BUSINESS TAX ACT

EXPLANATORY MEMORANDUM

These notes provide a detailed technical analysis on a section-by-section basis of the Business Tax Act (referred to as the “Act”).

1. Short Title

This section provides that the Act may be cited as the Business Tax Act 2016.

2. Commencement and Application

This section provides for the commencement and application of the Act.

Subsection (1) provides that the Act commences from the date that notice of the Act is published in the Gazette.

Subsection (2) provides that the Act applies from 1 July, 2016. Business profits tax is imposed under section 11 by reference to the taxpayer’s tax year. “Tax year” is defined in section 3. In the ordinary case, the tax year is the period of 12 months ending on 30 June. This coincides with the Government’s budget year.

A company uses its financial accounting period as its tax year (see section 3 definition of “tax year”). This is consistent with section 24 and is intended to limit the compliance burden on companies by keeping the tax year and financial reporting period aligned. For example, the tax year of a company with an annual balance date for its financial accounts of 31 March is the period 1 April to 31 March.

For companies using a substituted tax year, section 48(2) provides for a transitional tax year on commencement of the Act for the period from 1 July, 2016 to the start of the taxpayer’s first full substituted tax year. For example, if the taxpayer’s substituted tax year is 1 April to 31 March, the period 1 July, 2016 to 31 March, 2017 will be a transitional tax year. Companies with a substituted tax year are required to report their taxable income and pay tax for the transitional tax year. This ensures that there is no deferral benefit for companies using a substituted tax year.

It is intended that the Act will come into force under subsection (1) prior to the application date under subsection (2). This gives effect to section 48(4), which requires a person who will be liable for business profits tax or small business tax to apply for a taxpayer identification number from the commencement date of the Act under subsection (1). Applications for a TIN are made under section 9 of the Revenue Administration Act. This applies only if the person does not already have a TIN, such as a sole trader that has no employees.

While it is intended that the Act will come into force prior to 1 July 2016, the operation of subsection (2) means that the Act applies only to amounts of gross revenue derived, and expenditure or losses incurred, on or after that date.

Subsection (2) is expressed to be subject to subsections (3) and (4). Subsection (3) provides that section 35 applies from the date specified by the Secretary in a notice in the Gazette. Section 35 is intended to counter the base erosion that can arise from thin capitalisation practices (i.e. foreign investors financing business operations through an excessive use of debt over equity). Thin capitalisation practices take advantage of the tax rate differential between the tax value of the interest deduction and the non-resident withholding tax rate on interest payments (which is usually lower than the tax value of the interest deduction). At the time of enactment, the tax rates under the Act are aligned with the tax value of the interest deduction being 10% (the business profits tax rate) and the non-resident tax rate also being 10%. For this reason, section 35 is not immediately operative. However, the rates may change in the future and, therefore, the thin capitalisation rule has been included to protect against possible thin capitalisation practices that may arise in the future. Subsection (3) allows the Secretary to activate section 35 by notice in the Gazette.

Subsection (4) provides that the application date for the consequential amendment in clause 3 of Schedule 3 is 1 October 2014 (i.e. the application date of the Employment and Services Tax Act). Clause 3 of Schedule 3 makes a technical correction to the Employment and Services Tax Act to ensure that the source rule in section 9(1)(b) of the Employment and Services Tax Act aligns with the equivalent source rule for the business profits tax in section 9(3)(d) of the Act. This amendment has retrospective effect as it is favourable to taxpayers.

3. Definitions

This section sets out, in alphabetical order, definitions of terms used in the Act. These definitions apply unless the Act specifies otherwise. The main definitions are discussed below; the other definitions are self-explanatory. Sections 4 to 9 provide further definitions for the purposes of the Act.

Amount

This term is relevant to many provisions in the Act that refer to an “amount”. In particular, section 17 includes certain “amounts” in gross revenue.

The definition is inclusive so that “amount” otherwise has its normal meaning. In the context of the Act, “amount” means the total of something in value (such as income, price, cost, or expenditure).

It is expressly provided that an amount includes an “amount-in-kind”. Thus, an amount can be either in money or in kind (such as a benefit).

> **Example:** ABC Co sells goods to XYZ Co for $100. XYZ Co may pay $100 cash for the goods or it may provide services in return that have a value of $100. Regardless of how XYZ Co pays for the goods, the $100

cash or the services are both treated as an amount for the purposes of the Act.

Business

This term is central to the operation of the Act as the business profits tax (section 11) and the small business tax (section 12) are imposed on persons who are conducting a business.

"Business" is defined to mean any activity, whether continuous or short term, conducted for the purposes of economic gain. The central requirement for an activity to be a business is that it is conducted for "economic gain". The key indicators that an activity is conducted for economic gain are profit motive and the existence of some system and organisation to the activity conducted.

While normally a business is carried on continuously (i.e. there is repetition of commercial activity), the definition makes it clear that even a short-term activity is a business provided it is conducted for economic gain. For this reason, the Act refers to the "conduct" of a business rather than the "carrying on" of a business.

The definition expressly includes any trade, manufacture, profession or other commercial activity. The terms "trade", "manufacture" and "profession" are not separately defined and, therefore, have their ordinary meaning. The conduct of "trade" involves the exchange of goods or services and, therefore, the reference to trade includes the engaging in "simple merchanting" (i.e. the buying and selling of goods) and the provision of services including those services that are not professional services. "Manufacture" means the transformation of raw materials or component parts into intermediate or finished goods. A "profession" is a vocation in which skill, based on theoretical knowledge acquired through higher education, is applied to the affairs of others to meet their needs. Common examples of professions are legal practice, medical practice, dentistry, architecture, accountancy, pharmacy, and optometry. The definition also includes any other commercial activity, which should be interpreted broadly to include any activity that is business-like in character.

The definition expressly excludes an employment. This is because employment income is subject to the employment tax. "Employment" is defined in section 3 to have the same meaning as in the Employment and Services Tax Act. This ensures that the exclusion for employment from the definition of "business" aligns with the imposition of employment tax on employment income under the Employment and Services Tax Act.

Business asset

This term is primarily relevant to section 17(1)(b) (which includes the gain made by a person on the disposal of a business asset in gross revenue) and section 19(1)(d) (which allows a deduction for a loss made by a person on disposal of a business asset).

"Business asset" is defined to mean any asset used in the conduct of a business. "Asset" is not separately defined and is intended to have its ordinary meaning, namely anything that may be turned to pecuniary account. The word "asset" has been used in preference

to the word "property" which, if read narrowly, would unduly limit the scope of the definition of business asset. An asset is a business asset regardless of whether it is revenue or capital in nature. The definition expressly includes inventory, a depreciable asset, a business intangible and goodwill. “Inventory”, “depreciable asset” and “business intangible” are separately defined in section 3. “Goodwill is not defined and, therefore, has its ordinary meaning. In broad terms, “goodwill” is an intangible asset comprising that part of the overall value of a business that is not reflected in its tangible or other intangible assets. The value may derive from a brand, location, or the human capital of the business workforce.

The determination of whether an asset of a person is a business asset depends first on the characterisation of the person’s activities as a “business” (separately defined in section 3). In broad terms, a business is any activity undertaken for economic gain. If a person is conducting a business, an asset of the person is a business asset for the purposes of the Act when the following conditions are satisfied:

(1) The asset is “used” in the conduct of a business. “Use” is defined in section 3. The definition is inclusive so that it otherwise has its ordinary meaning, namely to put into service or apply for a purpose. The definition of “use” is extended to include “available for use”. This would cover, for example, an item of plant held in reserve should there be an increase in demand. The definition also covers “held”. This is intended to cover property, a structural improvement, or a right that is not physically used, but is otherwise held in a business, such as financial assets (shares, debts, and the like) of a business. The word “conduct” is used (rather than “carrying on”) to align with the broad definition of “business” in section 3, particularly the inclusion of a short-term commercial activity that may not involve repetition of activity.

(2) The asset is used wholly or partly to derive gross revenue. An asset that is used solely to derive exempt income is not a business asset even if it is an asset of a business.

Business intangible

This term is relevant to section 19(1)(c) (which provides a deduction for the decline in value of a person’s business intangibles during a tax year), and section 21 (which provides for the annual calculation of the deduction). While, for financial accounting purposes, the term “amortisation” is used to refer to the decline in value of business intangibles, for drafting simplicity, the term depreciation is used in the Act to refer to the decline in value of both depreciable assets and business intangibles.

In broad terms a business intangible loses value over its useful life as it is used in a business. The cost of a business intangible is deducted over the useful life of the intangible rather than as an outright deduction in the year acquired. This allocates the cost of the intangible to the tax years in which is it is “consumed” (or “used up”) in deriving gross revenue.

There are five broad categories of business intangibles:

(1) Intellectual and industrial property, such as copyrights, patents and trademarks (paragraph (a)).

(2) A customer list, distribution channel, or unique name, symbol, or picture, or other marketing intangible (paragraph (b)). It is noted that a marketing intangible will be a business intangible only if it has a limited useful life. A marketing intangible with an unlimited useful life will not be a business intangible.

(3) Contractual rights with a benefit of more than one year (paragraph (c)). For example, a right granted under a contract to act as an exclusive distributor for a period of three years is a business intangible. If the person appointed has paid for this right, then the amount paid is the cost of the intangible and this amount is deducted under section 19(1)(c) over the life of the right (i.e. three years). This inclusion covers also prepayments for a period of more than one year.

(4) Any other expenditure that provides an advantage or benefit for more than one year (paragraph (d)). For example, while advertising is normally a current expenditure wholly deductible in the tax year incurred, substantial expenditure to launch a new product may be regarded as capital as the life of the expenditure is likely to exceed one year. In this case, the expenditure would be regarded as an intangible deducted over its expected life. While paragraph (d) is drafted in broad terms, it does not include any expenditure to acquire tangible property (personal or real).

(5) Preliminary expenditure (separately defined in section 3) (paragraph (e)).

In each case, the property, right or expenditure is only a business intangible if it has a limited useful life and is used wholly or partly to derive gross revenue. "Use" is defined in section 3. The definition is inclusive so that it otherwise has its ordinary meaning, namely to put into service or apply for a purpose. The definition is extended to include "available for use" and "held". The reference to held is intended to counter any argument that the word "use" is limited to physical use. This may be relevant to intangible rights. An asset can be a business intangible even if it is only partly used to derive gross revenue. In this case, the depreciation deduction is apportioned under section 21(3). An intangible that is used solely to produce exempt income or for private purposes is not a business intangible.

Company

This term is relevant to the definitions of "distribution", "person", "resident company", "resident person", and "tax year" in section 3, the definition of "entity" in section 23(6), and sections 9(3)(c) (which provides a source rule relating to the gain arising on the disposal of, inter alia, shares in a company that derives more than 50% of its value from

real property in Nauru), 17(2)(a) (which excludes a distribution by a company from gross revenue), and 24(4) (which provides for a change in tax year by a company).

There are three inclusions in the definition:

(1) A corporation incorporated under the Corporations Act 1972 (paragraph (a)). Division 1 of Part III of the Corporations Act provides for the incorporation of companies in Nauru.

(2) A foreign corporation within the meaning of the Corporations Act 1972 (paragraph (b)). The definition of "foreign incorporation" has two inclusions: (i) a corporation, company, society, association, or other body incorporated outside Nauru; and (ii) an unincorporated society, association, or other body that under the law of its place of origin may sue or be sued or hold property in the name of the secretary or other officer of the body or association duly appointed for that purpose and that does not have its head office or principal place of business in Nauru.

(3) A statutory corporation created under Nauru law or the law of a foreign country (paragraph (c)). Statutory corporations do not go through a process of incorporation so may not be covered by paragraph (a) or (b) of the definition.

Depreciable asset

This term is relevant to the section 3 definition of "business asset", section 19(1)(c) (which provides a deduction for the decline in value (i.e. depreciation) of a person's depreciable assets during a tax year), and section 21 (which provides for the annual calculation of the depreciation deduction). In broad terms, a depreciable asset is tangible personal property or a structural improvement to real property that loses value over its useful life as it is used in a business. The cost of a depreciable asset is deducted over the useful life of the asset rather than as an outright deduction in the year the asset is acquired. This allocates the cost of the asset to the tax years in which the asset is "consumed" (i.e. used up) in deriving gross revenue.

An asset is a depreciable asset if the following four conditions are satisfied:

(1) The asset must be tangible movable property (such as plant, equipment, fixtures and fittings, vehicles and computers) or a structural improvement to real property. "Structural improvement" is separately defined in section 3. The main example of a structural improvement is a commercial building (such as a factory or warehouse). Importantly, it is only the structural improvement that is a depreciable asset and not the land on which it is located.

(2) The asset must have an ascertainable useful life of more than one year. An asset that does not have an ascertainable useful life (such as land) is not a depreciable asset. The cost of an asset acquired to derive gross revenue and that has an ascertainable useful life of one year or less is fully deductible in the tax year acquired provided section 19(1)(a) is satisfied. This is because the cost is fully consumed in the year the asset is acquired. However, in the case of inventory, this is subject to section 19(1)(b), which provides for the deductibility of

inventory at the time of disposal rather than acquisition (this reflects the fact that inventory holds its value while it is held by a taxpayer before being sold).

(3) The asset must be likely to lose value as a result of wear and tear, or obsolescence. In other words, the asset is consumed in the course of business operations and, therefore, will have no value at the end of its useful life. An asset that is likely to hold its value or appreciate in value is not a depreciable asset. Such an asset will still be a business asset if it satisfies the definition in section 3, but, ordinarily, it would be expected that there would be a gain on disposal of such an asset and such gain is included in gross revenue under section 17(1)(b). If there is a loss on disposal, the loss is an allowable deduction under section 19(1)(d), but not until the year of disposal.

(4) The asset must be used wholly or partly to derive gross revenue. "Use" is defined in section 3. The definition is inclusive so that it otherwise has its ordinary meaning, namely to put into service or apply for a purpose. The definition of "use" is extended to include "available for use". This would cover, for example, an item of plant held in reserve should there be an increase in demand. An asset can be a depreciable asset even if it is only partly used to derive gross revenue. In this case, the depreciation deduction is apportioned under section 21(3). An asset that is used solely to produce exempt income or for private purposes is not a depreciable asset.

Derived

This term is relevant to a number of provisions in the Act. The term "derived" effectively defines the time when an amount is taxable. For example, for business profits tax purposes, "derived" defines the time when an amount is included in gross revenue.

Paragraph (a) provides that, for the purposes of the business profits tax (i.e. tax imposed under section 11), "derived" means received or receivable depending on a person's method of tax accounting as determined under section 24. For a person accounting for tax on an accruals basis, "derived" means the arising of the right to receive an amount of gross revenue. For a person accounting for tax on a cash basis, "derived" means the receipt of an amount included in gross revenue. "Received" is defined in section 3 to mean an actual receipt or a constructive receipt.

Paragraph (b) applies for the purposes of other taxes imposed under the Act, namely the small business tax, non-resident tax, and international transportation business tax. For these taxes, derived means received (as defined in section 3).

Distribution

This term is relevant to section 17(2)(a) (which provides that a distribution by a company, partnership, trust, or other body of persons is not included in the gross revenue of the recipient) and section 20(1)(b) (which denies a person a deduction for a distribution).

"Distribution" is defined to mean a dividend paid by a company to a shareholder, an allocation of profits by a partnership to a partner, an entitlement to income of a beneficiary of a trust, or a distribution of profits by any other body of persons to a member of the body. It is expressly provided that an allocation of profits by a partnership to a partner includes a partner's drawings.

In broad terms, a distribution is an allocation of profits after a company, partnership, trust, or body has derived the profits.

Employment income

This term is relevant to section 17, which defines "gross revenue". Section 17(1)(a) specifies that employment income is not included in gross revenue. "Employment income" is subject to tax under the Employment and Services Tax Act.

"Employment income" is defined to have the same meaning as in the Employment and Services Tax Act. "Employment income" is defined in section 5 of that Act. Section 5(1)(a) includes the following amounts in employment income: salary, wages, an allowance, leave pay, payment in lieu of leave, overtime pay, bonus, commission, fees, gratuities, salary or wage supplements, and other similar amounts received by an employee in respect of employment. Section 5(1)(b) includes an amount received by an employee on termination of employment in employment income.

Instalment period

This term is relevant to section 41 (which provides for the payment of instalments of business profits tax) and section 48(3) and (4) (which provides for the payment of instalments of business profits tax during the first tax year under the Act, including a transitional tax year).

"Instalment period" is defined by reference to the tax year of a person. If the tax year of a person is the normal tax year under the Act, the instalment periods for the year are the periods of three months ending on September 30, December 31, March 31, and June 30.

If a company uses a substituted tax year, the instalment periods for the substituted tax year are the periods of three months ending on the last day of the third, sixth, ninth, and twelfth months of the year. For example, if the substituted tax year of a company is the calendar year, the instalment periods are the periods of three months ending on March 31, June 30, September 30, and December 31.

Insurance premium

This term is relevant to section 9(3)(e) (the source rule for insurance premiums), section 13 (imposition of non-resident tax on insurance premiums paid to non-residents), and section 44 (collection of non-resident tax on insurance premiums through withholding).

The definition of "insurance premium" is inclusive so that the term otherwise has its ordinary meaning, namely a premium paid for insurance against a risk. The definition expressly includes a premium for reinsurance or other offshore placement of insurance.

The definition expressly excludes a life insurance premium and, therefore, references in the Act to an insurance premium are confined to premiums for general insurance.

Interest

This term is primarily relevant to section 9(3)(d) (which provides rules for the determination of when interest is derived from sources in Nauru), section 13 (which imposes non-resident tax on interest derived by a non-resident person from sources in Nauru), and section 18(1)(e) (which treats interest paid on certain widely held debentures as exempt income).

"Interest" is defined broadly to reflect the fact that there is considerable flexibility on international monetary markets as to how financial instruments may be structured. This is particularly important for the imposition of non-resident tax under section 13.

The definition is inclusive so that "interest' otherwise has its ordinary meaning, namely an amount that is calculated by reference to a principal sum and that is compensation for the lender being kept out of the use or enjoyment of that principal sum. The definition has two inclusive paragraphs that extend the meaning of "interest" beyond the normal meaning.

Paragraph (a) includes any amount that is consideration for the use of money or for being given time to pay. An amount comes within paragraph (a) regardless of whether it is paid as a lump sum or periodically, and however it may be described. Paragraph (a) expressly includes discounts and premiums, as these are amounts paid for the use of money.

Paragraph (b) includes any amount that is functionally equivalent to an amount that comes within paragraph (a). Examples include an amount payable for the time value of money under a derivative financial instrument and a payment of defaulted interest by a guarantor.

International agreement

This term is relevant to section 18(1)(a) and (d) (which specifies amounts as exempt income). Amounts that are exempt income are not subject to tax under sections 11 to 14.

The definition specifies two classes of international agreement. Paragraph (a) includes an agreement between the Government of Nauru and a foreign government for the prevention of double taxation (i.e. a tax treaty). The parties to a tax treaty are referred to as "Contracting States". In broad terms, a tax treaty allocates taxing rights between the Contracting States in relation to income arising from transactions between the states (employment, business, and investment income). While Nauru does not have any tax treaties at the time of enactment of the Act, it is possible that Nauru may enter into such treaties at some later point in time and, therefore, paragraph (a) of the definition accommodates that possibility.

Paragraph (b) includes an agreement between the Government of Nauru and a foreign government or international organisation (separately defined in section 3) for the

provision of financial, technical, humanitarian, or administrative assistance to the Government.

International Financial Reporting Standards

This term is relevant to section 19(1)(b) (which provides that the deduction for the cost of inventory disposed of during a tax year is determined according to international financial reporting standards ("IFRS"), section 21(2) (which provides that the annual decline in value of a depreciable asset or business intangible is determined according to IFRS), section 24(1) (which provides that the taxable income of a taxpayer is determined according to IFRS subject to any modifications in the Act or regulations), and section 35(4) (which provides that the terms "debt" and "equity" for the purposes of the thin capitalisation rule have their meanings under IFRS).

"International financial reporting standards" is defined to mean the most recent International Financial Reporting Standards issued by the International Accounting Standards Board or any successor entity taking over the role of issuing International Financial Reporting Standards.

International organisation

This term is relevant to the section 3 definitions of "international agreement" (which includes an agreement between the Government of Nauru and an international organisation for the provision of financial, technical, humanitarian, or administrative assistance to the Government) and "person" (which includes an "international organisation").

"International organisation" is defined to mean an organisation the members of which are sovereign powers or the Governments of sovereign powers. Examples of an international organisation are the Asian Development Bank, or the United Nations and its Specialised Agencies, such as the World Bank.

While the income of an international organisation may be exempt income under section 18(1)(b), an international organisation may be liable for withholding tax under section 44 in relation to payments made to non-resident persons. For this reason, an international organisation is treated as a "person" for the purposes of the Act.

Inventory

This term is relevant to the computation of gross revenue (section 17(1)(a)) and the allowance of deductions under section 19(1)(b).

The definition of "inventory" is inclusive so the term otherwise has its ordinary meaning, namely any property that is turned over in the ordinary course of business. Ordinarily, inventory is tangible movable property, i.e. goods, but any property that is capable of being traded can be inventory. This includes real property and intangible property, such as shares in a company. Thus, for example, if a person's business is to buy and sell shares (i.e. a share trader), the shares are the inventory of the business. However, if the shares are part a purely passive investment activity of the person, they are not inventory.

Paragraph (a) includes anything that is produced, manufactured, purchased, or otherwise acquired for manufacture, sale, or exchange. This includes semi-finished and finished goods.

Paragraph (b) includes raw materials and consumables (such as oils and glues) used in a production or manufacturing process.

Paragraph (c) includes livestock, which are animals raised for profit to produce food or fibre (such as wool). While animals raised for labour would also be within the ordinary meaning of livestock, animals used as beasts of burden or working beasts are expressly excluded from being inventory.

Non-resident individual

This term is relevant to section 12, which imposes small business tax on non-resident individuals.

"Non-resident individual" is defined to mean an individual who is not a "resident individual" as defined in section 8. The following are non-resident individuals:

(1) A citizen of Nauru that has a permanent home outside Nauru, except employees of the Government of Nauru posted abroad.

(2) A foreign citizen (other than a resettled refugee).

Non-resident person

This term is primarily relevant to section 13 (which imposes non-resident tax on interest, a royalty or insurance premium derived by a non-resident person from sources in Nauru) and section 14 (which imposes international transportation business tax on a non-resident person operating a ship or aircraft in international traffic).

"Non-resident person" is defined to mean a person who is not a resident person. "Person" is defined in section 3 to mean an individual, partnership, trust, company, body of persons, government, political subdivision of a government, or international organisation. "Resident person" is defined in section 3. Taking account of the section 3 definitions of "person" and "resident person", the following are non-resident persons:

(1) A citizen of Nauru that has a permanent home outside Nauru, except employees of the Government of Nauru posted abroad.

(2) A foreign citizen (other than a resettled refugee).

(3) A partnership, trust, company, or other body of persons that is incorporated, formed, settled, or otherwise established or created outside Nauru.

(4) A foreign government.

