REPUBLIC OF NAURU

BUSINESS TAX (AMENDMENT) BILL 2020

EXPLANATORY MEMORANDUM

The *Business Tax (Amendment) Bill 2020* is a Bill for the *Business Tax (Amendment) Act 2020*.

This memorandum provides an explanation of the Bill and is only intended to indicate the general effect.

EXPLANATION OF CLAUSES

Clause 1 provides that, once enacted, the short title of the Bill will be the *Business Tax (Amendment) Act 2020.*

Clause 2 sets out when the Bill's provisions will commence which is upon certification by the Speaker.

Clause 3 is the enabling provision for the amendment of the *Business Tax Act 2016.*

Clause 4 amends Section 3 of the Act by inserting additional definitions required for the purposes of the Act.

Clause 5 amends Section 9 of the Act. Section 9 defines what constitutes sources of income in Nauru. This definition is essential to ensure that Nauruan sources of income are not mixed with foreign sources of income. This is necessary to ensure that Nauruan sourced income must be taxed in Nauru. Nauru must get the full benefit of the tax. This also ensures Nauru tax law is consistent with international standards. For the avoidance of doubt, Nauruan residents will not be affected as the ***tax-free threshold*** of Nauruans is not changed.

Clause 6 amends Section 11 of the Act by inserting new subclauses (2A) and (2B) which deal with tax credits.
Subclause (2A) provides that a tax credit allowed to a person for a tax year is offset against the person's business profits tax liability calculated under subsection (2) for the tax year. A tax credit differs from a tax deduction. A tax deduction is allowed in calculating taxable income, whereas a tax credit is a direct reduction in the amount of tax payable (i.e. tax credit is taken into account after the calculation of taxable income).

There are two broad types of tax credits allowed under the Act. First, a resident person deriving foreign income included in assessable foreign income may be allowed a credit (referred to as a "foreign tax credit") for foreign income tax paid in respect of the income (see new Clause 25A). A foreign tax credit provides relief from international double taxation. Second, a credit is allowed for instalments of business profits tax paid in advance (Section 41). As this tax credit is for the prepayment of tax, it is refundable if the total instalments paid for a tax year exceed the taxpayer's business tax liability for the year.

Section 11 is structured so that a person's business profits tax liability for a tax year is first determined under subsection (2) before the allowance of any tax credits. New subclause (2A) then provides that any tax credits allowed to the person for the tax year are offset against the person's business profits tax liability for the year as determined under subsection (2). The amount payable by the person at the end of a tax year is the net amount after the offset of tax credits.

If a person is entitled to more than one type of tax credit, then it is necessary to know the order in which the credits are to be applied. This is because different consequences follow in the case of an excess credit depending on the nature of the credit that comprises the excess. An excess tax credit arises when total tax credits exceed the total business profits tax payable. The credit for instalments of business profits tax is refundable to the taxpayer to the extent that the credit exceeds the business profits tax payable by the taxpayer. On the other hand, the foreign tax credit is neither refundable nor can it be carried forward for credit in a subsequent tax year (see new Clause 25A(3)). Consequently, the foreign tax credit must be used in the tax year in which it arises or otherwise it is lost.

The ordering rule in new subclause (2B) identifies the nature of the tax credit that comprises the amount of any excess credit. Subclause (2B) provides that the foreign tax credit is applied first. This is favourable to taxpayers because, as stated above, foreign tax credits can be used only in the tax year in which they arise. Consequently, under this order of application, any excess credit is likely to wholly or largely comprise refundable instalments of tax, thereby limiting the possibility of unused foreign tax credits.

Clause 7 amends Section 17 of the Act. Section 17 defines "gross revenue" for the purposes of the Act. The determination of the total gross revenue of a taxpayer for a tax year is the first step in the calculation of the taxpayer's taxable income for the year under Section 16.

Paragraph (a) amends subsection (1), which specifies the amounts that are included in the gross revenue of a taxpayer for a tax year. The amendments, when combined with new subclause (2A), provide for the taxation of the worldwide income of resident persons. Paragraph (a)(i) provides that the application of subsection (1) is subject to new subclause (2A), which sets out the jurisdiction to tax under the business profits tax. Paragraph (a)(ii) deletes the reference to "from sources in Nauru". This is consequent upon the inclusion of new subclause (2A).

