Revenue Law Journal

Volume 1 | Issue 1 Article 4

February 1990

Perspectives on the proposed double taxation agreement between Papua New Guinea and Australia

Kibuta Ongwamuhana
University of Papua New Guinea

Perspectives on the proposed double taxation agreement between Papua New Guinea and Australia

Abstract
In this article, the author examines the proposed Double Taxation Treaty between Australia and Papua New Guinea. Apart from analysing specific provisions, he discusses the proposed Agreement's immediate implications on Australia's domestic tax position, and the manner in which this Agreement departs from Australia's overall tax treaty regime. The discusssion shows that this will be a unique tax treaty in many respects.

Keywords
Double Taxation Treaty, Australia, Papua New Guinea

PERSPECTIVES ON THE PROPOSED DOUBLE TAXATION AGREEMENT BETWEEN PAPUA NEW GUINEA AND AUSTRALIA

Kibuta Ongwamuhana
Lecturer in Law
University of Papua New Guinea

In this article, the author examines the proposed Double Taxation Treaty between Australia and Papua New Guinea. Apart from analysing specific provisions, he discusses the proposed Agreement's immediate implications on Australia's domestic tax position, and the manner in which this Agreement departs from Australia's overall tax treaty regime. The discussion shows that this will be a unique tax treaty in many respects.

Australia and Papua New Guinea ('PNG') are in the process of concluding a Double Taxation Agreement. Negotiations are at an advanced stage, with many of the problem areas having been identified and agreement in principle reached at previous meetings. However, there are a few issues which have been deferred for further discussion. These relate to a desire by PNG to include some provisions in the proposed Agreement which reflect the special position PNG occupies in Australia's external economic relations. This article examines the provisions proposed by PNG and their immediate implications for Australia's domestic taxation. It also looks at how the proposed Agreement corresponds to Australia's other double taxation agreements and to established models of international tax treaty arrangements.

In its general scheme the proposed Agreement is fairly standard and follows closely the pattern set by the comprehensive double taxation agreement between Australia and the United Kingdom which was concluded in 1967. That agreement in turn was based on the OECD Draft Model Double Taxation Convention issued in 1963. However, in the course of its application, the OECD Draft underwent several changes leading to an improved final version which was adopted in April 1977. In the meantime, and since its first tax agreement with the United Kingdom, Australia has concluded nearly twenty double taxation agreements with other countries.[1] These are mainly countries with which Australia has close economic relations.

1 Australia has double taxation agreements with the United Kingdom, United States, Canada, New Zealand, Singapore, Japan, Federal Republic of Germany, Denmark, Netherlands, Belgium, the Philippines, Switzerland, Sweden, Malaysia, Ireland, Korea and Norway.

Although Australia's tax agreements, in their general tenor, are patterned on the OECD model, they also reflect, in their differing detail, the changing trends in tax treaty arrangements. Particularly noticeable in these agreements is an underlying desire to preserve a wider right of taxation in the country where the income originates. This could well be the effect which the more recent UN Model Double Taxation Convention is having on tax treaty perspectives. The UN Model, published in 1980, is aimed at preserving the source country's taxing power on income items upon which the OECD Model is seen to be unduly restrictive. It could also be that Australia's position as a net importer among the major industrial countries has made it more sensitive to source countries' revenue concerns and that this sensitivity is reflected in its tax treaty negotiating position.

The proposed agreement

The proposed Australia-PNG Double Taxation Agreement addresses those areas which have the potential for giving rise to double taxation of income flows between the two countries. It is important to note that there is substantial cross-border activity between the two countries. Because of the historical link between them, PNG continues to rely heavily on Australia for the sustenance of its economy. About 70% of PNG's high level personnel are Australian nationals contracted to work in various sectors of the economy. Much of the capital for the many enterprises operating in PNG comes from Australia. In addition, there is a large number of Australian firms and companies which have business interests in PNG and regularly send their employees to PNG on short-term accounting, auditing, engineering, architectural, or other assignments. As a result, tax authorities in the two countries have to work out an arrangement which ensures that nationals of the two countries with cross-border taxable activity do not suffer burdensome taxes as a result of the unilateral imposition of each country's domestic taxes.