(5) A political subdivision of a foreign government, such as a state or provincial government.

(6) An international organisation (as defined in section 3).

Person

This term is relevant to many sections in the Act. In particular, the definition is relevant to the charging provision in section 11 for the business profits tax under which tax is imposed on a "person".

"Person" is defined to mean an individual, partnership, trust, company, body of persons, government, political subdivision of a government, or international organisation.

Paragraph (a) includes an individual. An individual is a natural person.

Paragraph (b) includes a partnership, trust, company, and any other body of persons. "Company" is separately defined in section 3 to mean: (i) a corporation incorporated under the Corporations Act 1972; (ii) a foreign corporation within the meaning of the Corporations Act 1972; and (iii) a statutory corporation created under Nauru law or the law of a foreign country.

The other terms are not separately defined in the Act and, therefore, have their normal meaning. A partnership is the relation that exists when two or more persons carry on business for joint profit. A trust is any relationship that is recognised under the laws of equity as a trust. The main category of trust is a trust created by a settlement, but the definition would also include a constructive or resulting trust. The reference to "other body of persons" is a reference to an unincorporated association or body of persons (such as a members' club or society).

Paragraph (c) includes the Government of Nauru, a local authority in Nauru, a foreign government (such as the Government of Australia or New Zealand), or a political subdivision of a foreign government. The reference to a "political subdivision" of a foreign government is a reference to tiers of government below the national government, such as a state or provincial government of a foreign country.

Paragraph (d) includes an international organisation, which is separately defined in section 3 to mean an organisation the members of which are sovereign powers or the Governments of sovereign powers. Examples include the Asian Development Bank and the United Nations and its specialised agencies (such as the World Bank).

The definition of "person" is broad and includes entities that may not otherwise be a legal person under general law (such as a partnership or a body of persons). The definition of "person" is broad because the word is used in many different contexts in the Act. However, while "person" is defined broadly, it will take its meaning from the context. For example, only persons conducting a business are liable for business profits tax.

Importantly, the broad definition ensures that any obligation (such as a liability for tax) imposed under the Act in relation to an entity that is a person applies to the entity

collectively. Once the obligation is imposed on the entity, section 12 of the Revenue Administration Act provides that the individual or individuals constituting the "tax representative" of the entity must comply with the obligation on behalf of the entity.

Preliminary expenditure

This term is relevant to the section 3 definition of "business intangible", which includes preliminary expenditure.

Preliminary expenditure means expenditure that is incurred prior to the commencement of a business, other than expenditure incurred to acquire tangible personal property or real property. An amount is preliminary expenditure only if the income to be derived from the business will be wholly and exclusively included in gross revenue. Thus, for example, there is no deduction for preliminary expenditure if the whole or the part of the income from the business to which it relates will be exempt income.

Examples of pre-commencement expenditure include the cost of feasibility studies, the construction of prototypes and trial production activities.

Quarter

This term is relevant to the imposition of small business tax and collection of international transportation business tax. Small business tax is imposed, reported, and collected on a quarterly basis under sections 12, 39, and 40. Section 43(3) empowers the Secretary to allow the non-resident owner or charterer of an aircraft to file returns and pay international transportation business tax quarterly. The tax return and tax payable for a quarter is due by the last day of the month following the end of each quarter.

"Quarter" is defined to mean the period of three months ending on 30 September, 31 December, 31 March and 30 June.

Received

This term is primarily relevant to the tax accounting (i.e. timing) rules in the Act. The timing rule for the taxes imposed under Part 2 of the Act is specified by the word "derived" (see section 17(1) (business profits tax), section 12(2) (small business tax), section 13 (non-resident tax) and section 14 (international transportation business tax)). "Derived" is defined in section 3. Paragraph (a)(ii) of the definition of "derived" provides that a person accounting for business profits tax on a cash basis derives an amount when the amount is received. Paragraph (b) of the definition of "derived" provides that an amount is derived for the purposes of the small business tax, non-resident tax, or international transportation business tax when the amount is received.

"Received" is defined inclusively so that it otherwise has its ordinary meaning, namely to take into one's possession. The definition expands upon the ordinary meaning to legislatively provide for a principle of constructive receipt.

Paragraph (a) treats an amount as received by a person if it is applied on his or her behalf. This may be at the instruction of the person or under any law. For example, if

an amount owing to a person is paid to a creditor of the person under a garnishee order, the person is treated as having received the garnisheed amount.

Paragraph (b) treats an amount as received by a person if it is reinvested, accumulated or capitalised for the benefit of the person. For example, any interest on a term deposit that is reinvested by a bank is treated as received by the depositor.

Paragraph (c) treats an amount as received by a person if it is credited to an account, or carried to any reserve, or a sinking or insurance fund for the benefit of the person. For example, if a foreign parent company has lent money to its Nauru subsidiary and the interest payable under the loan is credited to the parent company in an inter-company loan account, the parent company will be treated as having received the interest at the time the amount is so credited.

Paragraph (d) treats an amount as received by a person if it is otherwise made available to the person.

Relative

This term is relevant to the definition of “associate” in section 4. Under section 4(3), *prima facie*, an individual and a relative of the individual are treated as “associates” of each other for the purposes of the Act. In this context, the term “associate” is mainly relevant to the determination of whether a person satisfies the business profits tax threshold (section 12(3)) and the base erosion measure in relation to interest and other amounts paid to associates (section 20(1)(h) and (i)).

“Relative” is defined by reference to an individual. The following are treated as a relative of an individual:

(1) An ancestor of the individual. This includes the parents, grandparents, and great-grandparents of the individual (paragraph (a)).

(2) A descendant of any of the grandparents of the individual. This includes the parents, siblings of the parents, and the siblings, children, grandchildren, great-grandchildren, nephews and nieces of the individual (paragraph (a)).

(3) An adopted child of the individual (paragraph (a)).

(4) An ancestor of the spouse of the individual. This includes the parents, grandparents, and great grandparents of the individual’s spouse (paragraph (b)).

(5) A descendant of any of the grandparents of the individual’s spouse. This includes the parents, siblings of the parents, and the siblings, children, grandchildren and great-grandchildren (including children from another marriage), nephews and nieces of the individual’s spouse (paragraph (b)).

(6) An adopted child of the individual’s spouse (paragraphs (b)).

(7) A spouse of the individual (paragraph (c)).

(8) A spouse of any person mentioned in (1)-(6) above (paragraph (c)).

Under the section 4(3), an individual and a relative of the individual are treated as associates of each other unless the Secretary is satisfied that neither person is reasonably expected to act in accordance with the directions, requests, suggestions, or wishes of the other.

Resident company

This term is relevant to section 18(1)(e) (which treats certain interest paid by a resident company to a non-resident as exempt income).

"Resident company" is defined to mean a company referred to in paragraph (b) of the section 3 definition of "resident person". This covers a company incorporated in Nauru. It also covers a corporation created by a Nauru statute. A statutory corporation that obtains its legal existence through a statute enacted in Nauru is created or established in Nauru and, therefore, is a resident company.

Resident person

This term is relevant to the source rules in section 9 and withholding tax under section 44.

There are three inclusions in the definition of resident person.

Paragraph (a) treats a resident individual as a resident person. "Resident individual" is defined in section 8 to mean: (i) a citizen of Nauru, except when a citizen has a permanent home outside Nauru; or (ii) an individual who lives in Nauru as a resettled refugee.

Paragraph (b) treats a partnership, trust, company or other body of persons that is incorporated, formed, settled, or otherwise established in Nauru as a resident person. "Incorporated" and "settled" are terms of legal art. "Incorporated" relates to a company and "settled" relates to a trust. Thus, a company that is incorporated in Nauru and a trust established by a deed of settlement executed in Nauru are resident persons. A statutory corporation is created by statute and, therefore, a statutory corporation created by statute enacted in Nauru will be a resident person on the basis that the corporation is established or created in Nauru. Partnerships and bodies of persons are created by agreement and, therefore, will be resident persons if the agreement is executed in Nauru.

Paragraph (c) treats the Government of Nauru or any local authority in Nauru as a resident person.

Royalty

This term is primarily relevant to section 13 (which imposes non-resident tax on a royalty derived by a non-resident person from sources in Nauru).

"Royalty" is defined broadly. The definition follows international norms and is consistent with the definition commonly found in tax treaties. Paragraphs (a) and (b) include any periodical or lump sum amount as consideration for the use of, or right to use, industrial or intellectual property rights (such as patents, trademarks, and copyrights).

Paragraph (c) includes any periodical or lump sum amount as consideration for the receipt or right to receive visual images and/or sounds transmitted by satellite, cable, optic fibre, or similar technology in respect of television, radio or internet broadcasting. This ensures that payments for the use of new communication technologies are treated as royalties.

Paragraph (d) includes any periodical or lump sum amount as consideration for the use of industrial, commercial, and scientific equipment (i.e. equipment lease rentals).

Paragraph (e) includes any periodical or lump sum amount as consideration for the supply of scientific, technical, industrial, or commercial knowledge, information, experience, or skill. This will include any consideration for the supply of knowhow. It is not intended that this paragraph include the supply of services. The distinction between knowhow and services can be difficult to make. In broad terms, knowhow is pre-existing knowledge and information that is secret that a person is given a right to use. On the other hand, in this context, the provision of services involves using one's customary skills to bring knowledge and information into existence.

There is some overlap between the definition of "services fee" under section 8(1) (which includes a knowhow payment) of the Employment and Services Tax Act and paragraph (e) of the definition of "royalty". While a knowhow payment comes within paragraph (e) of the definition of "royalty", the scope of paragraph (e) is broader than knowhow payments. If an amount is both a service fee subject to services tax and a royalty subject to tax under the Act, section 13(3)(c) gives priority to the application of the services tax.

Paragraph (f) includes any periodical or lump sum amount as consideration for the supply of services ancillary to the use of any property, right, or supply mentioned in paragraphs (a)-(e). This is the only circumstance in which service fees are treated as royalties. If an amount is both a service fee subject to services tax and a royalty subject to tax under the Act, section 13(3)(c) gives priority to the application of the services tax.

Paragraph (g) includes an amount as consideration for the right to take minerals or a living or non-living resource from the land or sea (such as timber). As the introductory words of the definition refer to an amount "however described", paragraph (g) includes any premium paid for such right. This covers a natural resource royalty, such as a payment made for the right to enter land and remove minerals or timber if the amount of the payment is based on the quantum or value of the resource taken. Paragraph (f) also includes an amount that is calculated by reference to the quantum of resources taken even though the recipient may have no rights in those resources. This would include for example a private overriding royalty paid in relation to a natural resource right.

Shareholder

This term is relevant to the section 3 definition of “distribution” and section 23(5)(b) (which limits the carry forward of a net loss by a company when there has been a majority change in ownership of the company).

The definition is inclusive so that shareholder will have its ordinary meaning under the Corporations Act. The definition includes any person with an ownership interest in a company. This is intended to cover an interest in a company that may not have a shareholding, such as a statutory corporation.

Spouse

This term is relevant to the section 3 definition of “relative”. Under paragraph (c) of the definition of “relative”, an individual and a spouse of the individual are treated as relatives. Paragraph (c) of the definition of “relative” also treats an individual and a spouse of a person referred to paragraphs (a) and (b) of the definition of “relative” as relatives. Thus, for example, an individual and the spouse of the sister of the individual are relatives. Further, under paragraph (b) of the definition of “relative”, an individual and a relative of the individual’s spouse are treated as relatives. Thus, for example, an individual and the sister-in-law of the individual’s spouse are treated as relatives.

Structural improvement

This term is relevant to the section 3 definition of “depreciable asset” (which includes a structural improvement to real property that satisfies paragraphs (a), (b), and (c) in the definition of “depreciable asset”).

“Structural improvement” is defined in relation to real property. It includes a building, road, driveway, car park, pipeline, bridge, tunnel, airport runway, canal, dock, wharf, retaining wall, fence, power lines, water or sewerage pipes, drainage, landscaping, or dam. As the definition is inclusive, it will also include any other improvement to real property.

Tax

This term is relevant to section 38 (which sets out the record-keeping obligations of a person liable to tax under the Act). It is also relevant to the Revenue Administration Act, which defines “tax” to mean a tax payable under a tax law. Thus, an amount that is a tax under the Act is treated as a tax for the purposes of the Revenue Administration Act.

“Tax” is defined to mean tax imposed under the Act. The following taxes are imposed under the Act: business profits tax (section 11); small business tax (section 12); non-resident tax (section 13); and international transportation business tax (section 14). The definition expressly includes an instalment of business profits tax payable under section 41.

Tax year

This definition is mainly relevant to the imposition of business profits tax under section 11. Under this section, business profits tax is imposed annually by reference to the taxpayer's tax year.

The basic rule is that the tax year is the period of 12 months ending on 30 June (i.e. the period 1 July to 30 June). This coincides with the Government's budget year.

For a company, the tax year is the period of twelve months ending on the date of the annual balance of its financial accounts. This avoids the compliance costs that would otherwise be incurred if the company has to prepare two sets of accounts based on different periods. It is particularly relevant to companies (whether incorporated in Nauru or elsewhere) that form part of a multinational group when the group has a financial accounting balance date that is different from June 30. For example, a company that uses the period of twelve months ending on March 31 as its financial accounting period will use the same period as its tax year. Section 24(4) applies when the financial accounting period of a company changes.

Use

This term is relevant to the section 3 definitions of "business asset", depreciable asset" and "business intangible", and section 21 (which provides for the depreciation of depreciable assets and business intangibles used to derive gross income).

The definition is inclusive so that it otherwise has its ordinary meaning, namely to put into service or apply for a purpose. The definition is extended to include "available for use". This would cover, for example, an item of plant held in reserve should there be an increase in demand. The definition also covers "held". This is intended to cover property, a structural improvement, or a right that is not physically used, but is otherwise held in a business, such as financial assets of a business.

4. Associate

This section defines "associate" for the purposes of the Act. The definition is relevant to section 12(3) (which permits the Secretary to aggregate the total gross revenue of associates in determining whether the business profits tax threshold is satisfied), section 20(1)(h) and (i) (which are base erosion measures that deny a deduction for interest and other amounts paid by the owner of a business to an associate unless the associate is taxed on the interest or other amount), and section 35 (thin capitalisation rule applicable to foreign-controlled resident companies).

The basic rule is set out in subsection (1), which provides that two persons are associates when the relationship that exists between them is such that one person may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of the other, or both persons may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of a third person. Whether a person may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of another person is determined objectively having regard to all the facts and circumstances.

The reference to both persons being reasonably expected to act in accordance with the directions, requests, suggestions, or wishes of a third person would cover, for example, “sister” companies under common control.

Subsection (2) states an exception, namely that two persons are not associates solely by reason of an employment or client relationship. In the absence of subsection (2), subsection (1) may treat an employer and employee as associates, as the employee would ordinarily be expected to act in accordance with the directions of his or her employer. Similarly, in the absence of subsection (2), subsection (1) may treat, for example, a lawyer and their client as associates as the lawyer would ordinarily be expected to act in accordance with the directions of its client.

The exception in subsection (2) applies only when the employment or client relationship is the sole reason why one person may act in accordance with the directions, requests, suggestions, or wishes of the other. If there is another reason why this may occur (e.g. the employee and employer are relatives), the two persons may still be associates.

Subsection (3) makes it clear that an individual and a relative of the individual are associates. “Relative” is defined in section 3 (see explanation above). There is an exception if the Secretary is satisfied that neither person is reasonably expected to act in accordance with the directions, requests, suggestions, or wishes of the other. This may be the case, for example, when an individual and a relative are estranged.

The following are examples of persons who would ordinarily be regarded as associates: husband and wife, siblings, parent and child, partners in a partnership, beneficiary and trustee, and controlling shareholders and the company they control.

5. Fair Market Value

This section defines “fair market value” for the purposes of the Act. The definition is the relevant to the determination of the cost of a business asset (section 29), and the determination of the consideration for the disposal of a business asset (section 31).

Subsection (1) sets out the basic rule. The fair market value of an asset, service, or benefit provided at a particular time is the value that the asset, service, or benefit would ordinarily fetch in the open market at that time. The fair market value is determined by reference to the market conditions prevailing at the time and place that the market value is to be determined. The relevant market may differ depending on the nature of the transaction - it may be a retail market, a wholesale market, or some specialist market in which the supplier and recipient are operating.

Subsection (1) is expressed to be subject to the application of the transfer pricing rules in section 34 applicable to cross-border transactions. Thus, the transfer pricing rules have priority over the fair market value rules in section 5.

If it is not possible to work out a fair market value of the actual asset, service, or benefit (“actual transaction”), subsection (2) states that the fair market value of a similar asset, service, or benefit (“similar transaction”) is used, adjusted to take account of the differences between the similar transaction and the actual transaction. Subsection (3)

provides that a transaction is similar to the actual transaction if it is the same as, or closely resembles, the actual transaction in character, quality, quantity, functionality, materials, or reputation.

Subsection (4) empowers the Secretary to determine the fair market value of an asset, service, or benefit when it is not possible to determine the amount of the fair market value under subsections (1) and (2). An example of when subsection (4) may apply is when there is no market for particular goods other than as between the actual seller and purchaser. The Secretary will look at all the relevant circumstances to find the price at which a particular asset, service, or benefit would have been sold for or provided in the open market had there been such a market for the asset, service, or benefit. For example, the Secretary may determine fair market value by looking at the cost of all inputs to an asset or service and adding to this the probable rate of return a taxpayer might be expected to seek for an investment with similar costs in a similar market. This is similar to the cost-plus methodology used for transfer pricing. Similarly, in appropriate cases, an approach based on the resale price method could be used to work out the fair market value. It is expressly provided that the valuation determined by the Secretary must be consistent with generally accepted valuation principles.

6. Non-profit Organisation

This section defines "non-profit organisation" for the purposes of the Act. The definition is relevant to section 18(1)(c) (which treats business income derived by a non-profit organisation as exempt income provided it relates to the core function of the organisation).

Subsection (1) provides that a "non-profit organisation" is an organisation that satisfies the following conditions:

(1) The organisation is established solely to provide relief to those suffering from poverty or distress, or for the advancement of education, amateur sport, or religion. An organisation that is established to provide relief to those suffering from poverty or distress, or for the advancement of education, amateur sport, or religion, and for some other purpose or purposes is not a non-profit organisation.

(2) No part of the income or other funds, or assets of the organisation are used, or are available for use for the private benefit of a proprietor or member of the organisation. The reference to a private benefit includes a monetary benefit (such as a distribution of the surplus of the organisation) or the private use of the facilities of the organisation. The income, funds, and assets must be used or available for use only for the public purposes of the organisation as set out in paragraph (a).

(3) The Secretary has certified, by notice in writing, that the organisation is a non-profit organisation. Thus, an organisation is a non-profit organisation only if the organisation is certified as a non-profit organisation. This is the case even if, as a matter of fact, the organisation satisfies conditions (1) and (2).

The word "organisation" is intended to have a broad meaning, including all forms of entity that may be engaged in charitable activities (such as a company, trust, or unincorporated body of persons).

Subsections (2) and (3) provide for applications to the Secretary by an organisation seeking certification as a non-profit organisation. Subsection (2) requires that the application must be in the form approved by the Secretary for such applications (see section 52 of the Revenue Administration Act). Subsection (3) obliges the Secretary to certify an organisation as a non-profit organisation if conditions (1) and (2) above are satisfied. A decision of the Secretary to refuse to certify an organisation as a non-profit organisation is a reviewable decision as defined in section 3 of the Revenue Administration Act and can be challenged only by applying to the Minister for review of the decision under section 42 of the Revenue Administration Act.

Subsection (4) provides that certification under subsection (3) remains in force until withdrawn by the Secretary by notice in writing to the organisation. The withdrawal of a certification may be as a result of a notification under subsection (5) or on the Secretary's own motion. A decision of the Secretary to withdraw the certification of an organisation as a non-profit is a reviewable decision as defined in section 3 of the Revenue Administration Act and the organisation can challenge the decision only by applying to the Minister for review of the decision under section 42 of the Revenue Administration Act.

Subsection (5) obliges an organisation to notify the Secretary immediately, in writing, if the organisation no longer satisfies the conditions to be a non-profit organisation. This applies to an organisation that ceases to satisfy conditions (1) and (2) above. An organisation that fails to notify the Secretary as required under subsection (4) may be liable for a late filing penalty under section 62 of the Revenue Administration Act or prosecuted for an offence under section 72 of the Revenue Administration Act.

7. Permanent Establishment

This term is relevant to section 9 (which provides rules for determining whether income is derived from sources in Nauru) and section 13(3)(b) (which provides that an amount of interest, a royalty, or insurance premium that is attributable to a permanent establishment in Nauru of a non-resident person is not subject to non-resident tax).

The definition of "permanent establishment" follows closely the definition in tax treaties. Notwithstanding that Nauru does not have any tax treaties at the time of enactment, it is intended that the existing learning on "permanent establishment" in relation to tax treaties is relevant to the interpretation of the definition, particularly as set out in the Commentary to the OECD Model Tax Convention on Income and Capital.

Subsection (1) sets out the basic notion of a permanent establishment, namely a place of business through which the business of a person is carried on. There are two key requirements, namely there must be: (i) a place of business; and (ii) a business activity must be conducted through the place of business (for example, it cannot be just a vacant office). The requirement is that a place of business is established. There is no time limit for a place of business to constitute a permanent establishment, although the 90-day time period in subsections (2)(c) and (3) may provide some guidance on this to avoid

very short term operations from being a permanent establishment. Subsection (1) is expressed to apply subject to the rest of the section.

Subsection (2)(a) includes a place of management, branch, office, factory, warehouse, or workshop. These are largely illustrative of the types of places that can qualify as a permanent establishment under the general principle stated in subsection (1). Each inclusion is to be interpreted broadly. For example, "office" includes any office no matter what activity is conducted through the office. However, there is an exception for an office that has representation of a person's business as its sole activity (i.e. a representative or liaison office). To qualify for the exception, the representative or liaison office must not engage in the negotiation of contracts of sale or supply. The negotiation of contracts is more than simply a liaison or representative function and goes to the core of a non-resident person's business.

Subsection (2)(b) includes a mine site, oil or gas well, quarry, or other place of exploration for, or exploitation of, natural resources. "Natural resources" is not defined and, therefore, has its ordinary meaning, namely any natural occurring materials or things that have economic value. The main examples of natural resources are minerals, oil and gas, timber, and fish. Again, the listed establishments are largely illustrative of the types of places that qualify as a permanent establishment under the general principle as stated in subsection (1) as they would ordinarily constitute a place of business. It is expressly provided that a boat or ship that provides a base for the exploration or exploitation of natural resources is a permanent establishment. This will be particularly relevant to fishing and possible future seabed mining activities in Nauru.

Subsection (2)(c) includes the furnishing of services by a person under the same or a connected project for a period or periods aggregating more than ninety days within any twelve-month period. The services may be furnished by the person in their personal capacity, or through employees or other personnel (such as contractors). The ninety-day period is tested over any twelve-month period and not by reference to the tax year. Paragraph (c) can be satisfied by the aggregation of two or more periods for a total period of ninety days within any period of twelve months provided the aggregated periods relate to the same or a connected project of the person providing the services or by an associate of the person. This is intended to prevent fragmentation of project activities among related persons so as to avoid the 90-day threshold.

