



Tax Alert

Scrutiny of Withholding Tax Application by IRC

The IRC has begun scrutinising the application of a range of withholding taxes. The IRC will launch a project to review and correct commonly made errors in taxpayer application of the withholding tax regimes. In addition, the IRC has announced a policy change with regard to the application of non-discrimination articles as included in certain tax treaties, effectively disallowing the automatic application of these articles by taxpayers to reduce WHT liabilities.

The Foreign Contractor Withholding Tax (FCWT) regime is familiar to most in PNG; foreign contractors of all sorts are typically subjected to 12% FCWT (48% non-resident tax rate applied to *deemed contract profits of 25%*). Where a foreign contractor decides to lodge an income tax return, however, FCWT is typically waived entirely and the foreign contractor is, for all intensive purposes, treated as a normal corporate taxpayer. It has been the IRC's practice that where a taxpayer has elected a particular method (return vs FCWT) that method cannot be changed mid-contract.

In some instances, taxpayers have upheld that their FCWT liability is reduced to 7.5% by application of non-discrimination articles (NDAs) in tax treaties (*on the basis that the resident corporate tax rate of 30% is applied to deemed profits of 25% instead of applying the non-resident rate of 48%*). Many taxpayers have received positive confirmation in this regard from the IRC.

The IRC has announced that it will be undertaking a review of taxpayer adherence to the WHT regimes, with particular focus on the FCWT regime. The initiative, entitled the FCWT Integrity Project, has resulted to a number of policy changes:

Immediate policy change on reduced rates

The first change in policy by the IRC is to no longer allow FCWT to be automatically reduced on the basis of NDAs. A taxpayer liable for FCWT at a rate of 12% will remain so liable regardless of whether the taxpayer is subject to a tax treaty with a NDA. This change in policy applies to all foreign contractors regardless of whether the IRC has previously issued confirmation that a NDA applies to a specific taxpayer. Formal letters from the IRC will be issued to the specific taxpayers in question revoking such positive confirmations. Effectively, all previous correspondence received from the IRC confirming that a taxpayer is subject to a reduced FCWT rate in light of a NDA is null and void

The change will occur with almost immediate effect, applying to all payments made to contractors from **16 September 2013**.

All withholding agents need to be aware of this immediate policy change and ensure that all withholdings from contractors who previously relied on NDAs to reduce their FCWT liability, be made at a standard 12%, regardless of any previous confirmations to the contrary.

Equal treatment can be accessed by contractors, subject to the applicable tax treaties, through the submission of tax returns. Put differently, the resident corporate rate of 30% will be applied to the net profit of taxpayers, where the net profit is substantiated by the submission of income tax returns. Taxpayers will not simply be able to adopt the “*simplicity of a withholding tax*” and get the benefit of a reduced rate under the tax treaties.

Foreign contractors have one year from the end of the tax year to decide to accept the increased FCWT or file tax on a net income basis.

The question remains whether the IRC is entitled to take make such an overarching decision regarding the application of tax treaties. The simple answer is yes. Tax treaties are subject to domestic interpretation. It is therefore up to the IRC to determine the application of the NDAs.

In order to abide by the NDA terms of the relevant tax treaties; the IRC must accept the lodgement of tax returns by those taxpayers subject to tax treaties. The lodgement of tax returns by other taxpayers will still be subject to the discretion of the Commissioner General.

Those taxpayers who already apply 12% FCWT on their gross income will not go without review. The IRC intends for their review to have wider application.

Withholding tax still payable with return

The other policy change to be effective is that FCWT may not be waived entirely where a taxpayer elects to submit a tax return. FCWT may still be withheld and remitted to the IRC on all contract payments. On the submission of the income tax returns, assessments will be issued for tax underpaid and refunds of tax overpaid will be processed.

This change has direct cash flow implications for taxpayers, as refunds could take prolonged periods to be paid. In fact, refunds are rarely processed by the IRC.

This policy change is not intended to be applied to those foreign contractors who have good compliance histories with the IRC. Where a taxpayer has a history of good corporate governance, and can demonstrate established ties with PNG, or provide some other form of undertaking, the IRC would look favourably at waiving FCWT with the submission of annual tax returns.

The IRC may now also consider allowing a taxpayer to change the method adopted (return or FCWT) mid-contract. The IRC stands firm that taxpayers will not be able to pick and choose a different method each year based on profit margin. Any change between methods would probably only be allowed once over the term of a contract.

Audits of withholding tax agents

The IRC admits that often the myriad of PNG WHTs create confusion for taxpayers and withholding agents. It is often difficult for businesses to accurately identify which WHT is applicable to a payment; as such payment may appear fall within the ambit of more than one of the WHT.

Withholding agents are often unaware that salaries and wages tax (SWT) and management fee withholding tax (MFWT) take precedents over FCWT. The IRC believes that in many instances taxpayers have been incorrectly registered for FCWT when in fact other WHT regimes (at higher rates) are applicable and withholding agents are therefore not remitting the correct amount of tax to the IRC. The IRC will consider the files of withholding agents to ensure that FCWT is applied correctly.

Audit of foreign contractors

Some foreign contractors seem to have the misguided view that they are exempt from all taxes where they are subject to FCWT. The IRC review will ensure that SWT at 42% is applied to those individuals working in PNG and earning PNG source remuneration and that management fee withholding tax at 17% is correctly applied where appropriate.

A voluntary disclosure programme will also form part of the review: where taxpayers fully disclose to the IRC that taxes have been underpaid (by the application the incorrect WHT regime) and make full payment of the outstanding taxes, all penalties will be waived. Where such underpayments are discovered by way of a tax audit, penalties of 20% will be applied and 20% interest per annum will be charged.

Contacts

Lutz Heim

Partner – Clients and Markets

Tel: +675 308 7030

lheim@deloitte.com.pg

James Kruse

Partner – Professional Business Services

Tel: +675 308 7060

jkruse@deloitte.com.pg

Andrew Harris

Principal – Taxation Services

Tel: +675 308 7010

andrewharris@deloitte.com.pg

Noel Smith

Principal – Taxation Services

Tel: +675 308 7035

nsmith@deloitte.com.pg

Tony Bernabe

Director – Professional Business Services

Tel: +675 308 7057

abernabe@deloitte.com.pg

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