Paragraph (b) amends subsection (2), which specifies amounts that are not included in gross revenue. Paragraph (a) provides that a distribution by a company, partnership, or trust is not included in gross revenue. With the extension of the tax base to include the foreign income of resident persons, paragraph (a) is amended so that it applies only to distributions paid by a resident company, resident partnership, or resident trust. A distribution paid by a non-resident company, non-resident partnership, or non-resident trust does not benefit from the exclusion in paragraph. Such a distribution derived by a resident person is included in gross revenue.

Paragraph (c) inserts new subclause (2A), which sets out the jurisdiction to tax under the business profits tax. The jurisdictional scope of the business profits tax differs depending on whether the person deriving the income is a resident person or a non-resident person. Subclause (2A)(a) provides that an amount is included in the gross revenue of a resident person (as defined in Section 3) if it is derived from any geographic source (i.e., both within and outside Nauru). This means that a resident person is taxed on worldwide income. Relief from international double taxation is provided by way of the foreign tax credit under new Clause 25A.

Subclause (2A)(b) provides that an amount is included in the gross revenue of a non-resident person (as defined in Section 3) only if it is derived from sources in Nauru. Section 9 provides rules for determining when income is derived from sources in Nauru.

Clause 8 inserts a new Division 3A of Part 3 of the Act. A new Clause 25A is inserted which provides that a Nauru resident receives a credit (referred to as a "foreign tax credit") for any tax paid on foreign income which is also subject to tax in Nauru. This ensures that the Nauru resident does not pay "double taxation", that is, the allowance of a credit ensures the income is only subject to tax once and not twice.

The foreign tax credit is limited to tax payable on the foreign income only, and not against tax payable on Nauru source income. In addition, excess credit cannot be carried forward to a subsequent year nor can it be applied against other income. This requirement ensures that the correct amount of tax is paid in Nauru and Nauru tax laws will be consistent with international standards. Nauruan residents will not be affected as the tax-free threshold is not being changed.

The new Clause 25B provides that any expenditure or losses incurred in a foreign country in deriving foreign income, can only be claimed as a deduction against the foreign income which is subject to tax in Nauru, and not against Nauru source income. This requirement ensures that the correct amount of tax is paid in Nauru and Nauru tax laws will be consistent with international standards. Nauruan residents will not be affected as the tax-free threshold is not being changed.

Part 3 specifies the substantive provisions in determining the business profits tax liability of a resident person. New Division 3A is inserted consequent upon the extension of the tax base to include the foreign income of residents. Division 3A includes two Clauses: (i) Clause 25A, which provides for the foreign tax credit as the relief for international double tax; and (ii) Clause 25B, which provides for a quarantining rule so that expenses incurred to derive foreign assessable income can be deducted only against that income.

New Clause 25A – Foreign Tax Credit

New Clause 25A provides for the foreign tax credit as the method of relief from international double taxation.

The need for relief from international double taxation arises because resident persons are liable for business profits tax on both Nauru source income and foreign income (new Clause 17(2A)(a)). Foreign income derived by a resident person is likely to also be taxed in the foreign country of source and, therefore, subject to double taxation. In this situation, it is usual for the residence country to provide relief and that is the purpose of the foreign tax credit. Broadly, under the foreign tax credit, a resident person can credit their foreign income tax payments in respect of assessable foreign income against the Nauru business profits tax payable on that income.

Subsection (1) provides for the allowance of the foreign tax credit. There are a number of conditions that must be satisfied before a person is entitled to claim a foreign tax credit:

(1) The person must be a "resident person" as defined in Section 3. As Nauru taxes only resident persons on worldwide income, the foreign tax credit is allowed only to resident persons. Non-resident persons are taxed only on Nauru source income (see new Clause 17(2A)(b)).

(2) The resident person must have derived "assessable foreign income". This is defined in section 3 to mean foreign income included in the gross revenue of the resident person. There are two requirements for an amount to be assessable foreign income.

First, the amount must be "foreign income". Section 3 defines "foreign income" to mean an amount that is not derived from sources in Nauru. Section 9 provides rules for determining when income is derived from sources in Nauru. The combined effect of the section 3 definition of "foreign income" and section 9 means that any income that is not derived from sources in Nauru under section 9 is foreign income. No foreign tax credit is allowed in respect of income derived from sources in Nauru even if foreign tax has actually been paid on that income because the foreign country has a different source rule than that applicable under section 9.