Subsection (3) includes a building site, a construction, assembly or installation project, or supervisory activities (such as the services of a consulting engineer) connected with such site or project, but only if the site, project, or activity continues for more than ninety days. Subsection (3) is expressed to be subject to subsection (4), which provides for aggregation of related building sites, projects, and activities of associates in determining the 90-day threshold. Again, this is intended to prevent fragmentation of projects and activities among related persons so as to avoid the 90-day threshold.

Subsection (5) specifies two situations when an agent is a permanent establishment of the principal. The first is when the agent regularly negotiates contracts on behalf of the principal. The focus is on the agent's role in the negotiation of contracts and not on the formal act of signing or concluding a contract. It is made clear that, if an agent regularly negotiates contracts on behalf of a principal, the agent is a permanent establishment of the principal regardless of whether the contracts are concluded in the name of the

principal or the agent. In particular, it is intended that a commissionaire (or undisclosed principal) arrangement can give rise to the agent being a permanent establishment of the principal. Under such an arrangement, an agent may contract with a customer of the principal in its own name rather than in the name of the principal. As far as the customer is concerned, they believe they are dealing with the commissionaire, but, under the contractual arrangements between the commissionaire and the principal, title to the goods passes direct from the principal to the customer

The second is when the agent maintains a stock of goods from which the agent regularly delivers goods on behalf of the principal. The ability to make timely delivery of goods is considered to be a central part of any sales activity.

While it is usual to have an independent agent exception to the definition of "permanent establishment", in the context of a small country like Nauru where significant levels of foreign investment may be facilitated through the Nauru Agency Corporation, all Nauru agents (dependent and independent) are treated as permanent establishments.

8. Resident Individuals

This section defines "resident individual" for the purposes of the Act. The definition of "resident individual" is relevant to the section 3 definitions of "resident person (which includes a resident individual) and "non-resident individual" (which is defined to mean an individual that is not a resident individual). The definition is relevant also for the rates of tax specified in Schedule 1 with a tax-free threshold applying to resident individuals under the business profits tax. By virtue of the section 3 definition of "non-resident individual", an individual who is not a resident individual is a non-resident individual for the purposes of the Act. Similarly, by virtue of the section 3 definition of "non-resident person", an individual who is not a resident individual is a non-resident person for the purposes of the Act.

Subsection (1)(a) treats a citizen of Nauru as a resident individual. An individual may be a citizen of Nauru under Part VIII of the Constitution or section 4 of the Naoero Citizenship Act, 2005. There is an exception when a citizen has a permanent home outside Nauru. This means that an individual who is a citizen of Nauru but who has made their permanent home outside Nauru is not a resident individual and, therefore, is a non-resident person for the purposes of the Act. Whether a citizen of Nauru has a permanent home outside Nauru will depend on all the facts and circumstances. The following factors will be important in the analysis: (i) whether the individual has formed an intention to live outside Nauru; (ii) the intended period of absence from Nauru (as a rule of thumb, an individual is likely to have a permanent home outside Nauru if the intended period of absence is three years or more); and (iii) the "durability" (or strength) of the individual's association with the foreign jurisdiction as compared to the durability of the association with Nauru.

Subsection (2) provides that a citizen of Nauru who is an employee of the Government of Nauru posted abroad is a resident individual during the period of the posting. This is the case even if they have a permanent home outside Nauru. This will apply to Nauruan diplomats, consular and trade officials, and the like.

Subsection (1)(b) treats an individual who lives in Nauru as a resettled refugee as a resident individual.

As stated above, an individual who is not a resident individual is a non-resident individual and a non-resident person for the purposes of the Act. Thus, the following individuals are non-resident individuals and non-resident persons:

(1) Citizens of Nauru that have a permanent home outside Nauru, except employees of the Government of Nauru posted abroad.

(2) Foreign citizens (other than a resettled refugee).

9. Source of Income

The section is relevant to the territorial limitation on the imposition of the tax under the Act. Business profits tax is imposed on a person who has taxable income for a tax year (section 11). The taxable income of a person is computed as the gross revenue of the person for a tax year less any deductions allowed to the person for the year (section 16). The gross revenue of a person includes only amounts derived from sources in Nauru (section 17(1)). Non-resident tax is imposed on a non-resident person who has derived interest, a royalty, or insurance premium from sources in Nauru (section 13).

The section provides rules (commonly referred to as "source rules") for determining when amounts are derived from sources in Nauru. "Derived" is defined in section 3 by reference to the relevant tax. For the business profits tax, the meaning of derived depends on the person's method of tax accounting (cash or accruals) as determined under section 24. For all other taxes, "derived" means received (separately defined in section 3).

Subsections (1) and (2) provide the basic rules for determining when business income is derived from sources in Nauru. These rules apply unless a specific rule in subsection (3) applies to a particular class of income.

Subsection (1) provides that an amount derived by a resident person in conducting business is derived from sources in Nauru except to the extent that the amount is attributable to a business conducted by the person through a permanent establishment outside Nauru. "Derived", "permanent establishment", and "resident person" are defined in section 3. The effect of this rule is that all business income of a resident person is derived from sources in Nauru except when the income is attributable to a fixed overseas business operation of the resident.

Subsection (2) provides that an amount derived by a non-resident person is derived from sources in Nauru if it satisfies one of three tests. The main test is in paragraph (a), which provides that an amount is derived from sources in Nauru to the extent to which it is attributable to a business conducted by a non-resident through a permanent establishment of the non-resident person in Nauru. "Derived", "non-resident person" and "permanent establishment" are defined in section 3. This rule is the same as the taxing rights rule in Article 7 of the OECD Model Tax Convention on Income and Capital and the learning under tax treaties on this Article is relevant in the interpretation of paragraph (a).

Paragraphs (b) and (c) are integrity measures intended to support the main test in paragraph (a). Under paragraph (b), an amount is derived from sources in Nauru to the extent to which it is attributable to sales in Nauru of goods or merchandise of the same or similar kind as those sold through a permanent establishment of the non-resident person in Nauru. This would apply, for example, if the head office of a non-resident person made direct sales to customers in Nauru of the same goods it sells through a permanent establishment in Nauru. Such direct sales could be made, for example, over the internet. Under paragraph (c), an amount is derived from sources in Nauru to the extent to which it is attributable to other business activities (such as the provision of services) of the same or similar kind to that conducted in Nauru through a permanent establishment of the non-resident.

Paragraphs (b) and (c) specify the same taxing rule as in Article 7 of the UN Model Tax Convention on Income and Capital and the learning under tax treaties based on the UN Model is relevant in the interpretation of subsection (2)(b) and (c).

Subsection (3) provides source rules for specific items of income. These rules apply despite the application of subsections (1) and (2). Thus, an amount specified in subsection (3) may be derived from sources in Nauru either because it comes within subsection (1) or (2), or because, while not coming within those subsections, it comes within subsection (3). Subsection (3) refers to the relevant “amount” being “derived” (defined in section 3).

Subsection (3)(a) provides that rent arising from the lease of real property is derived from sources in Nauru if the leased property is located in Nauru. This will be relevant if a person’s business involves the leasing of real property in Nauru.

Subsection (3)(b) provides that a gain arising on the disposal of real property is derived from sources in Nauru if the property is located in Nauru. This is relevant to section 17(1)(b) if the real property is a business asset. “Real property” is defined in subsection (4) to make it clear that it includes mining or petroleum rights, and information relating to such rights.

Subdivision (3)(c) provides that a gain arising on the disposal of an interest in a company, partnership, or trust, is derived from sources in Nauru if the value of the interest is derived, directly or indirectly solely or principally, from real property in Nauru. The purpose of this source rule is to prevent the avoidance of subsection (3)(b) by the owners of an entity selling their interest in the entity rather than the entity selling the real property. Again, it is relevant to section 17(1)(b) if the interest in the entity is a business asset.

Subsection (3)(d) provides that interest or a royalty is derived from sources in Nauru if it is either:

(1) Paid by a resident person, unless the amount paid is an expenditure of a business conducted by the resident person through a permanent establishment outside Nauru.

(2) Paid by non-resident person as an expenditure of business conducted by the person through a permanent establishment in Nauru.

This is relevant to both the business profits tax (when the interest or royalty is gross revenue) and non-resident tax (which is imposed on interest or a royalty derived from sources in Nauru).

“Interest”, “royalty”, “resident person”, “non-resident person” and “permanent establishment” are defined in section 3.

Subsection (3)(e) provides that an insurance premium is derived from sources in Nauru if the premium is for the insurance of a risk in Nauru. “Insurance premium” is defined in section 3. Examples of insurance premiums for risks in Nauru include insurance against damage or destruction of a building in Nauru, indemnity insurance relating to a business conducted in Nauru, and motor vehicle insurance relating to vehicle used in Nauru. The definition of insurance premiums excludes a premium for life insurance.

10. Act Binds the Republic

This section provides that the Act binds the Republic.

This is particularly important, for example, when the Government of Nauru conducts a business, or pays interest, a royalty, or insurance premium to a non-resident person subject to non-resident tax under section 13.

11. Imposition of Business Profits Tax

This section provides for the imposition of business profits tax on a person that has taxable income for a tax year. The business profits tax is imposed annually, assessed on a self-assessment basis (section 39(5)), and collected through a current payments system (section 41).

Subsection (1) provides for the imposition of the tax. Business profits tax is imposed for each tax year at the rate specified in Schedule 1 on every person conducting a business that has taxable income for the year. Subsection (1) specifies the key concepts underlying the imposition of business profits tax.

First, subsection (1) identifies the taxpayer for the purposes of the business profits tax. It is provided that business profits tax is imposed on a person conducting a business. This really specifies two requirements: (i) there must be a “person”; and (ii) the person must conduct a “business”.

“Person” is defined in section 3 to mean an individual, partnership, trust, company, body of persons, a government, a political subdivision of a government, and an international organisation. The definition is broad and is intended to cover every possible “entity” that may conduct a business. For non-corporate entities, such as partnerships, trusts, and bodies of persons, it is the entity (and not the owner or owners of the entity) that is the person liable for business profits tax in relation to the business activities of the entity. However, under section 12 of the Revenue Administration Act, the entity’s representative for tax purposes is responsible for paying any business profits

tax payable by the entity. For example, the partners in a partnership are responsible for the payment of the business profits tax payable by the partnership. Further, the imposition of business profits tax on a person means that, if a person carries on more than one business, the gross revenues and expenditures of all businesses of the person are aggregated in calculating the person's taxable income for a tax year.

Business profits tax is imposed only on those persons who are conducting business. Section 3 defines "business" to mean any activity, whether continuous or short term, conducted for the purposes of economic gain. The definition expressly includes a trade, manufacture, profession, or other commercial activity. The definition of "business" makes it clear that an activity can be a business regardless of whether it is conducted continuously or for a short term. The definition of "business" excludes employment as defined in the Employment and Services Tax Act. The term "conducting" (rather than, say, "carrying on") is used in subsection (1) so as to accommodate the broad definition of "business" in section 3, particularly the fact that a short-term activity may constitute a business for tax purposes.

The income arising from activities that do not constitute a business are not subject to business profits tax. Examples of activities that do not constitute a business include a passive investment activity and purely charitable activities.

Second, subsection (1) identifies the tax base for the business profits tax by reference to the concept of "taxable income". This is defined in section 16 to mean the gross revenue of a person less total deductions. "Gross revenue" is defined in section 17 and deductions are allowed under section 19. Importantly, the tax base under the business profits tax is a net concept after taking into account the expenditures incurred in deriving amounts included in gross revenue.

A person conducting a business may not be liable for business profits tax because the person's income is exempt income. For example, a non-profit organisation conducting a business (such as second-hand shop) may derive only exempt income (see section 18) and, therefore, have no taxable income.

Third, subsection (1) provides for the imposition of business profits tax on a periodic basis, by reference to the "tax year". Consequently, a person liable to business profits tax must compute their taxable income by reference to the tax year. "Tax year" is defined in section 3 to mean the period of twelve months ending on June 30. A company is permitted to use the company's reporting period for financial accounting purposes as its tax year (see section 3 definition of "tax year"). This is a rule of convenience to avoid companies having to do separate accounts for the business profits tax purposes. The requirement to compute taxable income by reference to the person's tax year means that it is necessary to allocate amounts of gross revenue and expenditures to particular tax years. In broad terms, section 24(1) provides that financial accounting rules apply for this purpose, subject to some modifications in the Act reflecting the differences between tax and accounting. In particular, section 24(2) and (3) provides that accounting rules determine when income is "derived", and expenditures and losses are "incurred", for the purposes of the business profits tax.

Finally, subsection (1) imposes business profits tax at the rate or rates of tax specified in Schedule 1. At the time of enactment, the rate of business profits tax was 10%. The

same rate of tax applies to all persons liable for business profits tax whether they are an individual or an entity, although a tax-free threshold applies to a resident individual. As the rate of tax is a flat rate, it is imposed at the entity level (see discussion above), including for those entities that are not separate legal persons (such as partnerships, trusts, and other non-corporate bodies of person).

Subsection (2) provides for the computation of the business profits tax payable by a person for a tax year. This involves applying the rate of business profits tax specified in Schedule 1 to the taxable income of the person for the year. For example, if the taxable income of a company is $500,000, the business profits tax payable is $50,000 ($500,000 x 10%).

Subsection (3) excludes two classes of person from the application of the business profits tax:

(1) A non-resident individual subject to the small business tax under section 12 is not subject to business profits tax. This means that when both the business profits tax and small business tax can apply to a non-resident individual, the small business tax has priority.

(2) A non-resident person conducting a fishing business in Nauru under an agreement with the Nauru Fisheries and Marine Resources Authority. The payments made by the non-resident under the agreement operate as a type of presumptive income tax and avoids the administrative complexity that would otherwise apply in attempting to tax such persons on the net income of their Nauru fishing operations.

12. Imposition of Small Business tax

This section provides for the imposition of the small business tax.

Subsection (1) provides for the imposition of small business tax for each quarter on a non-resident individual conducting business. Small business tax applies only to non-resident individuals. In particular, it does not apply to companies because a company must comply with certain reporting obligations under the companies' legislation, which means that it should be able to keep the records necessary to comply with the business profits tax imposed under section 11.

The non-resident individual must conduct business. Section 3 defines "business" to mean any activity, whether continuous or short term, conducted for the purposes of economic gain. The definition expressly includes a trade, manufacture, profession or other commercial activity. The definition of "business" in section 3 makes it clear that an activity can be a business regardless of whether it is conducted continuously or for a short term. The definition of "business" excludes employment as defined in the Employment and Services Tax Act. The term "conduct" (rather than "carry on") is used in subsection (1) so as to accommodate the broad definition of "business" in section 3, particularly the fact that a short-term activity may constitute a business for tax purposes.

An individual conducting business is subject to the small business tax only if the following conditions are satisfied:

(1) The individual is a non-resident individual. By virtue of the section 3 definition, the following are non-resident individuals: (i) a citizen of Nauru that has a permanent home outside Nauru, except employees of the Government of Nauru posted abroad; and a foreign citizen (other than a resettled refugee).

(2) The non-resident individual must conduct business solely in Nauru. The business profits tax applies when a non-resident individual conducts business partly in Nauru and partly outside Nauru.

(3) The non-resident individual was not subject to the business profits tax for the previous tax year. The basic position is that, once a non-resident individual becomes subject to the business profits tax, the individual continues to subject to that tax. This is the case even if the non-resident individual's annual gross revenue falls below the small business tax threshold. However, subsections (7) - (9) set out a procedure whereby a non-resident individual who has been subject to the business profits tax can apply to the Secretary for permission for the small business tax to apply.

(4) The total gross revenue of non-resident individual for the previous tax year did not exceed the business profits tax threshold. "Gross revenue" is defined in section 17. In broad terms, gross revenue is the gross proceeds of a business (such as sales revenue and services fees) without deduction of expenditures and losses. By virtue of section 17(2), gross revenue does not include: (i) a distribution by a company, partnership, or trust; (ii) amounts that are exempt income (see section 18); or (iii) amounts subject to separate taxation (namely amounts subject to the non-resident tax, international transportation business tax, or services tax). The business profits tax threshold is specified in Schedule 2, which, at the time of enactment, is $250,000. If a person who has been subject to the small business tax exceeds the business profits tax threshold for a tax year, the person is subject to the business profits tax starting from the next following tax year.

Subsection (2) provides that the amount of small business tax payable by a non-resident individual for a quarter is computed by applying the rate specified in Schedule 1 to the total gross revenue derived by the individual for the year. At the time of enactment, the rate of small business tax is 1.5%. Gross revenue is subject to small business tax in the tax year in which it is "derived" by the non-resident individual. "Derived" is defined in section 3. For the purposes of the small business tax, "derived" means "received" (paragraph (b) of the definition). An amount of gross revenue is received when it is either actually received or constructively received (see section 3 definition of "received"). Thus, small business tax is accounted for on a receipts (rather than accruals) basis.

The business profits tax threshold may be manipulated through fragmentation of business activity between associates. For this reason, subsection (3) provides that, in determining the total gross revenue of a non-resident individual for a tax year for the purposes of determining whether the individual exceeds the business profits tax threshold, the Secretary may have regard to the total gross revenue of an associate or associates of the individual for the year. "Associate" is defined broadly in section 3. In

exercising the discretion, it is expected that the Secretary would have regard to the nature of the business of the two persons, the way the businesses are carried on, the connections between the businesses, and any other relevant matter. The greater the similarity or connection between the two businesses, the more likely it is that the Secretary will exercise the discretion to take account of the total gross revenue of associates of a non-resident individual in determining the total gross revenue of the individual for the purposes of determining whether the business profits tax threshold is exceeded.

Subsections (4) - (6) set out a procedure under which a small business taxpayer can apply to the Secretary for permission for the business profits tax to apply instead. This will be particularly important for non-resident individuals who start up a business with low revenues but high costs in the start-up phase, as it will allow them to carry their losses forward under the business profits tax. Subsection (4) provides that the application must be made in writing in the approved form, i.e. the form approved by the Secretary for such applications (see section 52 of the Revenue Administration Act).

Subsection (5) provides that the Secretary may approve an application under subsection (4) if satisfied that the applicant will keep proper records. The approval of an application for the business profits tax to apply is at the discretion of the Secretary so that applications can be monitored to ensure that the applicant has the capacity to keep proper records for the purposes of complying with the business profits tax. Subsection (10) provides that the Secretary may grant the application subject to such conditions as the Secretary may specify by notice in writing to the applicant. This is intended to ensure that amounts do not go untaxed or are subject to double tax as a result of the change in the basis of taxation. A decision of the Secretary on an application under subsection (4) is a reviewable decision as defined in section 3 of the Revenue Administration Act and the applicant can challenge the decision only by applying to the Minister for review of the decision under section 42 of the Revenue Administration Act.

Subsection (6) provides that an approval under subsection (5) applies from the commencement of the first tax year after the approval is granted and remains in force indefinitely. The only exception to this is if the Secretary permits the person to again be subject to the small business tax under subsection (9).

If the total gross revenue of a person for a tax year exceeds the small business tax threshold, the person is automatically subject to the business profits tax for the next following tax year. This is the combined effect of subsection (1)(c) and section 11(3)(a). However, once a person is subject to the business profits tax for a tax year, the effect of subsection (1)(b) is that the person continues to be subject to that tax even if the person's total gross revenue for a tax year falls below the small business tax threshold. In other words, there is no automatic movement from the business profits tax to the small business tax. Subsections (7) - (9) set out a procedure whereby a non-resident individual who is subject to the business profits tax can apply for the small business tax to apply.

Subsection (7) applies to a non-resident individual who satisfies the following conditions:

(1) The individual is subject to the business profits tax for a tax year.

(2) The total gross revenue of the individual for the tax year did not exceed the small business tax threshold.

If these conditions are satisfied, the non-resident individual may apply to the Secretary for permission for the individual to be subject to the small business tax rather than the business profits tax.

The making of an application under subsection (7) is expressed to be subject to the operation of subsection (8). If an individual is subject to the business profits tax as a result of a prior successful application under subsection (4), then subsection (8) provides that an application under subsection (7) can be made only after three years from the date of service of the notice granting the person permission for the business profits tax to apply. This is intended to prevent persons moving between the small business tax and the business profits tax on an annual basis depending on which gives the lowest tax outcome.

Subsection (9) provides that the Secretary may grant an application under subsection (7) when reasonable cause is demonstrated. Whether there is reasonable cause to allow a non-resident individual to move from the business profits tax to the small business tax depends on all the circumstances. It would be expected that that the Secretary would not exercise the discretion if the total gross revenue of the applicant will be below the small business tax threshold only temporarily. Approval under subsection (9) applies from the date set out in the notice of approval. It would be expected that, normally, this would be the first quarter after the end of the individual's last tax year under the business profits tax. However, there is flexibility for the Secretary to allow an earlier start date for the small business tax and this could be subject to the condition under subsection (10) that the business profits tax is reported for a transitional year prior to the commencement of the first quarter under the small business tax.

Subsection (10) provides that an approval under subsection (9) may be subject to such conditions as the Secretary may specify by notice in writing to the applicant. This is intended to ensure that amounts do not go untaxed or are subject to double tax as a result of the change in the basis of taxation. A decision of the Secretary on an application under subsection (9) is a reviewable decision as defined in section 3 of the Revenue Administration Act and the applicant can challenge the decision only by applying to the Minister for review of the decision under section 42 of the Revenue Administration Act.

13. Imposition of Non-resident Tax

This section provides for the imposition of "non-resident tax" on a non-resident person who derives interest, a royalty, or insurance premium from sources in Nauru other than when the income is attributable to a permanent establishment of the non-resident in Nauru. The tax is a final tax on the income and is collected by withholding from the person paying the income (see section 44). The tax is imposed on the gross amount of the income derived by the non-resident person with no deduction allowed for expenditures or losses incurred in deriving the income. Section 15(a) provides that non-resident tax is a final tax on the interest, royalty, or insurance premium.

Interest, a royalty, or insurance premium derived by a non-resident from sources in Nauru is business income that should be subject to Nauru tax. In fact, the failure to tax such income may result in "base erosion" in relation to the business profits tax if the payer of the interest, royalty, or insurance premium is subject to such tax. Base erosion arises if the payer of an amount of interest, a royalty, or insurance premium is entitled to a tax deduction for the amount paid but there is no corresponding Nauru taxation in the hands of the non-resident person deriving the interest, royalty, or insurance premium.

As stated above, non-resident tax applies only when the non-resident person deriving the interest royalty, or insurance premium does not have a permanent establishment in Nauru. Separate taxation of such income is necessary largely for administrative reasons. The absence of any physical presence in Nauru means that the business profits tax on the interest, royalty, or insurance premium cannot be efficiently collected on an ordinary assessment basis. Further, if these items of income were taxed on an assessment basis, there would be the difficulty of allocating expenditures (particularly expenditures incurred outside Nauru) as deductions in working out the taxable income of the non-resident. It is very difficult for the Secretary to police the allocation of foreign-incurred expenditures as deductions against such income. The non-resident tax overcomes these difficulties as the tax is imposed on the gross amount of the income and is collected from the payer of the income through withholding under section 44. This is consistent with international norms. Importantly, the business profits tax applies if the non-resident person has a permanent establishment in Nauru. In that case, the administrative difficulties referred to above can be overcome.