Tax on resident

The agreement starts by addressing the question of residence. This is important because it is the basis upon which a country asserts taxing jurisdiction over a taxpayer. Both Australia and PNG under their domestic tax law impose tax on the worldwide income of persons who are resident or deemed to be resident within their territories. In order to eliminate the possibility of the occurrence of dual residence because of unilateral application of domestic tax rules, the proposed Agreement adopts the following tests for locating an individual's residence in only one of the contracting countries. First, a taxpayer who is a resident of both countries will be treated as resident only in the country in which she/he has a permanent home.[2] If she/he has a home in both countries, she/he will be treated as resident in the country in which she/he has an habitual

2 This is the permanent residence where one normally lives with one's family (see *Lysaght v IRC* (1928) 13 TC 526).

abode.[3] If she/he has an habitual abode in both countries, then the taxayer's residence will be determined by reference to the country in which his or her financial and other vital interests are closest.

In the case where the taxpayer is a body corporate, its residence will be determined by reference to the country in which its central management and control is located.[4] Where a company is managed and controlled equally from both countries,[5] then it will be treated as resident in the country where it is incorporated. These rules are set out in Article 4 of the proposed Agreement and are intended to operate as tie-breakers in situations where the application of domestic law of each country leads to dual residence of a particular taxpayer, with both countries asserting taxing power over that taxpayer. Since both countries look to incorporation as the primary test of company residence under their laws, the proposed Agreement will modify domestic law in cases where a company is incorporated in both countries. But if the application of domestic law does not yield overlapping residence, it will not be modified by the proposed Agreement.

Income from real property

Article 6 of the proposed Agreement deals with the taxation of income from real property and assigns primary tax jurisdiction to the country in which the property is situated. Real property under this article refers to such things as leases of land and other interests over land, including mining and exploration rights for natural resources. This provision is likely to affect Australian firms' and companies' mining interests in PNG.

PNG tax authorities are, however, seeking a novel addition to the current Draft to the effect that exploration expenditure incurred by an Australian company in the exploitation of petroleum or other mineral resources in PNG will be deductible in computing liability to Australian tax as if the natural resources were situated in Australia. The effect of such a provision would be to extend to PNG the allowance of capital deductions available under Division 10 (ss122A and 124AA) of the Australian Income Tax Assessment Act ('ITAA')[6] relating to petroleum and mining activities undertaken in Australia. PNG believes that this will provide added incentive to further involvement of Australian capital in PNG's mining sector for the mutual benefit of both countries.

3 According to *FTC v Applegate* (1979) 79 ATC 129, an habitual abode is not a permanent home. It is a fixed place of abode with which the taxpayer has an enduring relationship, a place determined by the continuity and durable association the taxpayer has with it.

4 This phrase has been discussed in the following cases: *Koitaki Para Rubber Estates v FCT* (1945) 64 CLR 15; *Malaya Shipping Co v FCT* (1946) 72 CLR 623; *North Australian Pastoral Co v FCT* (1946) 72 CLR 873; *Unit Construction Co v Bullock* [1960] AC 351.

5 See *Swedish Central Railway Co v IRC* [1925] AC 351; also, Lord Radcliffe's comments on the case in *Unit Construction Co*, ibid 366-367.

6 Section 122A of the Australian ITAA allows deduction of expenditure on prospecting, preparation of mining sites, construction of buildings and provision of facilities necessary for mining operations. It also allows costs for the acquisition of mining or prospecting rights, along with the incorporation costs for mining companies. Section 124AA allows similar expenditure in petroleum and gas operations undertaken by a resident taxpayer in Australia.

