.

Restrictions will also exist on the payment of VAT refunds in the six-month period following implementation.[12] During this period, refunds will not be issued and must be carried forward and claimed at the rate of 20% per month

9. The initial exempt status and subsequent input VAT credit restrictions have been fully removed.
10. I.e. 1 January 1999 to 30 June 1999.
11. I.e. 1 July 1999 to 31 March 2000.
12. I.e. 1 July 1999 to 31 December 1999.

starting with the return due on 21 January 2000. Provisions are made for the payment of refunds where the IRC has completed an audit during this period. In addition to establishing regime reserves, this measure has been identified as providing a period where taxpayers can become accustomed to the VAT regime.

XV. CONCLUSION

Effective 1 July 1999, the supply of goods and services in PNG will be subject to VAT. Careful planning needs to be undertaken in the lead up to 1 July 1999 to minimize any adverse implications of the transitional provisions. During the period prior to implementation, various administrative issues will need to be addressed and it would be assumed that such issues will be the subject of various debate during the transitional period.

CUMULATIVE INDEX

ARTICLES

DEVELOPMENTS