Subsection (1) provides for the imposition of non-resident tax on a non-resident person who derives interest, a royalty, or insurance premium from sources in Nauru. This tax is imposed only on a "non-resident person", which is defined in section 3 to mean any person who is not a resident person. The effect of the definition of "non-resident person" is that any person who is not within the section 3 definition of "resident person" is treated as a non-resident person, including a foreign-incorporated company, a foreign government, a political subdivision of a foreign government, and a public international organisation.

Non-resident tax is imposed under subsection (1) in respect of interest, a royalty, or insurance premium derived from sources in Nauru. This really states two conditions. First, the income received must have the character of interest, a royalty, or insurance premium. "Interest", "royalty, and "insurance premium" are defined in section 3. Second, the interest, royalty, or insurance premium must have a Nauru source. The rules for determining the source of income are in section 9. In the context of the non-resident tax, interest or a royalty will have a Nauru source under section 9(3)(d) if it is paid by:

(1) A resident person except when the interest or royalty is an expenditure of a business conducted by the person through a permanent establishment outside Nauru.

(2) A non-resident person as an expenditure of a business conducted by the person through a permanent establishment in Nauru.

Similarly, an insurance premium will have a Nauru source under section 9(3)(e) if it is for the insurance of a risk in Nauru.

Non-resident tax is imposed at the time the amount is "derived" by the non-resident person. By virtue of paragraph (b) of the definition of "derived" in section 3, an amount of interest, a royalty, or insurance premium is derived when received. "Received" is defined in section 3 to include a constructive receipt. For example, if a foreign parent company has lent money to its subsidiary in Nauru and the interest payable under the loan is credited to the benefit of the foreign parent company in an inter-company loan account (rather than actually paid), the foreign parent company will be treated as having received the interest at the time the amount is so credited (see paragraph (c) of the definition of "received" in section 3).

Non-resident tax is imposed at the rate specified in Schedule 1. At the time of enactment, the rate of tax was 10%.

While non-resident tax is formally imposed on the non-resident person receiving the interest, royalty, or insurance premium, the tax is collected through withholding by the person paying the interest, royalty, or insurance premium at the time of making the payment under section 44. Subsection (4) provides that the liability of a non-resident person for non-resident tax is satisfied to the extent that the payer of the income has paid the tax to the Secretary as required under section 44. A payer who fails to withhold tax as required under section 44(1) is personally liable for the tax (section 44(3)). Further, section 20(2) provides that, if the payer is entitled to a deduction for the interest, royalty, or insurance premium paid, the deduction is not allowed until the withholding tax has been paid to the Secretary. Withholding tax payable under section 44 is a "tax" for the purposes of the Revenue Administration Act (see definition of "tax" in section 3 of the Revenue Administration Act) and, therefore, unpaid withholding tax may be recovered from the payer under the collection and recovery provisions in the Revenue Administration Act.

Subsection (2) provides that the amount of non-resident tax payable by a non-resident person is computed by applying the rate of tax specified in Schedule 1 against the gross amount of the interest, royalty, or insurance premium derived. At the time of enactment, the rate of non-resident tax is 10%. Because non-resident tax is imposed on the gross amount of the interest, royalty, or insurance premium, no deductions are allowed for expenditures or losses incurred by the non-resident person in deriving the income.

Subsection (3)(a) provides that non-resident tax does not apply to an amount that is exempt income. The amounts treated as exempt income are specified in section 18. For example, an amount may be exempt under an international agreement between the Government of Nauru and the non-resident person's country of residence (section 18(1)(a)) or interest payable on certain widely held debentures issued on international monetary markets may be exempt under section 18(1)(e).

As stated above, a separate tax is imposed on the income because of the difficulty in taxing it on an ordinary assessment basis. If a non-resident person has a permanent establishment in Nauru, it is appropriate that any interest, royalty, or insurance premium forming part of the profits of the permanent establishment are taxed to the non-resident on an assessment basis. "Permanent establishment" is defined in section 3 and, in broad

terms, means a fixed place of business through which the business of the non-resident person is conducted. Subsection (3)(b) makes it clear that, in this situation, the income is taxable under the business profits tax.

Subsection (3)(c) provides that non-resident tax is not payable in respect of an amount subject to services tax imposed by section 12 of the Employment and Services Tax Act. This is relevant, for example, to knowhow payments that may come within paragraph (e) of the definition of "royalty" but which are treated as a service fee under section 8(1)(c) of the Employment and Services Tax Act and, therefore, subject to services tax under section 12 of that Act.

14. Imposition of International Transportation Business Tax

This section imposes a separate tax on the shipping and air transport income of a non-resident person. The tax is imposed on the gross revenue rather than net income of the non-resident person. This is because of the difficulty in allocating expenditures to the derivation of shipping and air transport income, particularly expenditures incurred outside Nauru. The taxation of international transportation business income of non-residents in this way is consistent with international norms. Section 15(a) provides that international transportation business tax is a final tax on the income to which it applies.

Subsection (1) provides for the imposition of the tax and, in so doing, specifies the key concepts underlying the imposition of the tax.

First, subsection (1) identifies those who are liable for international transportation business tax. It is provided that international transportation business tax is imposed on a non-resident person. "Non-resident person" is defined in section 3 to mean a person who is not a resident person. "Resident person" is also defined in section 3. In the ordinary case, the operator of a ship or aircraft will be a company and, therefore, the international transportation business tax will apply to company incorporated or formed outside Nauru.

Second, subsection (1) identifies the tax base by reference to the gross amount derived by the non-resident person for the carriage of passengers, livestock, mail, merchandise, or goods embarked or loaded in Nauru and destined for a place outside Nauru (i.e. the carriage is in international traffic). Thus, international transportation business tax is not imposed on the gross revenue of a non-resident person arising from purely internal transportation within Nauru. This is taxable under the business profits tax.

As international transportation business tax is imposed on the gross amount derived from the transportation, no deductions are allowed for expenditures incurred by the non-resident in deriving the revenue.

Finally, subsection (1) imposes international transportation business tax at the rate specified in Schedule 1. At the time of enactment, the rate is 2%.

Subsection (2) provides that international transportation business tax does not apply to the following:

(1) An amount that is exempt income. Amounts that are treated as exempt income are specified in section 18. There are two possible bases on which an amount may be exempt from international transportation business tax. First, the amount may be exempt from tax under an international agreement between the Nauru and another country, such as a tax treaty (section 18(1)(a)). Article 8 of a tax treaty commonly provides for residence country only taxation of international transportation income. Secondly, an amount may be exempt from tax on the basis that the non-resident's country of residence provides for a reciprocal exemption for Nauru resident ship or aircraft operators (section 18(1)(f)).

(2) An amount that relates to a passenger embarked in Nauru who was in Nauru solely as a result of being in transit between two places outside Nauru (such as a passenger in Nauru solely in transit on a flight between Australia and the Republic of the Marshall Islands).

(3) An amount that relates to the transhipment of livestock, mail, merchandise, or goods. "Transhipment" is not defined and, therefore, has its normal commercial meaning, namely the shipment of goods between two places via an intermediate destination (in this case Nauru). Transhipment may occur because the cargo is transferred to another ship or because the shipment is consolidated with other cargo to make a larger shipment.

The international transportation business tax imposed under the section is payable by the non-resident person deriving the transportation income. Subsection (3) provides that the liability is discharged if the tax has been paid in accordance with section 42 (ship) or 43 (aircraft).

15. General Provisions Relating to Taxes Imposed under this Act

This section specifies general provisions relating to the taxes imposed under sections 12 (small business tax), 13 (non-resident tax), and 14 (international transportation business tax).

Paragraph (a) provides that the taxes imposed under sections 12 to 14 are final taxes on the income in respect of which they are imposed. This ensures that income subject to the small business tax, non-resident tax, or international transportation business tax is not included in the computation of the taxable income of the person receiving the income.

Paragraph (b) provides that, in computing the taxable amount under sections 12 to 14, no deduction is allowed for any expenditure or loss incurred by the person in earning the income. This reinforces sections 12(2), 13(2), and 14(1), and makes it clear that the small business tax, non-resident tax, and international transportation business tax are imposed on the gross amount of the relevant income.

16. Taxable Income

This section provides for the computation of the taxable income of a person for a tax year. It is relevant to section 11 (which imposes business profits tax on a person who has taxable income for a tax year). The concept of "taxable income" states the tax base

under the business profits tax. It is the amount against which the rate or rates of business profits tax specified in Schedule 1 is applied in determining the amount of business profits tax payable for a tax year.

The taxable income of a person for a tax year is the gross revenue of the person for the year reduced by the total amount of deductions allowed to the person for the year. There are, therefore, two components in the calculation of taxable income: "gross revenue" (as defined in section 17) and "deductions" (as allowed under section 19). For example, if a person has gross revenue for a tax year of $200,000 and total deductions of $170,000 for the year, the taxable income of the person for the year is $30,000 ($200,000 - $170,000).

17. Gross Revenue

This section defines "gross revenue" for the purposes of the Act. It is relevant to section 12 (small business tax, which is imposed by reference to a person's gross revenue, section 16 (which provides for the calculation of taxable income (gross revenue is one component of the calculation), which is relevant to the business profits tax), and section 41(3) (which provides for the calculation of instalments of business profits tax in the first year of operation by reference to the gross revenue of the taxpayer).

As the concept of gross revenue is relevant for the business profits tax, small business tax, and instalments of tax, "gross revenue" is defined in subsection (1) by reference to the "tax period". Subsection (4) defines "tax period. For the business profits tax, the tax period is the tax year, which is defined in section 3 to mean the period of twelve months ending on 30 June. A company uses its financial accounting period as its tax year (see section 3 definition of "tax year). Thus, the computation of gross revenue for the business profits tax is an annual calculation. For small business tax, the tax period is the quarter, which is defined in section 3 to mean the period of three months ending on 30 September, 31 December, 31 March and 30 June. For instalments of tax in the first year of a taxpayer's business operations, the tax period is the instalment period, which is defined in section 3 to mean the period of three months ending on the third, sixth, ninth, and twelfth months of the tax year. Thus, the computation of gross revenue for the small business tax and the first year of instalments of tax is a quarterly calculation.

The gross revenue of a person for a tax period is the total of all the amounts derived by a person during the period that are included in gross revenue under subsection (1)(a)-(c). An amount is included in the gross revenue of a person under subsection (1) in the tax period in which it is "derived" by the person. "Derived" is defined in section 3. For the purposes of the business profits tax, a person accounting for tax on a cash basis derives an amount when it is received (separately defined in section 3) and a person accounting for tax on an accruals basis derives an amount when the right to receive arises (i.e. when the amount is receivable). For the purposes of the small business tax, a person derives an amount when it is received.

Section 3 defines "amount" to include an amount-in-kind. Thus, gross revenue includes both cash amounts and amounts received as in-kind benefits.

An amount is included in the gross revenue of a person under subsection (1) only if the person derives the amount from sources in Nauru. This sets the jurisdictional limit on

the business profits tax, and means that residents and non-residents alike are subject to business profits tax only on domestically sourced income. Thus, there is no taxation of the foreign-source income of residents. Section 9 provides rules for determining whether an amount is derived from sources in Nauru.

Subsection (1) states three classes of amount included in the gross revenue of a person. In broad terms, paragraph (a) includes in gross revenue the gross receipts from the conduct of a business by a person. This is a reference to the ordinary proceeds arising from the conduct of a business. The reference to "gross" receipts means that the amount included in gross revenue is the total amount derived without deduction of expenditures as deductions are allowed separately. Paragraph (a) expressly includes the following amounts in gross revenue:

(1) The gross proceeds from the disposal of inventory. In broad terms, inventory is goods that are turned over in the ordinary course of the person's business (i.e. goods that a person trades in) (see section 3 definition).

(2) The gross fees from the provision of personal services. It is expressly provided that this does not include "employment income", which is defined in section 3 to have the meaning in the Employment and Services Tax Act. Employment income is subject to separate taxation under the Employment and Services Tax Act.

(3) Interest, rent, royalties, and other proceeds of a business, however designated. For such an amount to be included in gross revenue it has to be a return on business operations (including a return on the capital of the business) and, therefore, amounts derived from a purely passive investment activity (i.e. an activity that is not a business activity) are not included in gross revenue.

Paragraph (b) includes in gross revenue the gain arising on disposal of a business asset by a person. "Business asset' is defined in section 3 to mean any asset used or held in the conduct of a business solely or partly to derive gross revenue. An asset is a business asset regardless of whether it is revenue or capital in nature. While inventory is a business asset under the section 3 definition, paragraph (b) does not apply to inventory as it is expressly covered by paragraph (a). Generally, the capital assets of a business decline in value as they are used in the business and the annual decline in value is allowed as a depreciation deduction (see sections 19(1)(c) and 21). Consequently, the main inclusion under paragraph (b) will be depreciation deductions that have been, in effect, "recaptured" in the consideration for the disposal of a depreciable asset or business intangible (i.e. the asset has been disposed of for more than its net book value for tax purposes). There may be occasions, however, when a person will dispose of a business asset for a gain above cost and paragraph (b) will also include the gain in gross revenue.

A gain on disposal of a business asset by a person is included in gross revenue under paragraph (b) in the tax period in which the person disposed of the asset (as determined under section 28). Subsection (3) provides that the gain arising on disposal of a business asset is computed as the consideration for the disposal less the net book value of the asset at the time of disposal. "Consideration" is determined under section 31 and "net book value" is determined under section 30. In broad terms, the net book value of an

asset is the original cost (section 29) of the asset reduced by depreciation deductions (if any) allowed in respect of the asset.

Example

X Pty Ltd conducts a trading business in Nauru. It purchased an item of computer equipment for $10,000 and subsequently sold the computer equipment for $7,500. The computer equipment is a depreciable asset and X Pty Ltd has been allowed $5,000 depreciation deductions prior to selling the equipment. The consideration for the disposal of the equipment is $7,500 and the net book value of the equipment at the time of disposal is $5,000 ($10,000 - $5,000). Thus, the gain on disposal is $2,500 ($7,500 - $5,000). This, in effect, represents depreciation deductions allowed to X Pty Ltd that it has recouped on disposal of the computer equipment.

If the consideration for the disposal of the equipment is $12,000, then the gain on disposal is $7,000 ($12,000 - $5,000). The gain represents $5,000 in recouped depreciation deductions and $2,000 of gain above cost.

Paragraph (c) includes in gross revenue the amount of any expenditure, a loss, or bad debt previously allowed as a deduction to a person that has been reimbursed or otherwise recovered by the person. The effect of paragraph (c) is to reverse the deduction that a person has been previously allowed for the expenditure, loss, or bad debt. The reversal is made in the tax period in which the amount is reimbursed or recovered.

Subsection (1) is expressed to be subject to subsection (2), which expressly provides that the gross revenue of a person does not include the following amounts:

(1) Gross revenue does not include a distribution by a company, partnership, trust or other body of persons (subsection (2)(a)). “Distribution” is defined in section 3 to mean a dividend (i.e. a distribution of profits) paid by a company to a member, an allocation of profits by a partnership to a partner (including drawings), an entitlement to income of a beneficiary of a trust, or a distribution of profits by any other body of persons to a member.

As explained above, the structure of the business profits tax is that the entity conducting a business is liable for business profits tax regardless of whether the entity is a separate legal person (such as a company) or not a separate legal person (such as a partnership or trust). The distribution or allocation of the profits of an entity to the owners of the entity is not subject to a separate tier of taxation. In other words, the profits of a business are subject to only one tier of taxation and that is at the entity level.

(2) Gross revenue does not include an amount that is exempt income as specified in section 18 (subsection (2)(b)).

(3) Gross revenue does not include an amount subject to non-resident tax under section 13 (namely certain payments of interest or royalties to non-residents) or subject to international transportation business tax under section 14 (subsection

(2)(c)). Non-resident tax and international transportation business tax are final taxes on the income to which they relate (see section 15).

(4) Gross revenue does not include an amount that is subject to services tax under the Employment and Services Tax Act (subsection (2)(d)).

18. Exempt Income

This section specifies amounts that are exempt income. Section 17(2)(b) provides that an amount that is exempt income is not included in gross revenue; section 13(3)(a) provides that interest, a royalty, or insurance premium that is exempt income is not subject to non-resident tax; and section 14(2)(a) provides international transportation income that is exempt income is not subject to international transportation business tax.

Subsection (1)(a) provides that an amount is exempt income to the extent that it is exempt from tax under an international agreement. "International agreement" is defined in section 3. The definition has two inclusions. Paragraph (a) of the definition of "international agreement" includes an agreement between the Government of Nauru and a foreign government for the prevention of double taxation (i.e. a "tax treaty"). At the time of enactment, Nauru does not have any tax treaties. However, if, in the future, Nauru enters into a tax treaty, Article 7 of the treaty will be of particular relevance to the business profits tax. Under Article 7, Nauru will be able tax the business profits of a person who is a resident of the other Contracting State to the treaty only when: (i) that person has a permanent establishment in Nauru; and (ii) the profits are attributable to activities conducted by the person through the permanent establishment. If the business profits of a resident of the other Contracting State are not connected to a permanent establishment in Nauru, then only the other Contracting State can tax the business profits (i.e. residence country only taxation).

Paragraph (b) of the definition of "international agreement" includes an agreement between the Government of Nauru and a foreign government or international organisation for the provision of financial, technical, humanitarian, or administrative assistance to the Government. If such an agreement provides an exemption from tax for an amount of gross revenue, then the amount is treated as exempt income. Importantly, an amount of gross revenue is exempt only to the extent provided for under the agreement. In this regard, the scope of tax exemptions provided for in international agreements can differ from agreement to agreement.

Subsection (1)(b) provides that an amount is exempt income to the extent that it is exempt from tax under the Diplomatic Privileges and Immunities Act 1976, the Consular Privileges and Immunities Act 1976, or the Special Missions Privileges and Immunities Act 1976. This is primarily relevant to income derived by diplomatic missions in Nauru of foreign countries or by international organisations.

Subsection (1)(c) provides that an amount derived by a non-profit organisation is exempt income. As an integrity measure to prevent abuse of the exemption, it does not apply to income from a business conducted by the organisation that is not directly related to the core function of the organisation. The determination of whether a business of a non-profit organisation is directly related to the core function of the organisation is a question of fact and degree determined having regard to all the circumstances. For

example, a religious bookshop conducted by a religious organisation is likely to be directly related to the core function of the organisation, but a petrol station operated by such organisation would most likely not be so directly related.

"Non-profit organisation" is defined in section 6. In broad terms, a "non-profit organisation" is an organisation that the Secretary has certified as genuinely conducting charitable or similar activities.

Subsection (1)(d) provides that an amount is exempt income to the extent that it is exempt from tax under an exemption provision in an agreement entered into by the Government when the following conditions are satisfied:

(1) The agreement is not an "international agreement" as defined in section 3. This means that the other party to the agreement is not a foreign government or international organisation.

(2) The agreement is for the provision of financial, technical, humanitarian, or administrative assistance to the Government of Nauru. As stated above, the agreement to which subsection (1)(d) applies is not an international agreement, which means that the other party to the agreement may be a private party. The agreement must be for the provision of financial, technical, humanitarian, or administrative assistance to the Government of Nauru. Exemptions in other agreements (such as a normal commercial agreement for the supply of goods to the Government) will not have legal effect (i.e. the Act will override the exemption).

(3) The Cabinet has concurred, in writing, with the exemption provision. Because of the impact of exemptions on the budgetary situation of the Government, it is important that Cabinet agrees to the exemption. An exemption provision for which Cabinet has not provided written concurrence with will have no legal effect.

(4) The name of the person benefitting from the exemption provision must be included in a notice published in the Gazette within thirty days after the agreement comes into effect. This ensures that there is transparency in the granting of exemptions.

Subsection (1)(e) provides that certain interest income paid to a non-resident person is exempt income. To qualify for exemption, the following conditions must be satisfied:

(1) A resident company must pay interest to a non-resident person. "Resident company" is defined in section 3 to mean a company that is incorporated or formed in Nauru. "Non-resident person" is defined in section 3 to mean a person who is not a resident person (as defined in section 3). The exemption does not apply to interest paid by any other resident (such as a resident individual) or to interest paid to a resident person.

(2) The interest must be payable under debentures issued by the resident company outside the Nauru for the purposes of raising loan funds outside Nauru.

“Debentures” has its ordinary meaning and will cover any security issued by a resident company.

(3) The debentures are widely issued. Consequently, the exemption does not apply, for example, to interest paid by a Nauru subsidiary to its foreign parent company. The requirement that the debentures be issued offshore and be widely held limits the exemption to interest paid on borrowings on international monetary markets.

(4) The resident company issued the debentures for the purpose of raising funds for use by the resident company in a business carried on in Nauru. The funds raised by the debenture must not be used to finance business operations outside Nauru.

(5) The interest must be paid outside Nauru.

The exemption recognises the realities of international monetary markets. Loan agreements for the issuing of securities on international monetary markets invariably include a gross-up clause under which the borrower bears the burden of any tax (including withholding tax) levied on the interest payable under the agreement. In other words, the interest payable is “grossed up” by the tax. The effect of this is to increase the cost of funds by the amount of the tax payable. The international norm is for countries to exempt such interest so that its residents are able to compete on international monetary markets in raising capital. The exemption is relevant to non-resident tax under section 13.

Subsection (1)(f) provides that an amount derived by a non-resident person from the operation of a ship or aircraft in international traffic is exempt income if the Secretary is satisfied that an equivalent exemption is provided to a resident person by the country in which the non-resident resides. This is relevant to the international transportation business tax under section 14. It is consistent with international norms and ensures that there is reciprocity in the taxation of international transportation income.

Subsection (2) specifies that a provision in another law providing that an amount is exempt from tax does not have legal effect unless also provided for in the Act. This is consistent with modern drafting practice that all tax exemptions should be provided in the relevant tax law for transparency reasons. This applies to exemptions provided in laws enacted before the Act is enacted. It applies also to laws enacted after the Act is enacted except when the later law expressly provides that it overrides this section (this is in accordance with the principle of parliamentary sovereignty that one Parliament cannot bind future parliaments).

19. Deductions

This section provides for the deduction of expenditures and losses in the computation of taxable income under section 16. As discussed above, there are two components to the computation of taxable income - gross revenue and total deductions. The total deductions allowed to a person for a tax year are subtracted from the person’s total gross revenue for the year to arrive at the amount of taxable income of the person for the year.