Already, PNG allows under its own domestic law the amortisation of capital expended in exploration and extraction of petroleum and mineral deposits. If the proposal is adopted, Australian companies investing in PNG's mining and petroleum sector will enjoy a system of double deduction uncommon in other tax treaties.

Business profits

The taxation of business profits is dealt with in Article 7, which assigns primary tax jurisdiction to the country in which the enterprise is located. However, if the enterprise carries on business in the other contracting country through a permanent establishment, then it may be taxed in that other country but only on the profits which arise from, or are connected with, the permanent establishment. Article 7 is intended to prevent the taxation of the income of non-residents from casual activities where the non-resident has no base of operations or a permanent establishment in the source country.

What is a permanent establishment?

Article 5 defines what constitutes a 'permanent establishment'. In line with the provision in the OECD Model, Article 5 of the proposed Agreement defines a permanent establishment as including a place of management, a branch, an office, a factory, a workshop, a mine, an oil natural resources. This article is significant because it prescribes the extent to which the country from which the profits are generated—(source country) can assert taxing power over such profits. The article will be relied upon in taxing the profits of a branch or agency of a foreign company. It will also catch profits of a foreign subsidiary if it is not locally incorporated. However, since PNG imposes a higher rate of corporation tax on foreign companies not incorporated in PNG,[7] most foreign companies tend to incorporate locally.

Article 5 also includes under the definition of permanent establishment things like a building site,[8] a construction, an installation, or an assembly project. Whereas the OECD Model requires that such site, installation or assembly project should last more than 12 months to qualify as a permanent establishment, the proposed PNG-Australia Agreement reduces the qualifying period to 90 days. This is important because it will allow the source country to assert taxing power over profits arising from activities of a short-term nature. It has been noted that where a 12 month time requirement is adopted, it is much easier for an enterprise engaged in a short-term project, or different projects each lasting less than 12 months, to escape source country tax for lack of a permanent establishment.

In determining whether an activity satisfies the time requirement, it is common practice to treat each site separately unless different sites are connected to the same project.

7 Companies incorporated in PNG are charged corporation tax at the rate of 35% while non-resident companies pay 48%. For the mining sector an additional profits tax of 17% is imposed.

8 This covers buildings, roads, bridges, canals, dams, pipelines, excavations, dredgings, etc.

The practice in the United States for the purposes of determining duration is to treat as a single project any consecutive activity or series of contracts which are commercially and geographically interdependent. A similar approach is followed in PNG. As a result, the qualifying period prescribed under a tax agreement is crucial to a country's taxation power over such activities.

PNG authorities are anxious to ensure that the period within which a continuing activity qualifies to be taxed as a permanent establishment is reduced to three months. This will enable them to tax more effectively logging activities and the activities of subcontractors in the petroleum and mining sectors. Most of the operators in this area are Australian residents who would escape source taxation if the period were made longer. But on Australia's part, this will be the only double tax agreement in which Australia has agreed to reduce the required period to three months. The other treaties adopt a six or twelve month period. Out of the 18 comprehensive double tax agreements Australia has concluded with foreign countries, half use a six month time requirement and the other half adopt the twelve month time requirement prescribed by the OECD Model Convention. Significantly, though, the 12 month period has been conceded only in treaties with countries whose trading relations with Australia are not closest.[9]

Important, too, in Article 5 is the proposed inclusion of three additional activities under the definition of permanent establishment. First, an enterprise will be taken to have a permanent establishment in the other country where it carries on supervisory activities in connection with a building site, construction or assembly project where such supervision lasts more than 90 days. Secondly, where substantial equipment is being used for or under contract with an enterprise of one country in the other country, such use will constitute a permanent establishment. But in this regard there is no time requirement. Thirdly, there is a clause which covers the provision of consultancy services by an enterprise of one country in the other country on activities which continue for an aggregate period of 90 days in any year of income. As a matter of interpretation, the consultancy activity need not be continuous. It will suffice if intermittent services are provided for periods which in aggregate add up to 90 days in a particular year of income.