Subsection (1) sets out amounts allowed as a deduction under the Act. Subsection (1)(a) states the basic deduction rule, namely that a deduction is allowed for expenditures or losses to the extent incurred by a person in deriving amounts included in gross revenue. To qualify for a deduction, there must be a sufficient connection between the expenditure or loss and the derivation of amounts included in gross revenue so that it can be said that the expenditure or loss was incurred "in" deriving amounts included in gross revenue. An expenditure or loss incurred for a purpose other than deriving gross revenue is not allowed as a deduction. For example, there is no deduction for an expenditure or loss incurred in deriving an amount that is exempt income, or in deriving an amount subject to non-resident tax under section 13 or a service fee subject to tax under section 12 of the Employment and Services Tax Act, as these amounts are not included in gross revenue (section 17(2)(b), (c), or (d) respectively). Similarly, there is no deduction for an expenditure or loss incurred for some purpose other than deriving gross revenue, such as for a private purpose (e.g. personal consumption). This is confirmed by section 20(1)(a).

A deduction is allowed under subsection (1)(a) only "to the extent" to which the expenditure or loss was incurred in deriving amounts included in gross revenue. Thus, an expenditure or loss incurred partly to derive gross revenue and partly for some other purpose (such as to derive exempt income or for a private purpose) must be apportioned so that only that part relating to the derivation of gross revenue is allowed as a deduction. Apportionment should be done on any reasonable basis having regard to the facts of the case.

An amount is allowed as a deduction under subsection (1)(a) in the tax year in which it is incurred. This will depend on the person's financial accounting method (see section 24). In broad terms, a person accounting on a cash basis incurs expenditure when it is paid (section 24(2)) and a person accounting on an accruals basis incurs expenditure when the obligation to pay arises (i.e. when it is payable) (section 24(3)).

Subsection (1)(b) allows a deduction for the cost of inventory disposed of by a person during a tax year. This is determined according to the IFRS. As inventory would normally be expected to hold its value while in stock, a deduction is allowed only for the cost of inventory sold during the tax year and not the total cost of inventory purchased during the year.

Subsection (1)(c) allows a deduction (referred to as a "depreciation deduction") for the decline in value of a person's depreciable assets or business intangibles from use during the tax year in deriving amounts included in gross revenue. "Depreciable asset" and "business intangible" are defined in section 3. In broad terms, a depreciable asset is tangible movable property (such as plant, equipment, fixtures and fittings, vehicles and computers) or a structural improvement to real property (such as commercial premises) that has a useful life in excess of one year and that declines in value through use in deriving gross revenue. In other words, a depreciable asset is a capital asset of a business and the depreciation deduction for a tax year effectively allocates part of the capital cost of the asset to each tax year forming part of the useful life of the asset.

In broad terms, business intangibles are industrial and intellectual property, contractual rights, and capital expenditures (such as prepayments) that have a useful life in excess of one year and which decline in value through use in deriving gross revenue. In other

words, a business intangible is a capital asset of a business and the depreciation deduction for a tax year effectively allocates part of the capital cost of the intangible to each tax year in the useful life of the intangible. As noted above, the decline in value of business intangibles is referred to as "amortisation" in financial accounting. However, as a drafting simplification measure, the term "depreciation" is used in the Act to refer to both depreciation and amortisation.

Section 21(2) provides that depreciation deductions are determined in accordance with financial accounting rules. These rules are based on the useful life of the depreciable asset or business intangible.

Subsection (1)(d) allows a deduction for a loss on disposal of a business asset during the year. Business asset" is defined in section 3 to mean any asset used or held in a business wholly or partly to derive gross revenue. An asset is a business asset regardless of whether it is revenue or capital in nature. While inventory is a business asset, subsection (1)(d) does not apply to inventory as it is expressly covered by subsection (1)(b). A loss in relation to a business asset is allowed as a deduction in the tax year in which the asset is disposed (see section 28 on the meaning of "disposal"). Subsection (2) provides that the loss arising on disposal of a business asset is the net book value of the asset at the time of disposal less the consideration for the disposal. "Net book value" is defined in section 30. In broad terms, the net book value is the cost of the asset (see section 29) reduced by depreciation deductions allowed in respect for the asset. If no depreciation deductions are allowed in respect of the asset, the net book value of the asset will be equal to the cost of the asset. "Consideration" is defined in section 31. In broad terms, the consideration for the disposal of a business asset is the price received or receivable for the asset.

Example

X Pty Ltd conducts a trading business in Nauru. It purchased an item of computer equipment for $10,000 and subsequently sold the computer equipment for $2,500. The computer equipment is a depreciable asset and X Pty Ltd has been allowed $5,000 depreciation deductions prior to selling the equipment. The consideration for the disposal of the equipment is $2,500 and the net book value of the equipment at the time of disposal is $5,000. Thus, the loss on disposal is $2,500 ($5,000 - $2,500). This, in effect, means that the computer equipment has actually declined in value at a rate faster than anticipated under the depreciation rules.

Subsection (1)(e) allows a deduction for an expenditure or loss that is specifically deductible under the Act. It is noted that most expenditures and losses will be deductible under subsection (1)(a), which applies if there is a sufficient connection between the expenditure or loss, and the derivation of an amount included in gross revenue, so that it can be said that the expenditure or loss has been incurred "in" deriving gross revenue. However, a deduction may be specifically allowed under another provision in the Act (such as a deduction under section 23 for a net loss carried forward) and the purpose of subsection (1)(e) is to cross-refer to such deduction provisions.

Subsection (1) is expressed to be subject to the Act. This means that a provision of the Act may preclude an amount from being deductible or modify the amount of the

deduction. For example, section 20 lists expenditures or losses for which no deduction is allowed, (when activated) section 35 denies a deduction for interest when a foreign-controlled resident company has an excessive level of debt capitalisation, and section 38(3)(a) empowers the Secretary to deny a deduction if there is insufficient documentary evidence to substantiate the incurring of an expenditure or loss.

Subsection (3) is an enabling provision for the Regulations to provide for deductions relating to mining operations. Under the Regulations, deductions may be provided for exploration, development (i.e. extraction), and rehabilitation expenditure incurred by a mining company.

20. Non-deductible Expenditures or Losses

This section sets out expenditures and losses for which no deduction is allowed under the Act.

Subsection (1)(a) denies a deduction for an expenditure or loss to the extent to which it is of a domestic or private nature. While such an expenditure or loss would not satisfy the criteria for deduction in section 19(1)(a), nevertheless the Act adopts the common drafting practice of reconfirming the non-deductibility of domestic or private expenditures or losses to avoid any doubt over the issue. Both subsection (1)(a) and section 19(1)(a) contemplate apportionment of expenditures incurred partly to derive an amount included in gross revenue and partly for a private or domestic purposes.

Subsection (1)(b) denies a deduction for a distribution, an amount of capital withdrawn, or a sum employed as capital. “Distribution” is defined in section 3 to mean a dividend paid by a company, an allocation of profits to a partner by a partnership (including drawings), an entitlement to income of a beneficiary of a trust, or a distribution of profits by any other body of person to a member of the body. Each of these amounts is, in effect, a distribution of profits. Consequently, a distribution is an allocation of profits by a company or other entity after the profits have been earned and, therefore, is not an amount incurred to derive gross revenue. Subsection (1)(b) also denies a deduction for capital withdrawn. The withdrawal of capital is the withdrawal of an amount previously contributed to an entity as capital (such as a partnership) that has been returned to the owner of the entity. Thus, the withdrawal of capital from an entity is not an expenditure incurred by the entity in deriving gross revenue. Finally, subsection (1)(b) provides that there is no deduction for amounts contributed as capital. Again, this is not an amount incurred in deriving gross revenue.

Subsection (1)(c) denies a deduction for an expenditure or loss of a capital nature, except to the extent provided for in section 19(1)(c) or (d). The basic structure of the deduction provisions is that expenditures incurred that are “consumed” in the tax year (i.e. operating expenditure) are deductible in the year incurred under section 19(1)(a)). Expenditures that are consumed over a longer period, namely expenditure incurred to acquire a depreciable asset or business intangible, are depreciated over the useful life of the expenditure (section 19(1)(c)). This is because the benefit of the expenditure extends beyond the tax year in which it is incurred. Unless expressly provide for in the Act, no deduction is allowed for any other capital expenditure. It is noted, though, that the definition of “business intangible” in section 3 is broad and includes many different types of capital expenditures that decline in value through being used or held in the

conduct of a business. Importantly, there is no deduction, either outright or through depreciation, for expenditure incurred to acquire assets that do not have an ascertainable useful life (such as land and goodwill) or that are reasonably expected to appreciate in value. In this case, the expenditure incurred forms part of the cost of the asset and is recognised when the asset is disposed of (section 17(1)(b) (gain) or 19(1)(d) (loss)).

Subsection (1)(d) denies a deduction for an amount that is carried to a reserve fund or recognised as a provision for expected future expenditures or losses in the financial accounts of person. A person creates a reserve fund or provision in their financial accounts to ensure that financial resources are available to meet future business obligations. Contributions to a reserve fund or a provision do not, however, amount to a present outgoing and no deduction is available until the amounts in the reserve fund or provision are actually incurred as expenditures. This is an important difference between the business profits tax and financial accounting rules, which require reserves and provisions to be created to meet certain future expected outgoings so as to alert investors and creditors to the possible future liabilities of the entity.

Subsection (1)(e) denies a deduction for expenditures or losses to the extent that they are recovered or recoverable under an insurance policy or under a contract of indemnity, guarantee, or surety. A deduction is denied in this case because the initial loss suffered by a person will be recovered once the insurance or indemnity, guarantee or surety is paid, and, therefore, no net loss will be incurred.

Subsection (1)(f) denies a deduction for business profits tax payable under the Act and any penalty or interest payable under the Revenue Administration Act in respect of any business profits tax payable. The payment of business profits tax is an application of gross revenue after it has been earned and not expenditure incurred in deriving gross revenue.

Subsection (1)(g) denies a deduction for a fine or penalty imposed under any law or regulation (whether criminal or civil). The non-deductibility rule is intended to achieve public policy objectives by preventing a person from effectively reducing the cost of a fine or penalty through obtaining a tax deduction for the fine or penalty.

Subsection (1)(h) is a "base erosion" measure consequent upon the fact that the business profits tax applies only to business income. Income (such as interest) derived from a passive investment activity is untaxed. In the absence of subsection (1)(h), the owner of a business (or an associate of the owner) could invest in the business by way of debt taking their return as deductible interest. As the interest is a deductible expenditure for the business, in effect, no tax is paid by that person conducting the business on the profits used to pay the interest. Further, the recipient of the interest is not taxed on the interest because the interest is earned as part of a passive investment activity and not a business activity. Subsection (1)(h) does not apply if the interest is included in the gross revenue of the recipient or is subject to non-resident tax (although section 35 (when activated) may limit deductibility of the interest in the latter case)

Subsection (1)(i) is another base erosion measure under which a deduction is denied for a service fee (as defined in the Employment and Services Tax Act), royalty, or insurance premium paid or payable to a non-resident associate except when the service fee, royalty, or insurance premium is subject to Nauru tax in the hands of the associate.

A service fee, royalty, or insurance premium is subject to Nauru tax if it is (i) included in the gross revenue of the non-resident associate; (ii) subject to non-resident tax; or (iii) subject to services tax under the Employment and Services Tax Act. In the absence of this limitation, there would be erosion of Nauru's tax base through the deductibility of the fee, royalty, or premium to the payer in computing the business profits tax liability of the payer without a corresponding tax liability of the non-resident associate in relation to the fee, royalty, or premium derived.

Subsection (1)(j) denies a deduction for a contribution made to a retirement or savings fund. The deduction denial applies even to employer contributions made in respect of employees. This is also a "base erosion" measure as neither the fund or the payout (pension or lump sum) is taxable in Nauru. There is an exception when the contribution has been subject to employment tax to the employee. In the absence of this exception, the contribution would, in effect, be double taxed – the denial of the deduction effectively taxes the contribution to the employer and then it is taxed again in the hands of the employee.

Subsection (2) is designed to protect the integrity of the withholding tax system in section 44 of the Act, and sections 17 and 18 of the Employment and Services Tax Act. It applies when a person is allowed a deduction for a payment from which the person is required to withhold tax under those sections and defers the allowance of the deduction until the withholding tax has been paid to the Secretary.

21. Depreciation of Depreciable Assets and Business Intangibles

This section provides for the computation of the amount of the depreciation deduction that a person is allowed for a tax year under section 19(1)(c).

Subsection (1) sets out the basic principle of deductibility. A person is allowed a deduction for the amount by which the value of the person's depreciable assets and business intangibles has declined during the tax year. "Depreciable asset" and "business intangible" are defined in section 3. In broad terms, "depreciable assets" are the physical assets of a business used to derive gross revenue, such as buildings, plant, equipment, machinery, fixtures and fittings, vehicles and computers that decline in value through use and business intangibles are industrial and intellectual property, contractual rights, and capital expenditures (such as prepayments) that decline in value through use in deriving gross revenue.

Subsection (2) provides for the computation of the decline in value of a depreciable asset or business intangible for a tax year. The amount of the decline is calculated in accordance with international financial accounting standards. There are two main methods of depreciation: straight-line and declining balance. Straight-line depreciation applies the depreciation rate against the cost of the asset or intangible. It assumes that a depreciable asset or business intangible declines in value evenly over its effective life. Declining balance depreciation applies the depreciation rate to the written down value of the depreciable asset or business intangible. This has the effect of allowing greater depreciation in the earlier part of the life of a depreciable asset and, therefore, is based on the assumption that an asset declines in value more quickly in the earlier years of use. Under financial accounting principles, it is usual for straight-line to apply to

structural improvements to land (such as commercial premises) and to business intangibles. Either method can apply to other depreciable assets.

The rate of depreciation of an asset under financial accounting depends on the effective or useful life of the asset as determined when the asset is acquired. For example, if the expected useful life of an asset is 4 years, the rate of depreciation on a straight-line basis is 25%. The financial accounting norm is that the declining balance depreciation rate is usually one and a half times the straight-line rate, so, in the example, it would be 37.5%.

The application of subsection (2) is illustrated by the following example:

Example 1

George acquires a computer on 1 July 2016. The computer cost $4,000 and is used solely in George's business to derive gross revenue. The computer is a depreciable asset as defined in section 3. A deduction is allowed for the annual decline in value of the computer (section 19(1)(c)). The expected useful life of the computer is 4 years and, for financial accounting purposes, George uses the straight-line depreciation method and, therefore, the annual depreciation rate is 25%. Consequently, the decline in value and, therefore, depreciation deduction, for the 2016/2017 tax year is $1,000 ($4,000 x 25%). Similarly, the decline in value and depreciation deduction for the next three tax years is also $1,000. At the end of the fourth tax year, the cost of the asset has been fully depreciated and no further depreciation deductions are allowed.

Subsection (1) is expressed to be subject to the rest of the section. Subsections (3) and (4) limit the amount of the depreciation deduction in two cases. Subsection (3) applies when a depreciable asset or business intangible has been used partly to derive gross revenue and partly for some other purpose. "Used" is defined in section 3 to include available for use. In this case, there are two steps in the computation of the decline in value. First, the decline in value for the year is determined under subsection (2) in the normal way. That amount is then multiplied by the fraction that represents the business use of the asset during the year to compute the annual depreciation deduction. In other words, the amount allowed as a deduction under subsection (1) is the proportion of the decline in value computed under subsection (2) that relates to the use of the asset to derive gross revenue.

The application of subsection (3) is illustrated by the following example:

Example 2

Assume that in Example 1 above, George uses the computer 75% of the time for business purposes and 25% for private purposes. The decline in value of the computer under subsection (2) for the 2016/2017 tax year is $1,000. However, subsection (3) requires this to be apportioned between business and private use. Consequently, the deductible amount of the decline in value is the proportion that relates to business use - $750 ($1,000 x 75%). Assuming the same use, the decline in value and

depreciation deduction for the next three tax years is also $1,000 and $750, respectively. At the end of the fourth tax year, the cost of the asset has been fully depreciated and no further depreciation deductions are allowed.

Subsection (4) applies if a depreciable asset or business intangible is used for only part of the tax year in deriving gross revenue. "Used" is defined in section 3 to include available for use. The most likely situation when this will occur is when a business acquires or disposes of an asset part way through the year. Again, there are two steps in the computation of the annual depreciation. First, the decline in value for the year is determined under subsection (2) as if the asset were used for the whole of the tax year in deriving gross revenue. That amount is then multiplied by a fraction that represents the number of days in the tax year that the asset is used to derive gross revenue divided by the total number of days in the year. An asset is treated as held for use on any non-working day in a tax year (e.g. a Sunday or a public holiday). For example, if a business acquired a depreciable asset on the last day of the tax year, the business would be entitled to a deduction for only 1/365th of decline in value otherwise available for the year.

The application of subsection (4) is illustrated by the following example:

Example 3

Assume that in Example 1 above George acquired the computer on February 1, 2017. This means that George used the computer to derive gross revenue for only 215 of the 365 days in the 2016/2017 tax year. Consequently, the depreciation deduction for the 2016/2017 tax year is $589 (($4,000 x 25%) x $^{215}/_{365}$). George is allowed a depreciation deduction of $1,000 in each of the next three tax years. At the end of the 2019/2020 tax year, George has been allowed total depreciation deductions of $3,589 in relation to the computer. If the computer is used for the whole of the 2020/2021 tax year, the remaining value of the computer ($411) is allowed as a deduction in that year.

If a person disposes of a depreciable asset or business intangible, any gain on disposal is included in gross revenue under section 17(1)(b) and any loss is allowed as a deduction under section 19(1)(d). A gain is computed as the consideration for the disposal reduced by the net book value of the asset or intangible at the time of disposal (section 17(3)). A loss is computed as the net book value of the asset or intangible reduced by the consideration for the disposal (section 19(2)). Section 30 provides that the "net book value" of a depreciable asset or business intangible is the cost of the asset or intangible (section 29) reduced by the depreciation deductions allowed in respect of the asset or intangible.

Example 4

Assume that, in Example 1, George sells the asset on January 31, 2019 for $2,500. George has been allowed a depreciation deduction of $1,000 for each of the 2016/2017 and 2017/2018 tax years. The depreciation deduction for the 2018/2019 tax year is $589 ($1000 x 215/365).

Consequently, the net book value of the asset at the time of disposal is $1,411 ($4,000 - $2,589). George has made a gain on the disposal of the computer of $1,089 ($2,500 - $1,411). This amount is included in gross revenue under section 17(1)(b). This represents an amount that has been allowed as a depreciation deduction but which has been recovered by George on the disposal of the computer. It means that the computer has not, in reality, depreciated as rapidly as the tax system had anticipated it would.

Suppose, instead, that the computer was sold for $1,000 on January 31, 2019. The net book value of the computer at the time of disposal is $1,411. George has made a loss on the disposal of the computer of $411 ($1,411 - $1,000). This amount is allowed as a deduction under section 19(1)(d). This represents the additional wear and tear suffered by the computer not captured in the depreciation deductions because the computer has, in reality, depreciated more rapidly than the tax system had anticipated it would.

Subsection (5) applies to a disposal of a depreciable asset or business intangible that has been only partly used to derive gross revenue. Similar to the application of subsection (3), subsection (5) requires the gain or loss to be apportioned so that only the part relating to the use of the asset to derive gross revenue is included in gross revenue or allowed as a deduction.

Example 5

Assume that in Example 4, George has used the computer 75% of the time in his business to derive gross revenue and 25% of the time for the private purposes. The decline in value for the each of the 2016/2017 and 2017/2018 tax years is $1,000 and the depreciation deduction for each year is $750 ($4,000 x 25% x $^{215}/_{365}$). The decline in value for the 2018/2019 tax year is $589 and the depreciation deduction is $442 ($589 x 75%). Under section 30(1), the net book value of the asset is reduced by the depreciation deductions allowed in respect of the asset or that would have been allowed but for section 21(3). In other words, the cost of the asset is reduced by the full decline in value over the George's period of ownership. Consequently, the net book value of the computer at the time of disposal is $1,411 ($4,000 - $2,589). If George sells the computer for $2,500, George has made a gain on the disposal of the computer of $1,089 ($2,500 - $1,411). The amount of the gain included in gross revenue is $817 ($1089 x 75%) being the portion of the gain that relates to use of the computer to derive gross revenue. The balance represents the private use of the computer for which no depreciation deductions were allowed.

Similarly, if George sold the computer for $1,000, George has made a loss on the disposal of the computer of $411 ($1,411 - $1,000). This means that the computer has declined in value through use greater than anticipated through the depreciation deductions. However, part of this greater decline in value relates to the private use of the computer and,

therefore, the amount of the loss must be apportioned so that only that part relating to use to derive gross revenue is allowed as a deduction. Consequently, the amount of the loss allowed as a deduction is $308 ($411 x 75%). The balance represents the decline in value relating to the personal use of the computer for which no depreciation deductions were allowed.

22. Bad Debts

This section allows a deduction for bad debts.

A bad debt deduction is allowed in two classes of case. First, a bad debt deduction is allowed to a person accounting for income tax on an accruals basis (see section 24(3)) when a person has included an amount in gross revenue that has not been received by the person. In this case, the effect of the bad debt deduction is to rewrite the amount previously included in gross revenue on an accruals basis. This is necessary because, generally, persons accounting for income tax on an accruals basis include amounts in gross revenue before the amounts are actually received (i.e. the right to receive usually arises before the actual receipt).

Secondly, it applies to a person that is in the business of lending money (such as a bank or other financial institution) when the amount lent cannot be recovered by the person. As the debt itself is on revenue account (a money lender deals in debts), there is no requirement for the amount of the debt to have been previously included in gross revenue. In this case, the bad debt deduction is effectively a timing rule for revenue losses of banks and other financial institutions. The loss is allowed as a deduction when it is written off in the financial institution’s accounts rather than when it is actually incurred (which may be later).

In both cases, there are two conditions that must be satisfied for a person to be allowed a bad debt deduction for a tax year:

(1) The debt or part of the debt must be written off in the person’s financial accounts during the year. Thus, the timing of the tax deduction corresponds to the treatment of the amount as a bad debt for financial accounting purposes.

(2) There must be reasonable grounds for believing that the debt will not be recovered. For example, the debtor is in bankruptcy or has absconded without paying their debts.

If a deduction is allowed under this section for a bad debt and the debt is subsequently recovered, the amount recovered is re-included in gross revenue under section 17(1)(c).

Subsection (2) makes it clear that the amount that a person is allowed as a deduction under subsection (1) is not to exceed the amount written off in the person’s financial accounts as a bad debt. This is relevant if the amount written off is less than the total debt outstanding.

Example

X Pty Ltd has supplied goods to Y Pty Ltd during a tax year for price of $100. X Pty Ltd accounts on an accruals basis and has included the $100 in its gross income for the year. Y Pty Ltd is in financial difficulties and has not paid the price by the end of the tax year. During the following tax year, X Pty Ltd has reasonable grounds for believing that only 50% of the debt will be recovered. As a result, X Pty Ltd writes off 50% of the debt in its financial accounts for the following tax year. The effect of section 22(2) is that the amount of the deduction is limited to the amount actually written off in the Taxpayer's accounts. This is the case even if there is some doubt about the recoverability of the entire debt.

23. Net Loss Carried Forward

This section provides for a three-year carry forward period for business losses.

Subsection (1) provides that a person has a net loss for a tax year if the total amount of deductions allowed to the person for the year (other than a net loss carried forward deduction) exceeds the total gross revenue of the person for the year. The amount of the excess is the amount of the net loss.

If a person has a net loss for a tax year, subsection (2) provides that the net loss is carried forward and allowed as a deduction in computing the person's taxable income for the following tax year. Subsection (3) provides that, if a net loss is not fully deducted under subsection (2), it is carried forward to the next following tax year and so on until it is fully deducted but up to a maximum carry forward period of three tax years after the end of the tax year in which the net loss was incurred.

Subsection (4) provides that, if a person has a net loss carried forward for more than one tax year, the net loss of the earliest tax year is deducted first. This ensures that each net loss gets the full benefit of the three-year carry forward period before it is exhausted.

As an anti-avoidance measure, subsection (5) specifies a limitation on the carry forward of a net loss by entities so as to prevent the trading in loss entities. "Entity" is defined in subsection (6) to mean a company, partnership, trust, or other body of persons. Subsection (5) applies to any entity treated as a separate taxpayer for the purposes of the business profits tax, although it will be mainly relevant to companies. The loss carry forward limitation applies when there is a change of more than 50% in the underlying ownership of an entity. "Underlying ownership" is defined in subsection (6) to mean an ownership interest in an entity held, directly or indirectly through an interposed entity or entities, by an individual or a person not ultimately owned by an individual (such as a government).

Example

X Co Pty Ltd is a company that is owned by two individuals, A and B. X Co has a loss carry forward for a tax year. A holds 60% of the shares in X Co and B holds 40%. In this case, both A and B hold their shares directly in X Co and, therefore, their shareholding is also their underlying ownership interest in X Co. If A were to sell their shares to C, then there is a change in more than 50% of the underlying ownership of X Co.

> Suppose, instead, that Holders Co Pty Ltd owns all the shares in X Co. In turn, two individuals, A and B hold the shares in Holders. A holds 60% of the shares in Holders and B holds 40%. As Holders wholly owns X Co, A's has an indirect ownership interest and, therefore, an underlying ownership interest, in X Co of 60% and B has an indirect ownership interest and underlying ownership interest of 40%. If A were to sell their shares in Holders to C, then there is a change in more than 50% of the underlying ownership of X Co.

If there is a change in more than 50% in the underlying ownership of an entity, any net loss carried forward incurred prior to the change is not allowed as a deduction in a tax year after the change. However, there is an exception to the prohibition on the carry forward of net losses when both the following conditions are satisfied:

(1) The entity carries on the same business after the 50% change in underlying ownership as it carried on before the change until the earlier of: (i) the net loss has been fully deducted; or (ii) net loss carry forward period (three years) has expired.

(2) Either there is no new business or investment entered into before the net loss has been fully deducted or the net loss carry forward period expires or, if there is a new business or investment, it was not entered into with the principal purpose of utilising the entity's tax losses.

If these conditions are satisfied, it is clear that the person acquiring the loss entity did so to acquire the business of the entity not the tax losses. In this case, the deduction of the carry forward losses is allowed. The determination of the principal purpose of adding a new business or investment depends on all the facts. For example, if the added business is closely related to the existing business, then it may be argued that the principal purpose is not to access the losses.

24. Method Tax Accounting

This section provides for tax accounting rules applicable to the business profits tax. The tax accounting rules are relevant to the allocation of amounts of gross revenue and deductible expenditures to tax years.

Subsection (1) provides that a person must compute taxable income in accordance with the most recent International Financial Reporting Standards issued by the International Accounting Standards Board or any successor entity taking over the role of issuing International Financial Reporting Standards (see section 3 definition of "International Financial Reporting Standards"). To ease compliance and administrative burdens, the intention is that there is close similarity between taxable income and financial accounting profit for a tax year.

The section is expressed to be subject to the Act providing otherwise. Thus, the Act may apply to modify or clarify the application of financial accounting standards in computing taxable income. For example, section 20(1)(d) denies a deduction for an amount carried to a reserve or provision in the financial accounts of a person carrying on business. Thus, a deduction is allowed under the Act only for expenditures actually

incurred and not for amounts carried to accounting reserves or provisions in anticipation of future expenditures.

For financial accounting purposes, amounts are accounted for on either a cash or accrual basis. Subsections (2) and (3) link the tax terms "derived" and "incurred" with financial accounting principles relating to cash or accruals accounting. Amounts are included in gross revenue when "derived" (section 17(1)), and expenditures and losses allowed as a deduction when "incurred" (section 19(1)(a)).

Subsection (2) provides that, if, under financial accounting, a person accounts on a cash basis, the person derives an amount of gross revenue at the time the person receives the amount. This includes an actual receipt and a constructive receipt under the extended definition of "received" in section 3. A person incurs expenditure under cash-basis accounting at the time the expenditure is paid.

This means that a person accounting for income tax on a cash basis reports amounts of gross revenue in the tax year in which they are received and reports expenditure in the tax year in which they are paid. This is largely declaratory of the position under financial accounting rules. However, through the definition of "received", subsection (2) ensures that a principle of constructive receipt applies for the purposes of the Act.

Subsection (3) provides that, if, under financial accounting, a person accounts on an accrual basis, the person derives an amount when the person is entitled to receive it (i.e. at the time the amount is recoverable as a debt). This is the case even if the time for payment is postponed or payment is made by instalments.

Example

X Pty Ltd sells large electrical goods and, as a company, is required for financial accounting purposes to account on an accrual basis. On 1 June 2017, X Pty Ltd sells a television to a customer for $500. X Pty Ltd allows the customer 90 days to pay for the television. The customer pays for the television on 15 July 2017. The effect of subsection (3) is that X Pty Ltd is treated as having derived $500 of gross revenue on 1 June 2017. This must be included in X Pty Ltd's gross revenue for the 2017/2018 tax year even though X Pty Ltd actually receives payment in the following tax year.

Subsection (3) also provides that a person incurs expenditure at the time it is payable by the person.

Subsection (4) applies when there is a change in the tax year of a company. This will occur when the financial accounting period of the company changes. This may happen, for example, as a result of a takeover of the company. If the tax year (referred to as the "previous tax year") of a company changes, subsection (4) provides that the period from the end the last full previous tax year to the commencement of the new tax year is treated, for the purposes of the Act, as a separate tax year.

Example

> X Pty Ltd uses the 12-month period ending on 30 June as its financial accounting period and, therefore, its tax year. As a result of a takeover in 2017, X Pty Ltd's financial accounting period changes to the 12-month period ending on 31 December. This means that the period 1 July 2017 to 31 December 2017 is a separate tax year with the period 1 January 2018 to 31 December 2018, the first full tax year based on the company's new financial accounting period.

Subsection (5) is an enabling provision for regulations for the calculation of the taxable income of insurance companies. In particular, the regulations may provide for the deduction for the reserve for unexpired risks. This would be an exception to the normal rule that there are no deductions for accounting reserves.

25. Change in Tax Accounting Method

This section provides a procedure for a person to change their method of tax accounting. Changes in accounting methods need to be carefully regulated as they can give rise to the risk of under-taxation (or the possibility of over-taxation).

Subsection (1) provides that a person may make a written application to the Secretary for permission to make a change in their method of tax accounting. The Secretary may approve an application only if the person has demonstrated that the change is appropriate to properly measure the person's taxable income. Ordinarily, a change made in accordance with financial accounting requirements would be accepted for tax purposes. Two examples of situations when subsection (1) applies are: (1) when a person changes from cash to accruals accounting, or vice versa: and (2) when a person changes from direct costing to absorption costing for inventory, or vice versa

Subsection (2) provides that, if a person's method of accounting changes, the person must make adjustments in the tax year of change to items of income, deduction, or credit, or to any other items affected by the change so that no item is omitted and no item is taken into account more than once. This is particularly relevant when a person changes accounting methods from cash to accrual or from accrual to cash accounting. In the absence of this subsection, a change in tax accounting method could result in items of income being recognised twice (for example, when derived under accruals accounting and again when received under cash accounting) or not at all (for example, not recognised when the invoice is issued under cash accounting and then not recognised when received under accruals accounting). Subsection (2) requires persons to recognise accrued amounts and received amounts appropriately to prevent these results.

> **Example**
>
> Martin carries on business and accounts for business profits tax on a cash basis. The business expands and, at the start of the 2017/18 tax year, Martin is given permission by the Secretary to change methods to use the accruals method. Martin has issued invoices in the 2016/17 tax year that are not paid until the 2017/18 tax year. In the absence of subsection (2), amounts invoiced in the 2016/17 tax year will not be taxed in that year because they have not been received under the cash method nor will they be taxed in the 2017/18 tax year because they

accrued in the 2016/17 tax year under the accruals method. Subsection (2) avoids this outcome by requiring Martin to include the 2016/17 invoiced amounts in gross revenue for the 2017/18 tax year.

Suppose the opposite happens. Martin is using the accruals method and, at the start of the 2017/18 tax year, Martin is given permission by the Secretary to use the cash method because his business has contracted. In the absence of subsection (2), amounts invoiced in the 2016/17 tax year will be taxed in that year because they have accrued in that year and then they will be taxed again in the 2017/18 tax year because they have been received in that year. Subsection (2) avoids this outcome by requiring Martin to exclude the amounts from gross revenue in the 2017/18 tax year.

26. Jointly Owned Business Assets

This section provides for the apportionment of a gain or loss made on disposal of a jointly owned business asset, such as a jointly owned rental property held as part of a business operation.

Subsection (1) requires the owners of a jointly owned business asset to apportion a gain or loss arising on disposal of the asset according to their respective interests in the asset. The section is relevant to section 17(1)(b) (which includes the gain arising on disposal of business asset in gross revenue) and section 19(1)(d) (which allows a deduction for a loss arising on disposal of a business asset).

Subsection (2) provides for an equal apportionment when it is not possible to ascertain the relative interests of the different owners. This could be the case, for example, when a rental property held as a business asset is owned through a joint tenancy.

Example 1

George and Mia own a rental property as part of a business as tenants-in-common. They have an equal interest in the property. The property is sold and a gain of $100,000 is made on the disposal. The effect of subsection (1) is that the gain is apportioned equally between the owners so that George and Mia each report a gain of $50,000.

Example 2

Suppose the same facts as in Example 1, but instead George and Mia own the property as joint tenants. Under a joint tenancy, each joint tenant owns the whole of the property jointly with the other joint tenant(s). Unlike with a tenancy-in-common, under a joint tenancy, no joint tenant has a specific share of the property. Further, the principle of survivorship applies under a joint tenancy such that if one joint tenant dies, their interest in the property automatically transfers to the surviving joint tenant(s). The presumption under general law is that each joint tenant has an equal interest in the property. Subsection (2) gives effect to this

presumption. Thus, subsection (2) deems George and Mia to own the property equally and, again, they would each report a gain of $50,000.

27. Acquisition of a Business Asset

This section sets out when a person acquires a business asset for the purposes of the Act.

Subsection (1) provides that a person acquires an asset when legal title to the asset passes to the person. This is consistent with the basic rule in section 28(1), which provides that a person disposes of an asset when the person has sold, exchanged, or otherwise transferred legal title to the asset. In the ordinary case, therefore, a change in ownership of an asset will result in both a disposal and acquisition of the asset. Thus, in the case of a sale of an asset, the sale results in the seller disposing of the asset and the buyer acquiring the asset.

In the case of an asset that is a right or option, subsection (2) provides that a person acquires the asset when the right or option is granted to the person. This is consistent with the deemed disposal rule in section 28(2). Thus, on the grant of an option, the grantor is treated as having disposed of the option (section 28(2)) and the grantee is treated as having acquired the option.

28. Disposal of a Business Asset

This section sets out when a person has disposed of a business asset for the purposes of the Act. The gain and loss rules in section 17(1)(b) and 19(1)(d) apply when there has been a disposal of a business asset.

The basic rule is in subsection (1). Subsections (2)-(5) deal with special cases. Subsection (1) provides that a person has disposed of a business asset at the time the person has sold, exchanged (such as a barter transaction), or otherwise transferred legal title to the asset (such as by way of gift). Subsection (1) also treats the loss or destruction of a business asset (for example, as a result of a fire) as a disposal of the asset. Further, subsection (1) also sets out when there is a disposal of an intangible business asset (such as a contractual right), namely when the asset is cancelled, redeemed, relinquished, or surrendered, or when the asset otherwise expires (such as the expiration of a licence).

Subsection (2) applies when a person creates a business asset in another person being an asset that the first-mentioned person did not own before it was created in the second-mentioned person. In this case, the first-mentioned person who created the business asset is treated as having made a disposal of the asset to the second-mentioned person at the time the asset is created. An example of when subsection (2) applies is when a person who owns a business asset, such as commercial premises, grants an option to another person to purchase the premises. While the grantor of the option owns the premises, the option is a separate asset that the grantor creates in the grantee by contract. Consequently, the option is not a business asset that the grantor owns and then transfers to the grantee and, therefore, is not covered by subsection (1). Subsection (2) treats the grantor as having made a disposal of the option to the grantee at the time that the option is created.

Subsection (3) provides that the disposal of a business asset by succession or under a will occurs at the time the asset is transmitted.

Subsection (4) provides that a disposal includes the disposal of a part of a business asset. This may include a physical separation and disposal (for example, a subdivision of real property) or any other part disposal possible in law such as a temporal disposal (for example, rights to property for a period).

Subsection (5) applies when a business asset of a person (referred to as the "owner") is vested in a liquidator, trustee-in-bankruptcy, or receiver. It is provided that the vesting of the asset is not a disposal of the asset for the purposes of this Act, and the acts done in relation to the asset by the liquidator, trustee-in-bankruptcy, or receiver are treated as having been done by the owner. This is an exception to the general rule in subsection (1) and means that there is no separate disposal in relation to the transfer of an asset to a liquidator, trustee-in-possession, or receiver.

29. Cost of a Business Asset

This section sets out the rules for determining the cost of business assets for the purposes of the Act. The section is relevant mainly in computing the gain or loss arising on disposal of a business asset. A gain on disposal of a business asset is computed as the consideration for the disposal less the net book value of the asset at the time of disposal (section 17(3)). A loss on disposal of a business asset is computed as the net book value of the asset at the time of disposal less the consideration for the disposal (section 19(2)). The cost of a business asset is the starting point in computing the net book value of an asset at the time of disposal (section 30).

The basic rule is in subsection (1), which provides that the cost of an asset (other than a business intangible) is the sum of the following amounts:

(1) The total consideration given by the person for the asset. This includes the fair market value (section 5) of any consideration given in kind. The fair market value is determined at the time the asset was acquired (see section 27). If the asset is constructed, produced, or developed (rather than purchased), the cost of the asset includes the cost of construction, production, or development.

(2) The total amount of any incidental expenditure incurred in acquiring or disposing of the asset. Examples of incidental expenditure include professional fees (such as for the services of an agent, lawyer, valuer, auctioneer or surveyor), and advertising costs (particularly on disposal).

(3) The total expenditure incurred to install, alter, renew, reconstruct or improve the asset.

Example 1

Paul purchased a warehouse for $500,000 and, in relation to the purchase, incurred $2,000 in legal fees. After two years, Paul adds another storeroom onto the property for a cost of $50,000. Paul then sells

the warehouse. At the time of sale, the cost of the warehouse is $552,000 being the sum of:

* The purchase price ($500,000) (subsection (1)(a)).

* The legal fees ($2,000) (subsection (1)(b)).

* The cost of the capital improvement ($50,000) (subsection (1)(c)).

Subsection (2) provides that the cost of a business intangible (such as an industrial or intellectual property right, or a contractual right) is the total expenditure incurred in acquiring, creating, improving, or renewing the business intangible, and any incidental expenditure incurred in acquiring or disposing of the business intangible.

Example 2

X Pty Ltd, an Australian company, has appointed Terry as the exclusive distributor of its products in Nauru. Terry has paid X Pty Ltd $100,000 to be appointed the exclusive distributor for five years. Terry's rights under the contract are a business intangible within paragraph (b) of the section 3 definition and the cost of the intangible is $100,000.

Subsection (3) provides that the cost of a business asset does not include any amount that is allowed as a deduction under section 19(1)(a) (ordinary business expenses). Thus, an amount that is both deductible under section 19(1)(a) and includible in the cost of a business asset under subsection (1) or (2) is treated as a deductible expenditure. This is particularly relevant to the incidental expenditures of acquiring and disposing of an asset, as these expenditures may be deductible under the general principle in section 19(1)(a). Subsection (3) ensures that a person does not obtain a double benefit, i.e. both a deduction for an expenditure and inclusion of the amount of the expenditure in the cost of a business asset.

Subsection (4) provides that the cost of a business asset includes any amount given for the grant of an option to acquire the asset.

Example

John grants Jane an option to acquire commercial premises owned by John that has a net book value of $200,000. The exercise price under the option is $500,000 and the price paid for the option is $25,000. Jane subsequently exercises the option. Jane's cost for the acquisition of the premises is $525,000, being the sum of the cost of the option $25,000 and the exercise price for the premises.

If Jane fails to exercise the option, then Jane has made a loss equal to the option price of $25,000 on expiration of the option.

The definition of a depreciable asset in section 3 includes a structural improvement to real property (such as commercial premises). Subsection (5) makes it clear that the cost of a structural improvement does not include the cost of the land on which it is located.

Subsection (6) provides that the cost of a business asset of a person is not reduced by an impairment write down in relation to the asset made in the financial accounts of the person. Subsection (11) defines "impairment write down", in relation to a business asset of a person to mean the write down of the value of the asset in the financial accounts of the person because the fair market value of the asset is less than the cost of the asset. This is particularly relevant to intangible assets, such as goodwill. The effect of subsection (6) is that the financial accounting rule requiring the write down of the value of impaired assets does not apply for the purposes of tax. The loss in value is recognised on disposal of the business asset.

Subsection (7) applies to part disposals of business assets and it apportions the original cost of the undivided asset between the divided parts in proportion to the fair market value (see section 5) of the parts at the time of the asset's acquisition (see section 27). Other criteria, such as the relative size of the parts, are not relevant to this apportionment.

Example

Roxanna has a business of property development. Roxanna acquired land for $500,000 on July 1, 2016 as part of the business (i.e. the land is a business asset). On July 1, 2018, Roxanna subdivides the land into two equal allotments and sells one for subdivided allotments for $400,000 and retains the other. At the time of acquisition of the original block of land, the market value of each subdivided allotment was $250,000. Section 29(7) requires that 50% of the cost of the original block is allocated to the subdivided allotment sold and the other 50% is allocated to the subdivided allotment retained. Thus, the gain on disposal of the subdivided allotment sold is $150,000 ($400,000 - $250,000). The subdivided allotment retained has a cost of $250,000.

Subsection (8) excludes from the cost of a business asset of a person any grant, subsidy, rebate, commission, or other assistance received or receivable by the person in respect of the acquisition of the asset unless the amount is included in the person's gross revenue. Loans, including low interest and interest-free loans, are not treated as "assistance" for this purpose (subsection (9)).

The acquisition of an asset by a person may result in the inclusion of an amount in the gross revenue of the person under section 17. Subsection (10)(a) treats the amount included in gross revenue as part of the cost of the asset to ensure that there will be no double taxation on a subsequent disposal of the asset. The cost of the asset also includes any additional amount the person may have paid for the acquisition of the asset.

Subsection (10)(b) provides a similar rule for the acquisition of an asset that is the derivation of exempt income. The asset has a cost equal to the exempt amount plus any consideration given for the asset. This prevents the exemption being recaptured on a subsequent disposal of the asset.

The Secretary may apply section 34 to determine the cost of a business asset acquired in a non-arm's length transaction.

30. Net Book Value of a Business Asset

This section sets out rules for determining the net book value of a business asset for the purposes of the Act. It is relevant in computing the gain or loss arising on disposal of a business asset. A gain on disposal of a business asset is computed as the consideration for the disposal less the net book value of the asset at the time of disposal (section 17(3)). A loss on disposal of a business asset is computed as the net book value of the asset at the time of disposal less the consideration for the disposal (section 19(2)).

Subsection (1) provides that the net book value of a business asset is the cost of the asset reduced by the depreciation deductions (if any) allowed in respect of the asset. If no depreciation deductions are allowed in respect of a business asset, the net book value of the asset is the cost of the asset.

Example 1

ABC Pty Ltd acquires an item of plant on 1 July 2016 for $100,000. The effective life of the plant for financial accounting purposes is 5 years and ABC uses straight-line depreciation in its financial accounts. Thus, the annual depreciation rate is 20% straight-line. The plant is used in ABC's business for the 2016/2017 and 2017/2018 tax years and ABC claims a depreciation deduction for those years under section 19(1)(c) as computed in accordance with section 21. The amount of the depreciation deduction is $20,000 ($100,000 x 20%) for each year. At the end of the 2017/2018 tax year, the net book value of the plant is $60,000 ($100,000 - $40,000). This recognises the fact that $40,000 of the cost has been allowed as deduction through the depreciation provisions.

If a depreciable asset or business intangible has been used partly to derive gross revenue and partly for some other purpose (such as a private purpose or to derive exempt income), the reduction in cost in computing net book value is the full decline in value computed without taking account of the deduction adjustment in section 21(3).

Example 2

Assume the same facts as in Example 1 except that ABC Pty Ltd uses the plant 75% of the time to derive amounts included in gross revenue and 25% of the time to derive exempt income. The effect of section 21(3) is that the depreciation deduction allowed for each year is only $15,000 ($20,000 x 75%). However, the net book value of the asset is computed by reference to the full decline in value. Thus, the net book value is still $60,000.

Subsection (2) applies when a person disposes of part only of a business asset and section 29(7) applies to allocate the cost of the asset between the part disposed of and the part retained. If the business asset is a depreciable asset or business intangible, then

it is necessary to determine the net book value of the part of the business asset sold and the part retained. In this case, subsection (2)(a) provides that the net book value of the part of the asset disposed of is the part of the cost allocated to the disposed part of the asset reduced by the depreciation deductions related to such allocated cost. Similarly, subsection (2)(b) provides the net book value of the part of the asset retained is the part of the cost allocated to the retained part of the asset reduced by the depreciation deductions related to such allocated cost.

Example 3

Roxanna owns an office building that is a business asset. Roxanna acquired building for $500,000 on July 1, 2016. On June 30, 2018, Roxanna subdivides the building into two equal titles and sells one of subdivided titles on that day for $400,000 and retains the other. At the time of acquisition of the original building, the market value of each subdivided title was $250,000. Section 29(7) requires that 50% of the cost of the original building is allocated to the subdivided title sold and the other 50% is allocated to the subdivided title retained.

As the building is a depreciable asset, Roxanna has been allowed depreciation deductions in respect of the cost of the building. Under financial accounting principles, the building has been depreciated at the rate of 5% straight-line and, therefore, the depreciation deductions allowed in respect of the building prior to the subdivision of the tile were $50,000. These depreciation deductions are allocated 50% to the subdivided title sold and 50% to the subdivided title retained. Consequently, section 30(2)(a) provides that the net book value of the subdivided title sold is $225,000 ($250,000 - $25,000) and section 30(2)(b) provides that the net book value of the subdivided title retained is also $225,000.