What makes the inclusion of such apparently short-term activities significant is that the OECD Model excludes them from its definition of permanent establishment because of their temporary nature.[10] This has been a source of contention, particularly in treaties with developing countries which view a narrow definition of permanent establishment as being restrictive of their power to tax at source. The frequency with

9 The shorter period requirement of six months is used in tax treaties with the United Kingdom, USA, Japan, Germany, New Zealand, the Philippines, Singapore, Malaysia and Korea.

10 The OECD Model proceeds on the premise that a permanent establishment is a fixed place of business where the activity of an enterprise is carried on with a fair degree of continuity and regularity; see *Consolidated Premium Iron Ores v IRC* (1957) 28 TC 127, 157; also Rosenbloom HD, 'Trends in Tax Treaties Between the United States and Developing Countries' in *IFA Seminar Proceedings*, 1979, p 18.

which such activities are undertaken, and the substantial revenue they generate, has ensured passionate negotiations to make them taxable in the source country. Therefore, the inclusion of supervisory and consultancy services provided by foreigners, particularly for projects undertaken in PNG, will render taxable a large amount of revenue which would otherwise escape tax at source.

Income from international traffic

With regard to the taxation of profits from the operation of ships and aircraft in international traffic, the proposed PNG-Australia Agreement adopts a scheme of taxation which departs slightly from the OECD Model Convention. Under the Convention such profits are taxed only in the country in which the operator of the vessel is based. But the proposed Agreement intends to distinguish two classes of profits under this category.

On the one hand, profits which arise from the carriage of passengers and cargo across the two countries are to be taxed only in the country in which the operator is resident. However, profits which a resident of one country receives from journeys confined solely to places within the other country are to be taxed in the country in which they arise. An example of profits which may be caught under this provision are the proceeds from commercial aircraft and cruises which ferry tourists from Brisbane and Cairns for tours within PNG's provincial and other tourist attraction centres.

Taxation of dividends

Dividends and profit distributions are to be taxed in the country in which the recipient is resident, a fairly standard provision under the OECD Model Convention. But the dividend article in the proposed Agreement departs from the Model in two respects. First, it allows the use of two different rates of tax at source and does not discriminate between portfolio dividends and ordinary dividends. Where the source is Australia, the tax rate on a dividend destined for PNG must not exceed 15% of the gross dividend. PNG is allowed to charge up to 20% tax on a dividend payable to an Australian resident. This represents a significant concession by Australia, particularly because in all its taxation treaties Australia has not agreed to differential rates for another country.

Nonetheless, Australia's insistence on its right as a source country to tax dividends at the rate of 15% has been quite consistent.[11] It is noteworthy that the dividend withholding tax rates prescribed by the proposed Agreement are much lower than the rates charged in both countries. Australia charges a 30% rate on all dividends, while PNG has a non-resident dividend withholding tax at 48% of the gross amount. A

11 In all its tax treaties Australia adopts a 15% source tax on dividends. Only the treaty with Canada imposes the lower rate of 10% prescribed by the OECD Model Convention. In its commentary on article 10 of the OECD Model, Australia had expressed reservations on the OECD proposition. Australia reserved its right to tax, at a rate not less than 15%, all dividends paid by a company resident in Australia.

non-resident withholding tax on dividend income is often the final tax on the non-resident taxpayer.

PNG authorities also want the Agreement to extend the entitlement to imputation credits on franked dividends paid by Australia companies to shareholders of such companies who are resident in PNG. At present, s 46 of the Australian ITAA allows such credits only on dividends payable to resident shareholders. Section 46(2), which is the relevant subsection, provides that:

> . . .a shareholder, being a company that is a resident, is entitled to a rebate on its assessment in respect of income of the year of income of the amount obtained by applying the average rate of tax payable by the shareholder—
>
> (a) if the shareholder is a private company in relation to the year of income, to the sum of—
>
> (i) one half of the part of any private company dividends that is included in its taxable income; and
>
> (ii) the part of any other dividends that is included in its taxable income; and
>
> (b) if the shareholder is not a private company in relation to the year of income, to the part of any dividends that is included in its taxable income.