The gain on the disposal of the subdivided title sold is $175,000 ($400,000 – $225,000), which includes $25,000 of recaptured depreciation deductions. Roxanna continues to depreciate the subdivided title retained based on a net book value at July 1, 2018 of $225,000.

31. Consideration for the Disposal of a Business Asset

This section sets out the rules for determining the consideration for the disposal of a business asset. The section is relevant mainly in computing the gain or loss arising on disposal of a business asset. A gain on disposal of a business asset is computed as the consideration for the disposal less the net book value of the asset at the time of disposal (section 17(3)). A loss on disposal of a business asset is computed as the net book value of the asset at the time of disposal less the consideration for the disposal (section 19(2)).

Subsection (1) sets out the basic rule that the consideration for the disposal of a business asset by a person is the total amount received or receivable by the person for the asset including the fair market value of any consideration-in-kind. The fair market value of consideration-in-kind is determined under section 5 at the time of disposal (as determined under section 28).

Subsection (2) provides that the consideration for the disposal of a business asset by a person includes the consideration for the grant of an option in relation to the asset by the person but only if the person has not been subject to tax in respect of any gain made on the grant of the option. An option over a business asset is itself a business asset and, therefore, the grant of the option will give rise to a gain equal to the option price (less any incidental costs in granting the option). Subsection (2) ensures that the option price is not taxed again as part of the consideration for the business asset to which option relates.

Example 1

John grants Jane an option to acquire commercial premises owned by John that has a net book value of $200,000. The exercise price under the option is $500,000 and the price paid for the option is $25,000. Jane subsequently exercises the option.

John has made two gains:

(1) A capital gain of $25,000 on grant of the option. The consideration received is $25,000 and there is zero cost.

(2) A capital gain of $300,000 on disposal of the land. The consideration received is $500,000 and net book value is $200,000.

As the gain on grant of the option is separately included in gross revenue, the consideration received for the option is not included as part of the consideration received for the land.

Subsection (3) provides that the consideration for an asset that is lost or destroyed includes any compensation, indemnity, or damages received or receivable as a result of the loss or destruction of the asset. This includes amounts paid under insurance policies, as a result of settlements of lawsuits, or under judicial decisions. In the absence of subsection (3), a person might argue that the amounts were received because of the insurance policy, judicial decision, or settlement and not the disposal of the asset. Subsection (3) looks through the intermediate stage and treats the amounts as received in consequence of the loss or destruction of the asset that gave rise to a right to payment under the insurance policy, judicial decision, or settlement.

Example 2

Roxanna is the owner of a dive boat used in her dive business that cost $100,000. The boat is completely destroyed during a severe storm. The boat is treated as disposed of under section 28(1). The boat is insured and Roxanna receives $100,000 compensation from the insurance company. The insurance payment is treated as the consideration received on disposal of the boat.

Subsection (4) requires a person to apportion any undivided consideration provided for two or more assets in proportion to their respective fair market values (see section 5) determined at the time of the disposal (see section 28).

Subsection (5) applies when a taxpayer is unable to provide documentary evidence of the consideration for the disposal of an asset. In this case, subsection (5) specifies that the consideration is the fair market value of the asset at the time of disposal. The fair market value of an asset is determined under section 5 and the time of disposal is determined under section 28.

The Secretary may apply section 34 to determine the consideration for a business asset disposed of in a non-arm's length transaction.

32. Deferral of Recognition of Gain or Loss

This section specifies four cases when the recognition of a gain or loss arising on an actual disposal of a business asset is deferred until a later time.

The first case is when an asset is transferred between spouses as part of a divorce settlement or under an agreement to live apart (subsection (1)(a)). While the transfer of the asset is a "disposal" (as there is a change in legal ownership of the asset), the transfer is ignored for all purposes the Act. However, subsection (2) provides that subsection (1)(a) applies only when the recipient spouse will be subject to tax in relation to any subsequent disposal of the asset (i.e. the recipient spouse uses the asset to derive amounts included in gross revenue). For example, subsection (1)(a) will not apply if the recipient spouse is: (i) a non-resident who is not conducting business in Nauru through a permanent establishment; (ii) exempt from tax generally; or (iii) not taxed in respect of the particular asset (i.e. the asset is not a business asset of the recipient).

Subsection (3) provides that the recipient spouse takes over the net book value of the asset to the transferring spouse at the time of the transfer. Consequently, the effect of subsection (1)(a) and (3) is that recognition of the gain (or loss) that has accrued prior to the date of the transfer between spouses is deferred until the recipient spouse subsequently disposes of the asset.

Example 1

A and B are husband and wife who have divorced. Under the divorce agreement, A is required to transfer a business asset to B, who will use the asset in her own business. A acquired the asset for a cost of $100,000. At the time of the transfer, the asset has a fair market value of $200,000. Two years later, B sells the asset for $300,000. The asset is not a depreciable asset or business intangible. Thus, the net book value of the asset at the time of transfer is the cost of the asset.

The transfer of the asset from A to B is a disposal of a business asset. As the transfer is a non-arm's length transaction, the Secretary may apply section 34(1) to treat the fair market value of the transferred asset at the time of the transfer as the consideration for the asset. Thus, there is a gain of $100,000 ($200,00 - $100,000) in respect of the disposal.

> Despite this, section 32(1)(a) provides that no gain arises in respect of the disposal. Instead, under section 32(3), B takes over A's net book value ($100,000) and taxation of the gain that has accrued in respect of the asset is deferred until B subsequently disposes of the asset. Consequently, when B subsequently sells the asset, B makes a gain of $200,000 ($300,000 - $100,000) – this represents $100,000 of deferred gain that accrued while A owned the asset and $100,000 of gain that accrued while B owned the asset.

The second case is when an asset is transmitted on the death of a person to the executor or beneficiary of the person's estate (subsection (1)(b)). Again, subsection (2) provides that subsection (1)(b) applies only when the executor or beneficiary will be subject to tax in relation to any subsequent disposal of the asset (i.e. the executor or beneficiary uses the asset to derive amounts included in gross revenue). For example, subsection (1)(b) will not apply if the executor or beneficiary is: (i) a non-resident who is not conducting business in Nauru through a permanent establishment; (ii) exempt from tax generally; or (iii) not taxed in respect of the particular asset (i.e. the asset is not a business asset of the recipient). Subsection (3) provides that that the executor or beneficiary takes over the net book value of the asset to the deceased at the time of the transfer.

The third case is when an asset (referred to as the "replaced asset") is lost or destroyed, or compulsorily acquired under any law (subsection (1)(c)). Again there is an actual disposal of the asset (see section 28(1)), but the disposal is ignored for all purposes of the Act. There are two conditions that must be satisfied for the non-recognition rule to apply. First, the consideration for the disposal must be reinvested in an asset of a like kind (referred to as the "replacement asset"). Second, the replacement asset must be acquired within one year of the disposal of the replaced asset or within such further time as the Secretary allows.

The fourth case is when a person disposes of a depreciable asset (referred to as the "replaced asset") and acquires a new depreciable asset (subsection (1)(d)). There are two conditions that must be satisfied for the non-recognition rule to apply. First, the person must acquire a depreciable asset of a like kind (referred to as the "replacement asset"). Second, the replacement asset must be acquired within six months of the disposal of the replaced asset or within such further time as the Secretary allows. The non-recognition rule is intended to facilitate updating of business assets, particularly depreciable assets like plant and equipment.

Subsections (4) and (5) provide that the net book value of the replaced asset is "rolled over" into the replacement asset. The cost of the replacement asset is increased by any amount paid for the asset that is in addition to the proceeds of disposal of the replaced asset (subsection (4)) or is reduced (but not below zero) by any part of a gain made on disposal of the replaced asset that is not used in acquiring the replacement asset (subsection (5)). Subsection (6) applies when the excess under subsection (5) is not fully utilised because of the limitation that the cost of the replacement asset cannot be reduced below zero. In this case, the unutilised part of the excess is included in the taxpayer's gross revenue.

> **Example 2**

X Pty Ltd has an item of plant that cost $100,000 that is destroyed by a fire. At the time of the fire, X Pty Ltd had been allowed depreciation deductions of $20,000 and, therefore, the net book value of the plant at that time is $80,000. X Pty Ltd receives $100,000 as an insurance payment for the asset. X Co buys a replacement asset for $110,000. In this case, the full amount of the insurance payment has been used to acquire the replacement asset.

X Co has made a $20,000 gain on disposal of the plant ($100,000 - $80,000), but section 32(1)(c) applies and the gain is not taxed in respect of the disposal. As the cost of the replacement asset exceeds the consideration received for the replaced asset, subsection (4) applies. The amount of the excess is $10,000. Consequently, the cost of the replacement asset is $90,000 (being the net book value of the replaced asset at the date of disposal (i.e. $80,000) plus the excess ($10,000)). If X Pty Ltd subsequently sells the replacement asset for $120,000 (assuming no further depreciation deductions), the gain is $30,000 ($120,000 - $90,000). This captures the $20,000 gain that accrued on disposal of the replaced asset ($100,000 - $80,000) and the $10,000 gain that has accrued in respect of the replacement asset ($110,000 - $100,000).

Example 3

Suppose the same facts as in Example 2 except that the replacement asset cost $90,000. In this case, only $90,000 of the $100,000 insurance payment has been used to acquire the replacement asset.

Again, X Pty Ltd has made a $20,000 gain ($100,000 - $80,000) on disposal of the plant, but section 32(1)(c) applies and the gain is not taxed in respect of the disposal. As the consideration received for the replaced asset exceeds the cost of the replacement asset, subsection (5) applies. The amount of the excess is $10,000 and constitutes that part of the insurance payment that has not been reinvested in the replacement asset. Consequently, the cost of the replacement asset is $70,000 (being the net book value of the replaced asset ($80,000) reduced by the part of the insurance proceeds that have not been reinvested ($10,000)). If the replacement asset is subsequently sold for $120,000 (assuming no further depreciation deductions), the gain is $50,000 ($120,000 - $70,000) representing the $20,000 gain on disposal of the replaced asset and the $30,000 gain on the replacement asset.

33. Registration of Transferred Assets

This section provides for a rule relating to the registration of a transferred asset.

The section provides that any person authorised by law to register or approve the transfer of an asset must not register or approve the transfer unless satisfied that any tax

payable in respect of the transfer of the asset has been paid, or that the transfer is not subject to tax (e.g. the asset is not a business asset of the transferor).

34. Transfer Pricing

This section provides for transfer pricing rules.

The effect of the section is that pricing in transactions must be based on arm's length principles. If they are not, subsection (1) obliges the Secretary to allocate amounts of gross revenue, gains, deductions, losses, and tax credits between the parties to the transaction so as to reflect the outcome that would have been achieved in an arm's length transaction (i.e. a transaction between independent persons dealing at arm's length when the outcome of the dealing results in arm's length consideration being paid and received (subsection (4)). Subsection (1) applies to both domestic and cross-border transactions, although, in relation to the latter, the application of subsection (1) is subject to Regulations made in accordance with subsections (2) and (3).

Non-resident persons, in particular, may use transfer pricing as a means of reducing amounts derived from sources in Nauru. For example, a non-resident parent company may supply goods or services to a Nauru subsidiary for a price that is greater than the arm's length price so as to reduce the taxable income (and, therefore, Nauru tax liability) of the subsidiary. Similarly, a foreign head office of a non-resident company may deal with a Nauru permanent establishment of the company in such a way as to reduce the non-resident's taxable income in Nauru. For this reason, subsections (2) and (3) provide that cross-border transfer pricing adjustments must be made in accordance with the Regulations. The Regulations will be consistent with the international norms for transfer pricing as developed by the OECD.

35. Thin Capitalisation

This section provides for a thin capitalisation rule.

Subsection (1) provides that a foreign-controlled resident company that has an average debt to average equity ratio in excess of 2:1 for a tax year, is disallowed a deduction for the interest paid by the company during the year on the excessive amount of debt. The section applies only to a "foreign-controlled resident company", which is defined in subsection (4) to mean a resident company in which more than 50% of the ownership in the company is held by a non-resident person either alone or together with an associate or associates. "Resident company" and "non-resident person" are defined in section 3, and "associate" is defined in section 4. The section does not apply if the foreign-controlled resident company is a financial institution as the business of such an institution involves dealing in debts.

The calculation of the debt-to-equity ratio of a foreign-controlled resident company for a tax year is based on the average debt and average equity of the company for the year. The terms "average debt" and "average equity" are defined in subsection (4) and are calculated on a monthly basis. A foreign controlled resident company's average debt for a tax year is the sum of the amount debt at the end of each month divided by 12. A similar calculation is made of the average equity for a tax year. "Debt" is defined in subsection (4) to mean the debt obligations of the company on which interest is payable

as determined according to IFRS. Only interest-bearing debt is taken into account in calculating the level of debt. "Debt obligation" is defined in subsection (4) to mean an obligation to make a repayment of money to another person, including obligations arising under promissory notes, bills of exchange, and bonds, but does not including accounts payable (i.e. trade credit) or a repayment of money on which no interest is payable (i.e. interest-free debt). "Equity" is defined in subsection (4) to mean the equity of the company as determined under IFRS. It is expressly provided that equity includes debt obligations on which no interest is payable.

Subsection (2) provides an exception to subsection (1) when the average debt of the company for a tax year does not exceed the arm's length debt amount (i.e. the amount of debt that a financial institution that is not related to the company would be prepared to lend to the company having regard to all the circumstances of the company (subsection (4)).

Subsection (3) applies to permanent establishments in Nauru of non-resident companies. A number of non-resident companies will be doing business in Nauru through a permanent establishment rather than subsidiary and it is important that the thin capitalisation rule applies also to permanent establishments. Subsection (3) provides that the section applies to a permanent establishment in Nauru of a resident company on the basis of the following:

(1) The permanent establishment is deemed to be a "foreign-owned resident company". This ensures that the section applies to permanent establishments.

(2) The average debt to equity ratio of the permanent establishment is computed by reference to the debt obligations of the non-resident company that are attributable to the operations of the permanent establishment.

(3) The average debt to equity ratio of the permanent establishment is computed by reference to the equity of the non-resident company that is attributable to the operations of the permanent establishment.

The section is intended to prevent thin capitalisation practices (i.e. financing business operations through an excessive use of debt over equity). Thin capitalisation practices take advantage of the tax rate differential between the tax value of the interest deduction for the subsidiary or permanent establishment and the non-resident withholding tax rate on interest payments (which is usually lower than the tax value of the interest deduction. At the time of enactment, the tax rates under the Act are aligned with the tax value of the interest deduction being 10% (the business profits tax rate) and the non-resident tax rate being 10% and, therefore, there is no risk of base erosion with foreign investment. For this reason, section 35 is not immediately operative. However, this may change in the future and, therefore, the thin capitalisation rule has been included to protect against possible thin capitalisation practices that may arise in the future. Section 3(3) allows the Secretary to activate section 35 by notice in the Gazette should the relative tax rates change in the future.

36. Tax Avoidance Schemes

This section provides for a general anti-avoidance rule applicable to taxes imposed under the Act.

Subsection (1) provides that the section applies when the Secretary is satisfied of the following:

(1) A scheme has been entered into or carried out. The concept of a "scheme" is defined broadly in subsection (5) and is not limited to express, legally enforceable agreements, and can include a unilateral course of action.

(2) A person has obtained a tax benefit in connection with the scheme. The concept of a "tax benefit" is explained in subsection (5). The following are a "tax benefit" for the purposes of the section: (i) a reduction in a liability to pay tax; (ii) a delay in the arising of a liability to pay tax; (iii) any other advantage obtained from a delay in the payment of tax; (iv) anything that causes an amount of gross revenue to be exempt income (i.e. not taxed); (v) anything that causes an amount of gross revenue to otherwise not be subject to tax (such as an arrangement to convert Nauru-source income into foreign-source income); or (vi) anything that causes an amount that would otherwise be subject to tax not to be taxed.

(3) Having regard to the substance of the scheme, it would be concluded that a person, or one of the persons, who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the person referred to in (2) to obtain the tax benefit. Importantly, the person who has the requisite purpose and the person who obtained the tax benefit need not be the same person. In other words, the section can apply when a person enters into a scheme with the sole or dominant purpose that another person obtains a tax benefit under the scheme.

When the requirements in subsection (1) are satisfied, subsection (2) empowers the Secretary to determine the liability of the person who obtained the tax benefit as if the scheme had not been entered into or carried out. Subsection (2) enables the Secretary to "rewrite" a transaction by treating particular events as if they did or did not happen and at particular times or involving particular third party actions. Subsection (2) also empowers the Secretary to make compensating adjustments to the tax liability of any other person affected by the scheme. For a compensating adjustment to be made in relation to a person, the person need not be a party to the scheme, it is required only that they are affected by the scheme.

Subsection (3) obliges the Secretary to notify the person whose liability has been determined or adjusted under the section by serving a notice of assessment on the person to give effect to the determination or adjustment. An assessment made under this section is a "tax assessment" for the purposes of the Revenue Administration Act (see the definition of "tax assessment" in section 3 of the Revenue Administration Act). This means, for example, that the assessment can be amended under section 21 of the Revenue Administration Act and can be the subject of an objection under section 41 of the Revenue Administration Act.

Subsection (4) provides for a time limit on the serving of a tax avoidance assessment under the section. The Secretary must serve notice of the assessment within five years

from the last day of the tax year to which the determination or adjustment relates. This aligns with the 5-year time limit for amending assessments in section 21(4) of the Revenue Administration Act.

37. Application of Revenue Administration Act

This section provides for the application of the Revenue Administration Act for the purposes of administering the taxes imposed under the Act.

It is provided that the Revenue Administration Act applies for the purposes of the administration of the Act but subject the application of Part 5 of the Act. The Revenue Administration Act provides for harmonised procedural and administrative rules applicable to taxes imposed in Nauru. For this reason, the Act is a "tax law" for the purposes of the Revenue Administration Act. However, the application of the Revenue Administration Act for the purposes of the Act is subject to Part 5 of the Act. Part 5 provides for procedural and administrative rules that are specific to the taxes imposed under the Act. Thus, the legislative structure is that any procedural or administrative rules that are specific to the taxes imposed under the Act are provided for in the Act, while any generic procedural or administrative rules are provided for in the Revenue Administration Act. For example, the obligation to file a tax return is in the relevant Act requiring the return as the due date for filing returns can differ from tax to tax (see section 39 of the Act). However, general rules relating to returns, such as extensions of time to file returns, are provided for in Part 5 of the Revenue Administration Act.

The Revenue Administration (Amendment) Act 2015 amends the Revenue Administration Act consequent upon the enactment of the Act. In particular, the Act is treated as a "tax law" for the purposes of the Revenue Administration Act. The main implications of this are:

(1) The business profits tax (including an instalment of business profits tax), small business tax, non-resident tax, and international transportation business tax, are taxes for the purposes of the Revenue Administration Act (see section 3 definition of "tax").

(2) Withholding tax imposed under section 44 is "withholding tax" for the purposes of the Revenue Administration Act and, therefore, a "tax" for the purposes of the Revenue Administration Act (see section 3 definitions of "tax" and "withholding tax").

(3) A person liable for business profits tax (including an instalment of business profits tax), small business tax, non-resident tax, international transportation business tax, and section 44 withholding tax is a taxpayer for the purposes of the Revenue Administration Act (see section 3 definition of "taxpayer").

(4) Business profits tax (including an instalment of business profits tax), small business tax, non-resident tax, international transportation business tax, and section 44 withholding tax that is not paid by the due date (or extended due date) is unpaid tax for the purposes of the Revenue Administration Act (see section 3 definition of "unpaid tax").

38. Records

This section sets out the record-keeping obligations of persons liable for tax under the Act.

Subsection (1) obliges a person to keep such accounts, documents and records as enable computation of the tax payable by the person under the Act. In the case of the business profits tax, this requires records to be kept of gross revenue (such as sales revenue and fees for services rendered), and expenditures and losses allowed as deductions (such as purchases) for a tax year.

Subsection (2) applies to a person subject to the small business tax. Consistent with the application of the tax to small businesses, subsection (2) provides for simplified record keeping for persons subject to the small business tax. Such persons are required to keep the following records:

(1) A cash book recording daily sales, including credit sales.

(2) If the person employs employees, a salary and wages register. This is particularly relevant when the employees are subject to employment tax.

Subsection (4) provides that the Regulations may specify documents that must be maintained by a person liable for tax under the Act. It is intended that, in particular, this can give content to the broad statement of the requirement under subsection (1).

Subsection (1) applies to all taxes imposed under the Act, although is subject to subsection (2) in relation to the small business tax. Thus, subsection (1) applies also for the purposes of the non-resident tax and international transportation business tax (see section 3 definition of “tax”).

Accounts, documents, and records must be kept in accordance with section 14 of the Revenue Administration Act. In particular, section 14 of the Revenue Administration Act requires that accounts, documents, and records are:

(1) Kept in English.

(2) Kept in such manner so as to enable a person’s tax liability under the Act to be readily ascertained.

(3) Kept for five years from the end of reporting period to which they relate. In the case of the business profits tax, the reporting period is the tax year and, in the case of the small business tax, the reporting period is the quarter (defined in section 3).

A person who fails to keep records as required under this section and section 14 of the Revenue Administration Act may be liable for a penalty under section 61 of the Revenue Administration Act or prosecuted for an offence under section 70 of the Revenue Administration Act.

Subsection (3)(a) provides that the Secretary may disallow a person a deduction for an expenditure or loss when the person cannot properly substantiate the incurring of the expenditure or loss. Further, subsection (3)(b) provides that the Secretary may disallow the inclusion of expenditure in the cost of a business asset if the person cannot properly substantiate the incurring of the expenditure.

39. Tax Returns

This section provides for the filing of business profits tax and small business tax returns.

Subsection (1) obliges a person liable for business profits tax (see section 11) to file a business profits tax return for each tax year. A business profits tax return must be filed within three months after the end of the tax year. Thus, a business profits tax return must be filed by 30 September following the end of the tax year. A company must file its business profits return within three months after the end of its financial accounting period. For example, if a company's financial accounting period is the calendar year, then the business profits tax return for each calendar year must be filed by 31 March after the end of the year.

Subsection (1) is expressed to be subject to subsection (2), which provides that there is no obligation on a resident individual to file a business profits tax return for a tax year if the individual has no liability to pay business profits tax for that year. This is primarily relevant for individuals whose total taxable income for a tax year is subject to the zero rate of tax under paragraph (1)(a) of Schedule 1. The exception in subsection (2) is subject to the Secretary otherwise requiring such an individual to file a business profits tax return. For example, the Secretary may require a resident individual with a net loss for a tax year to a file a business profits tax return for the year to facilitate the claiming of the net loss carried forward deduction under section 23.

Subsection (3) obliges a person liable for small business tax (see section 11) to file a small business tax return for each quarter. Small business tax returns must be filed within one month after the end of the quarter. Section 3 defines "quarter" to mean the period of three months ending on 30 September, 31 December, 31 March, and 30 June. Consequently, small business tax returns must be filed by October 31, January 31, April 30, and July 31.

Subsection (4) provides that a business profits tax return or small business tax return must be filed in the form approved by the Secretary for such returns (see section 52 of the Revenue Administration Act) and in the manner provided for in section 53 of the Revenue Administration Act.