PNG further seeks to use the proposed Agreement to reintroduce a tax relief arrangement formerly available by virtue of s 46 which when read together with s 7(2) of the Australian ITAA extended the intercompany dividend rebate between Australian companies to dividends paid to an Australian company by a company in PNG. Section 7(2) provided that:

> A taxpayer who is a resident in PNG shall, for the purposes of assessment and payment of income tax derived from sources in Australia, be deemed to be a resident of Australia.

The arrangement had existed until 1973[12] when the relief was restricted by the enactment of s 46(10), and repealed in 1975 when PNG became an independent state.[13] The need for its reintroduction underlies the view in PNG that tax changes in Australia have an important impact on PNG because of the degree to which its economy is dependent on Australia.

There are two more proposals upon which PNG authorities are keen to obtain Australian assent. The first seeks to treat PNG company tax paid or deemed to have been paid under the tax sparing provisions of the proposed Agreement as if it were Australian company tax for the purposes of allowing imputation credits to Australian resident shareholders. The second proposal seeks to allow full tax sparing relief for PNG tax foregone as part of that country's tax incentive scheme in place of the partial relief available under the gross-up method favoured by Australia. PNG believes that the partial relief would diminish the incentive provided under PNG's domestic tax system. Moreover, PNG wants the tax sparing

12 Act No 165 of 1973 s 9.
13 Act No 80 of 1975 s 5.

relief to continue without time limit in line with that country's other treaty arrangement.[14]

Interest and royalties

The proposed Agreement deals with the taxation of income from interest and royalties in much the same way. Primary jurisdiction will lie with the country in which the recipient of the interest or the royalty is resident, but the country of source may tax the same income at a rate not exceeding 10%. This provision will not vary the application of domestic law in either country. Each already imposes a comparable rate of tax on such income. The only change will be the availability of a foreign tax credit proposed under Article 23.[15]

Income from alienation of property

The taxation of profits from the alienation of property is dealt with in Article 13. Profits from the sale of real or incorporeal property (including shares or other interest in a company) are to be taxed in the country where the property is located. This, too, is a fairly standard arrangement. PNG is, however, suggesting the inclusion of a provision which could greatly benefit Australian residents taking up long-term employment in PNG. It is proposed that the period for which an Australian resident working in PNG may elect to have one's Australian dwelling treated as one's principal residence for the purposes of the exemption from capital gains tax under s 160ZZQ of the Australian ITAA should be extended from the present 4 years to 7 years.

If accepted, the 7 year absence from the dwelling will be treated as temporary cessation of residence in terms of ss 160ZZQ(11) and 160ZZQ(21) of the Act. As a result, any use of the premises for income-generating purposes (eg renting) during that period would be disregarded in determining liability to capital gains tax. The extension of the election period to 7 years will enable Australian contract workers in PNG to serve at least two 3 year contracts without the risk of losing the tax relief on their principal residence in Australia.

Income from dependent personal services

PNG seeks to have the salaries, wages or other employment emoluments derived from short-term assignments by Australian residents in PNG taxed exclusively at source. A total exemption of that income from Australian tax is proposed. In its present form, Article 15 of the proposed Agreement, which deals with income from dependent personal services, gives exclusive jurisdiction to the country in which the person is ordinarily resident. The source country would tax such income only if the recipient is present in that country for a total period of 90 days or more and such

14 Incidentally, PNG has finalised only one tax treaty, with Canada. Three more are being negotiated with the following countries: the Federal Republic of Germany, the United Kingdom and Australia.