Subsection (5) provides that a business profits tax return and small business tax return are self-assessment returns for the purposes of the Revenue Administration Act. This means that, under section 18 of the Revenue Administration Act, a person who has filed a business profits tax return or small business tax return for a tax year is treated as having made a self-assessment of the tax payable for the year. The liability is the amount of business profits tax or small business tax as specified in the return.

Part 5 of the Revenue Administration Act provides for general rules applicable to business profits tax returns and small business tax returns. In particular, section 15 of

the Revenue Administration Act empowers the Secretary to grant a person an extension of time to file a business profits tax return or small business tax return.

A person who fails to file a return by the due date, or extended due date if an extension of time is granted, may be liable for a penalty under section 62 of the Revenue Administration Act or prosecuted for an offence under section 72 of the Revenue Administration Act. Further, a person who files a false or fraudulent return may be liable for a penalty under section 64 of the Revenue Administration Act or prosecuted for an offence under section 74 of the Revenue Administration Act.

40. Payment of Tax

This section provides for the payment of business profits tax and small business tax.

Subsection (1) provides that the business profits tax payable by a person for a tax year is due on the due date for the filing of the business profits tax return for the year. This is three months after the end of the tax year (section 39(1)). The intention is that business profits tax is payable with the filing of the business profits tax return. This is consistent with business profits tax being a self-assessed tax (section 39(5)).

Subsection (2) provides that the small business tax payable by a person for a quarter is due on the due date for the filing of the small business tax return for the quarter. This is one month after the end of the quarter (section 39(3)). Again, the intention is that small business tax is payable with the filing of the return, which is consistent with the tax being a self-assessed tax (section 39(5)).

A person who fails to pay business profits tax or small business tax by the due date is liable for late payment interest under section 28 of the Revenue Administration Act. In addition, the person may be liable for late payment penalty under section 63 of the Revenue Administration Act or prosecuted for an offence under section 73 of the Revenue Administration Act.

The Secretary can use the measures in Division 3 of Part 7 of the Revenue Administration Act to collect any unpaid business profits tax or small business tax.

Subsection (3) provides that non-resident tax is due on the date specified in section 44(2). Non-resident tax is collected through withholding under section 44.

Subsection (4) provides that the rules for payment of international transportation business tax are in sections 42 (ships) and 43 (aircraft).

41. Instalments of Business Profits Tax

This section provides for the payment of business profits tax by quarterly instalments. While business profits tax is imposed annually by reference to the tax year, the tax is collected in quarterly instalments during the year. At the end of the tax year, the total amount paid by a person in instalments during the year is credited against the person's assessed tax liability for the year. If a person's assessed tax liability for a tax year exceeds the instalments paid for the year, the person must pay the excess with their business profits tax return for the year (sections 39(1) and 40(1)). If the instalments

paid by a person during a tax year exceed the person's assessed tax liability for the year, the excess is applied in accordance with section 37(4) of the Revenue Administration Act.

Subsection (1) obliges a person liable for business profits tax to pay quarterly instalments of tax for each tax year. Instalments are payable by the 15th day of the month following the end of the quarter. In the ordinary case, instalments of tax are payable on 15 October, 15 January, 15 April, and 15 July. If a company uses a substituted tax year, instalments of tax are payable on the fifteenth day of the month following the end of third, sixth, ninth, and twelfth months of the company's tax year. For example, if a company's tax year is the 12-month period ending on 31 December, instalments of tax for the year are due on 15 April, 15 July, 15 October, and 15 January.

Subsection (2) provides that the amount of each instalment of tax for a tax year is one-quarter of the amount of the business profits tax liability for the previous tax year. For example, if the business profits tax liability for the previous tax year is $400,000, each instalment of tax for the following tax year is $100,000.

Subsection (3) provides that, if a person did not conduct business in the previous tax year, the amount of each instalment under subsection (2) is 0.5% of the person's gross revenue for each instalment period. "Gross revenue" is defined in section 17. "Instalment period" is defined in section 3 by reference to the tax year of a person. The instalment periods for a tax year of a person are the periods of three months ending on the last day of the third, sixth, ninth, and twelfth months of the year.

Subsection (3) is expressed to be subject to subsection (4), provides that no instalments are payable under subsection (3) by a resident individual if the Secretary is satisfied that the taxable income of the individual for tax year is reasonably expected to be below the tax-free threshold specified in Schedule 1.

Subsection (5) provides that instalments of business profits tax paid by a person during a tax year are credited against the assessed business profits tax liability (including a self-assessed liability) of the person for the year.

Subsection (6) provides that, if the total amount of a person's instalments for a tax year exceeds the person's assessed business profits tax liability for the year, the excess is applied in accordance with section 37(4) of the Revenue Administration Act. This means that the excess is applied in the following order:

(1) First in payment of any other business profits tax owing by the taxpayer.

(2) Then in payment of any other tax owing by the taxpayer under any other tax law.

(3) With the agreement of the taxpayer, then as a credit against a future tax liability, including a future liability for an instalment of tax.

(4) Then the remainder, if any, is refunded to the taxpayer.

Instalments of business profits tax are treated as a "tax" for the purposes of the Act (see section 3 definition) and, therefore, are also treated as a "tax" for the purposes of the Revenue Administration Act (see the definition of "tax" in section 3 of the Revenue Administration Act). This means that the Secretary can use the measures in Division 3 of Part 7 of the Revenue Administration Act to recover unpaid instalments of business profits tax. A person who fails to pay an instalment of business profits tax by the due date is liable for late payment interest under section 28 of the Revenue Administration Act. In addition, the person may be liable for late payment penalty under section 63 of the Revenue Administration Act or prosecuted for an offence under section 73 of the Revenue Administration Act.

42. Collection of International Transportation Business Tax from Non-resident Ship Owners or Charterers

This section provides for the collection of international transportation business tax imposed under section 14 in respect ships owned or chartered by non-residents. The tax payable is 2% of the gross amount derived by a non-resident owner or charterer of a ship from the carriage of passengers, livestock, mail, merchandise, or goods embarked or loaded in Nauru. Section 14(3) provides that the international transportation business tax liability of the non-resident owner or charterer of a ship is discharged if tax is paid in accordance with section 42, which provides a procedure for the collection of the tax from the captain or chief commanding officer of the ship, or the shipping agent in Nauru for the non-resident owner or charterer of the ship, before it departs from Nauru.

Subsection (1)(a) obliges the ship's captain or chief commanding officer, or Nauru shipping agent of the non-resident owner or charterer, to file a return showing the gross amount derived for the carriage of passengers, livestock, mail, merchandise, or goods embarked in Nauru and the international transportation business tax payable. The return must be filed before the grant of clearance for the departure of the ship from Nauru. Subsection (3) provides that the return must be in the approved form (see section 52 of the Revenue Administration Act) and filed in the manner specified in section 53 of the Revenue Administration Act. A return required to be filed under subsection (1) is treated as a "tax return" for the purposes of the Revenue Administration Act, which includes generic provisions relating to tax returns. Further, subsection (3)(c) provides that the return is a self-assessment return for the purposes of the Revenue Administration Act. This means that section 18 of the Revenue Administration Act applies in relation to the return and the non-resident owner or charterer of ship is treated as having made an assessment of the amount of international transportation business tax payable being the amount set out in the return.

Subsection (1)(b) obliges the ship's captain or chief commanding officer, or Nauru shipping agent of the non-resident owner or charterer, to pay the non-resident international business tax due in respect of the ship with the return. This is consistent with non-resident international business tax being a self-assessed tax (see subsection (3)(c)). International transportation business tax is a "tax" for the purposes of the Revenue Administration Act and, therefore, any unpaid tax can be recovered from the captain or chief commanding officer, or Nauru shipping agent of the non-resident owner or charterer under Division 3 of Part 7 of the Revenue Administration Act. To this end, subsection (7) treats the captain, chief commanding officer, or shipping agent in Nauru to whom subsection (1) applies as the tax representative of the non-resident

owner or charterer of the ship for the purposes of the Revenue Administration Act. This means that the liabilities and obligations of tax representatives referred to in section 12 of the Revenue Administration Act apply to the captain, chief commanding officer, or shipping agent in Nauru.

Subsection (2) provides that the captain or chief commanding officer, or Nauru shipping agent of the non-resident owner or charterer is not obliged to file a return under subsection (1) if the gross amount derived by the non-resident ship owner or charterer is exempt income under section 18(1)(f). Evidence in support of the exemption must be provided to the Secretary.

Importantly, subsection (1) requires that the return must be filed and tax paid before the departure of the ship from Nauru. However, subsection (4) provides the Secretary with discretion to allow the subsection (1)(a) return to be filed, and tax paid, within thirty days after the ship has left Nauru, but only if the non-resident owner or charterer of the ship has made satisfactory arrangements for the payment of the tax due. This could include, for example, providing security under section 26 of the Revenue Administration Act.

Subsection (5) links with the clearance procedure for ships in section 37 of the Port Authority Act. Under section 37 of the Port Authority Act, the Authority is empowered to give a public officer, whose duty is to grant departure clearance to a vessel, written notice of the amount of fees or rates levied under the Port Authority Act in respect of the vessel. If such notice is given, the public officer must not grant clearance until the amount due has been paid or has been secured to the satisfaction of the Port Authority.

Subsection (5) provides for the same procedure to apply in relation to international business transportation tax. It is provided that, if the Secretary gives written notice to a public officer referred to in section 37 of the Port Authority Act that an amount of international transportation business tax is due in respect of a ship, the public officer must not grant clearance until the tax due has been paid or has been secured to the satisfaction of the Secretary.

Subsection (6) provides that nothing in the section (particularly subsection (4)) relieves the non-resident owner or charterer of a ship from liability for the international transportation business tax that is not paid by the captain, chief commanding officer, or Nauru shipping agent of the non-resident owner or charterer of the ship. Consequently, while the section provides a mechanism for the collection of international transportation business tax from the captain or chief commanding officer, or Nauru shipping agent of the non-resident owner or charterer, the primary liability for the tax remains with the non-resident as imposed under section 14.

43. Collection of International Transportation Business Tax from Non-resident Aircraft Owners or Charterers

This section provides for the collection of international transportation business tax imposed under section 14 in respect aircraft owned or chartered by non-residents. The tax payable is 2% of the gross amount derived by a non-resident owner or operator of an aircraft from the carriage of passengers, livestock, mail, merchandise or goods embarked or loaded in Nauru. Section 14(3) provides that the international

transportation business tax liability of the non-resident owner or charterer of an aircraft is discharged if tax is paid in accordance with section 43.

The procedure for filing returns and payment of tax in the case of aircraft is the same as for ships under section 42 with the obligation falling on the pilot of the aircraft or the Nauru agent of the non-resident owner or charterer of the aircraft. Subsection (7) treats a pilot or Nauru agent as the tax representative of the non-resident owner or charterer of the aircraft for the purposes of the Revenue Administration Act. This means that the liabilities and obligations of tax representatives referred to in section 12 of the Revenue Administration Act apply to the pilot or Nauru agent.

The only procedural difference is that a non-resident owner or charterer can apply to the Secretary for permission to file returns and pay tax quarterly. This concession is provided for as aircraft may make regular scheduled visits Nauru. If permission is granted the returns and tax are due on April 30, July 31, October 31, and January 31 (see section 3 definition of "quarter").

Subsection (5) provides for the procedure similar to that in section 42(5) applicable in relation to ships. Under subsection (5), if the Secretary gives written notice to the Civil Aviation Authority of Nauru that an amount of international transportation business tax is due in respect of an aircraft, the Authority must not grant clearance for the aircraft to depart Nauru until the tax due has been paid or has been secured to the satisfaction of the Secretary.

Subsection (6) provides that nothing in the section relieves the non-resident owner or charterer of an aircraft from liability for the international transportation business tax that is not paid by the pilot or Nauru agent. Consequently, while the section provides a mechanism for the collection of international transportation business tax from the pilot or Nauru agent, the primary liability for the tax remains with the non-resident owner or charterer of the aircraft as imposed under section 14.

44. Withholding Tax

A non-resident person deriving interest, a royalty, or insurance premium from sources in Nauru is liable under section 13 for non-resident tax in respect of the amount derived. This section provides for the collection of the tax through withholding from the person paying the interest, royalty or premium.

Subsection (1) obliges a resident person or a permanent establishment in Nauru of a non-resident person making a payment of interest, a royalty, or insurance premium that is subject to non-resident tax to withhold tax from the gross amount paid at the non-resident tax rate specified in Schedule 1. At the time of enactment, the rate of tax is 10%.

The obligation to withhold tax under subsection (1) arises on the making of a payment of interest, a royalty, or insurance premium to a non-resident person. Subsection (8) provides that income subject to withholding tax under subsection (1) is treated as having been paid to a non-resident person if any of the following applies:

(1) The income is actually paid to the non-resident person. This would be the normal case.

(2) The income is applied on behalf of the non-resident person either at the instruction of the person or under any law.

(3) The income is reinvested, accumulated, or capitalised for the benefit of the non-resident person.

(4). The income is credited to an account for the benefit of the non-resident person. For example, the obligation to withhold tax arises on the crediting of an amount (e.g. interest) to an inter-company loan account.

The primary liability for non-resident tax under section 13 arises when the non-resident receives the interest, royalty, or insurance premium. To ensure that the primary liability and the withholding obligation arise at the same time, the concept of paid (or payment) under the subsection (8) aligns with the concept of "received" as defined in section 3.

The obligation to withhold arises only when the interest, royalty, or insurance premium is subject to non-resident tax. This means that there is no obligation to withhold if the interest, royalty, insurance premium is exempt income such as interest exempt from tax under section 18(1)(e) or if the interest, royalty, or insurance premium is attributable to a business carried on by the non-resident person through a permanent establishment in Nauru (section 13(3)(b)). In the latter case, the interest, royalty, or insurance premium is subject to business profits tax under section 11.

Subsection (2) provides that a person required to withhold tax under subsection (1) (referred to as a "payer") must file a withholding tax return and pay the withheld tax to the Secretary within 15 days after the end of the month in which the amount was paid. A withholding tax return is a tax return for the purposes of the Revenue Administration Act (see the definition of "tax return" in section 3 of the Revenue Administration Act). This means that the general rules applicable to tax returns in that Act apply to a withholding tax return. Thus, for example, the Secretary may grant a payer an extension of time to file the return under section 15 of the Revenue Administration Act if the payer demonstrates reasonable cause for the grant of the extension. It also means that a payer may be liable for an administrative penalty for the late filing of a withholding tax return under section 62 of the Revenue Administration Act or, alternatively, prosecuted for an offence under section 72 of the Revenue Administration Act.

Tax that a person is required to withhold under subsection (1) is treated as "withholding tax" for the purposes of the Revenue Administration Act and, therefore, is a "tax" for the purposes of that Act (see section 3 definitions of "tax" and "withholding tax" in that Act). The Secretary can rely on the recovery provisions in Division 3 of Part 7 of the Revenue Administration Act to collect unpaid withholding tax from a payer. A payer who fails to pay withholding tax by the due date is liable for late payment interest under section 28 of the Revenue Administration Act. In addition, the payer may be liable for late payment penalty under section 63 or the Revenue Administration Act or prosecuted for an offence under section 73 of the Revenue Administration Act.

Subsection (3) imposes a personal liability on a person who either: (i) fails to withhold tax as required under subsection (1); or (ii) withholds tax but fails to remit the tax to the Secretary as required under subsection (1).

Subsection (4) provides that a person personally liable for tax under subsection (3) that has not been withheld from a payment has a legal entitlement (i.e. a “cause of action”) to recover the tax from the non-resident recipient of the interest, royalty, or insurance premium. This applies only when the personal liability under subsection (3) arises because the person has failed to withhold the tax. It does not apply when the tax has been withheld but not remitted to the Secretary. The withholding of the tax discharges the non-resident’s liability for non-resident tax (section 13(4)).

Subsection (5) empowers the Secretary to collect non-resident tax from the recipient of a payment of interest, royalties, or insurance premiums when the person who was required to withhold tax from the payment failed to do so. The power to collect tax from the recipient of a payment of interest, a royalty, or insurance premium arises only when the payer fails to withhold the tax. If there has been a withholding of the tax, the non-resident’s liability is discharged under section 13(4).

Subsection (6) makes it clear that if, the Secretary recovers the tax from the recipient of the payment, the payer of the interest, royalty, or insurance premium is still liable in respect of the failure. For example, the payer may be prosecuted for an offence in respect of the failure to withhold tax (section 71 of the Revenue Administration Act).

Subsection (7)(a) obliges a person required to withhold tax to keep records of the gross amount of interest, a royalty, or insurance premium paid to non-resident persons and the amount of tax withheld from each payment. The records must be kept in accordance with section 14 of the Revenue Administration Act. A person who fails to keep records as required under this section and section 14 of the Revenue Administration Act may be liable for a penalty under section 61 of the Revenue Administration Act or prosecuted for an offence under section 70 of the Revenue Administration Act.

Subsection (7)(b) obliges a person required to withhold tax to file an annual withholding tax summary with the Secretary in the approved form (see section 52 of the Revenue Administration Act). The summary must be filed within 15 days after the end of the tax year or within such further period as the Secretary may allow by notice in writing. For this purposes, subsection (9) provides that the tax year is the period of 12 months ending on June 30. This is the case even if the person withholding the tax is a company using a substituted tax year. The Revenue Administration (Amendment) Act 2015 makes a consequential amendment to the definition of “tax return” in section 3 of the Revenue Administration Act to include an annual withholding tax summary under subsection (7)(b).

45. Currency Translation

This section provides for the currency of account for the purposes of the Act.

Subsection (1) provides that all amounts taken into account under the Act must be expressed in Australian dollars.

Subsection (2) provides for the translation of foreign currencies to Australian dollars. A foreign currency amount is to be translated to Australian dollars at the Reserve Bank of Australia exchange rate on the date the amount is taken into account for the purposes of the Act. This will be relevant, for example, when gross revenue is paid in a currency other than Australian dollars, such as in US dollars.

46. Regulations

This section enables Cabinet to make regulations under the Act.

Subsection (1) empowers the Cabinet to make regulations under the Act. The Regulations may provide for the amendment of the Schedules. This means that the rates of tax and the business profits tax threshold can be amended by regulation rather than through a legislative amendment to the Act.

Subsection (1) also expressly provides for the making of Regulations on transitional matters. Subsection (2) provides that transitional Regulations made within 6 months after the commencement date (the date specified in section 2(1)) may provide that they take effect from the application date (July 1, 2016, being the date specified in section 2(2)). This is necessary to facilitate the implementation of Act as it is not possible to anticipate all transitional issues that may arise.

47. Consequential Amendments to the Employment and Services Tax Act

This section makes an amendment to the Employment and Services Tax Act consequent upon enactment of the Act. Consequential amendments to the Revenue Administration Act are provided for in the Revenue Administration (Amendment) Act.

48. Transitional Provisions

This section sets out transitional provisions.

Subsection (1) provides that amount is exempt from tax to the extent provided for under a provision in an agreement entered into by the Government prior to the commencement date of the Act. “Commencement date” is defined in subsection (5) to mean the date that notice of the Act is published in the Gazette in accordance with section 2(1).

Subsection (2) applies when a company uses a substituted tax year. In this case, the period from July 1, 2016 to the start of the company’s first full tax year under the Act is treated as a transitional tax year. For example, if the taxpayer’s substituted tax year is April 1 to March 31, the period July 1, 2016 to March 31, 2017 is a transitional tax year. A company is required to report its taxable income and pay tax for this period.

Subsection (3) provides for the calculation of the amount of each instalment of business profits tax payable by a person under section 41 for an instalment period during the tax year July 1 2016 to June 30, 2017. The amount of each instalment is 0.5% of the person’s gross revenue for the period. The application of subsection (3) is expressed to be subject to section 41(4), which provides that no instalments are payable under section 41 by a resident individual if the Secretary is satisfied that the taxable income

of the individual for a tax year is reasonably expected to be below the tax-free threshold specified in Schedule 1.

Subsection (4) applies when the first tax year of a company under the Act is a transitional tax year (i.e. the company uses a substituted tax year). In this case, the amount of an instalment of business profits tax payable by the company under section 41 for an instalment period during the transitional tax year and the company's first full tax year under the Act is 0.5% of the company's gross revenue for the instalment period. It is necessary to apply the 0.5% rule also to the company's first full tax year because the tax payable for a transitional tax year will not be based on a full tax year.

Subsection (5) obliges a person who will be liable for business profits tax or small business tax and who does not have a taxpayer identification number (TIN) at the commencement date of the Act to apply for a TIN as required by the Secretary as set out in a notice published in the Gazette. This is intended to facilitate the issuing of TINs to taxpayers in advance of the application of the Act.

Schedule 1

This Schedule sets out the rates of tax.

Paragraph [1] sets out the rates of business profits tax. This includes a zero rate (i.e. a tax-free threshold) for resident individuals. "Resident individual" is defined in section 7 to mean the following:

(1) A citizen of Nauru other than a citizen who has a permanent home outside Nauru. However, a citizen of Nauru who is an employee of the Government of Nauru posted abroad is still treated as a resident individual even if they have a permanent home outside Nauru because the posting.

(2) A resettled refugee residing in Nauru.

Paragraph [2] sets out the rate of small business tax.

Paragraph [3] sets out the rate of non-resident tax.

Paragraph [4] sets out the rate of international transportation business tax.

Schedule 2

This Schedule sets out the business profits tax threshold. This is relevant to determining whether a non-resident individual conducting business is subject to the small business tax or business profits tax. If the gross revenue of a non-resident individual exceeds the business profits tax threshold for a tax year, the individual is subject to the business profits tax from the start of the following tax year.

Schedule 3

This Schedule sets out the consequential amendments to the Employment and Taxes Act.

Paragraph [1] amends the definition of “permanent establishment” in section 3 of the Employment and Services Taxes Act to provide that “permanent establishment” has the meaning in the Business Tax Act. The definition of “permanent establishment” in the Act has been updated consequent upon recent OECD developments to strengthen the concept of permanent establishment. As a consequence, the definition in the Employment and Services Taxes Act has been deleted and replaced by a definition that cross-refers to the definition in the Act.

Paragraph [2] amends section 6 of the Employment and Services Taxes Act, which defines “non-profit organisation”. The definition has been revised to provide that “non-profit organisation” has the meaning in the Business Tax Act.

Paragraph [3] amends section 9(1)(b) of the Employment and Services Tax Act, which provides that employment income or a services fee paid by a resident person is derived by the recipient from sources in Nauru and, therefore, subject to tax under that Act. However, it was not intended that tax would apply if the employment income or services fee is an outgoing of a foreign permanent establishment of a resident person. The amendment in paragraph [3] rewrites section 9(1)(b) of the Employment and Services Tax Act to make this clear. The amendment is treated as a consequential amendment as it ensures that the source rule in section 9(1)(b) of the Employment and Services Tax Act aligns with the equivalent source rule in section 8(3)(d) of the Act. Section 2(3) provides that this amendment has effect from 1 October 2014 (the application date of the Employment and Services Tax Act). The retrospective application of the amendment is because the amendment is beneficial to taxpayers.