15 For Australian residents, a foreign tax credit is already available under s 160AF as modified in 1988 by the newly-inserted subsection.

remuneration is paid from sources within that state. But PNG feels that a 90 day requirement would operate to its disadvantage because it would restrict greatly that country's taxing power over employment income earned by non-resident employees over shorter periods of time.

As mentioned at the beginning, many Australians work on brief assignments in PNG. It is understandable that PNG should regard the salaries, wages and allowances paid to such employees as an important source of tax revenue for the country.

Conclusion

On the whole the proposed tax Agreement between Australia and PNG is not seen simply as a mechanism for the allocation of taxing powers and the avoidance of double taxation of income flows between the two countries. The proposed Agreement is also seen as a vehicle for resource allocation in the form of investment and manpower flows to PNG, which is crucial to that country's development effort.

The proposed agreement appears to underlie a conscious economic policy which can be seen as a follow up to the 'Joint Declaration of Principles', a bilateral document adopted recently underlining the importance Australia attaches to its interests in PNG. But whether the proposed Agreement represents a consistent tax policy intended to promote investment in the underdeveloped countries of the South Pacific region, or simply a case of a most favoured nation, is not quite clear.

If this Agreement is to be a trendsetter, certain policy issues will have to be addressed. The first is whether the Agreement will serve as a precedent for future negotiations with less developed countries in the region, for example Fiji or the other states in the South Pacific. Already, there are strong indications that this will not be the case. The PNG—Australia Agreement is likely to remain a unique treaty. A preamble to the proposed Agreement emphasising the special relationship between the two countries is being considered. This will prevent reliance on the terms of the Agreement in double taxation negotiations with other countries.

Another issue that has to be addressed is the need to maintain equity of taxation. A tax policy which encourages investment abroad is likely to undermine neutrality at home. This can be justified only if Australian capital in PNG produces investment profit flows which help Australia's overall balance of payments position. This cannot happen if profits are retained by the companies and kept beyond the reach of the Australian revenue authorities. If that happens, need will arise to review the focus of tax treaty policy.

There are some interesting international comparisons on this point. The United States has gone through tax policies which at first openly favoured foreign investment, especially after World War II. Foreign source income was taxed at preferential rates. The foreign tax credit was broadened, and an exemption or deferral of tax was granted on the undistributed or reinvested profits of American firms trading overseas. With time, however, a complete turnaround in policy occurred.

Current tax policy in USA is against preferential treatment of the foreign investor and instead prefers to give incentives to domestic investors by way of an investment credit for capital and equipment utilised in the United States.[16] The reason could well be that, with soaring unemployment at home, maintaining a policy which promotes foreign investment and the creation of jobs overseas is very hard to defend politically. Besides, providing incentives for foreign investment is now seen as an interference with the efficient allocation of investment resources which should be left to flow to areas of higher profit return without the distorting effect of incentives. As a result of such views, tax deferral provisions have been systematically removed from US domestic legislation. Similarly, recent tax treaties which have attempted to included provisions which are favourable to foreign investors have failed to obtain Senate approval.

By contrast, European countries pursue policies which encourage overseas investments, particularly in developing countries. In their tax treaties most European countries allow tax sparing credit on undistributed profits and adopt provisions in their own countries which give effect to investment incentives in the source country. For example, Britain now allows a tax credit on foreign taxes actually paid and those foregone in the source country as a result of some incentive scheme.

Australia may well benefit from these international tax practices in charting its tax treaty course. At previous sessions, taxation officials clearly indicated that some of the additional proposals put forward by the PNG negotiators are contrary to Australia's long standing tax treaty practice, while some may undermine policies which prompted certain reforms in domestic legislation. Australia is also mindful of the fact that, given the treaty nature of the proposed Agreement, conceding too much to PNG could set a precedent which would compromise Australia's ability to negotiate effectively with other countries in future treaties.

16 See Patrick RJ, 'US Tax Treaties with Developing Countries' in Hellawel JA (ed), *US Taxation and Developing Countries* (1980) 307.