Second, the foreign income must be included in gross revenue, i.e. it must be taxable in Nauru. Thus, no foreign tax credit is allowed for foreign tax paid in respect of foreign income that is exempt from Nauru business profits tax or outside the scope of the tax.

(3) The resident person must have paid foreign income tax in respect of the assessable foreign income. "Foreign income tax" is defined in subsection (5) to mean any tax on income or gains (however described), including withholding tax, imposed by the government of a foreign country or foreign territory, or a political subdivision (such as province or state) of a government of a foreign country or foreign territory. The definition expressly excludes any penalty, additional tax, or interest payable in respect of such tax. The reference to withholding tax covers, for example, withholding tax imposed on foreign source distributions, interest, or royalties derived by resident persons. Such taxes are imposed on a gross (rather than net basis) but are considered to be income taxes because they are the international norm for taxing such income of non-residents.

A foreign tax credit can be claimed only when the foreign tax has been paid (and not just when it is payable). If the foreign tax is paid after the Nauru business profits tax is paid, the assessment for the tax year in which the foreign income was derived can be later amended to allow for the credit. However, subsection (4)(a) limits the claiming of the foreign tax credit to two years after the end of the tax year in which the foreign income was derived. If the foreign tax is paid after that time, the credit is lost unless the Secretary allows further time for the foreign tax to be paid and still qualify for a credit. Further, subsection (4)(b) provides that a resident person must have a receipt and any additional documentary evidence as required by the Secretary provided by the foreign tax authority that evidences the payment of the foreign income tax

If these conditions are satisfied, subsection (1) provides that the resident person is entitled to a foreign tax credit. The amount of the credit is specified in subsection (2) and is limited to the business profits tax payable in respect of the assessable foreign income derived by the person for the year (referred to as the foreign tax credit limit). This means that the foreign tax credit allowed is the lesser of: (i) the foreign income tax paid on the foreign income; or (ii) the Nauru business profits tax payable on the foreign income. The foreign tax credit limit is calculated on a global basis (i.e. assessable foreign income and foreign taxes are aggregated across countries).

Subsection (2) provides that the business profits tax payable in respect of the foreign income is calculated by applying the resident person’s average rate of business profits tax applicable for the tax year against the person’s net foreign income for that year. Subsection (5) provides that a resident person’s average rate of business profits tax for a tax year is the business profits tax payable by the person for the year (before the allowance of any tax credit) as a percentage of the taxable income of the person for the year. The base for the calculation of the average rate of business profits tax is taxable income. Thus, exempt foreign income (such as exempt distributions) are not taken into account in determining the average rate of Nauru business profits tax.

The other component of the credit limit calculation is net foreign income of the resident person for the tax year. This is defined in subsection (5) as the total assessable foreign income of the person for the year reduced by deductions allocated to that income. Deductions that relate exclusively to the derivation of assessable foreign income are allocated to that income. Other deductions are apportioned to the assessable foreign income on any reasonable basis.

The effect of the foreign tax credit limit is that no foreign tax credit is allowed for foreign tax paid in excess of the business profits tax payable on the assessable foreign income. Subsection (3) provides that the foreign tax credit is a non-refundable credit. If an excess foreign tax credit was refunded to taxpayers, it would mean that Nauru would be financing the income tax paid by residents to countries with higher income tax rates on business profits. Further, it is provided in subsection (3) that any excess foreign tax credit of a resident person

for a tax year is not allowed as a deduction nor can it be carried forward as a credit allowed in the following tax year or.

New Clause 25B – Foreign Losses

New Clause 25B provides for the quarantining of foreign losses. This prevents a resident person from deducting foreign expenses against Nauru source income. The carry forward of foreign losses under this section replicates the general net loss carry forward rule in Section 23.

Subsection (1) provides that the deductions that a resident person is allowed under the Act relating to the derivation of assessable foreign income are deductible only against that income. "Resident person" and "assessable foreign income" are defined in Section 3.

If, as a result of the quarantining rule in subsection (1), the amount of deductions allowed to a resident person for a tax year in deriving assessable foreign income exceeds the amount of the person's assessable foreign income for the year, the excess is treated as a foreign loss (subsection (5)). Subsection (2) provides that a resident person who has a foreign loss for a tax year can carry the loss forward as a deduction in the next following tax year against the person's assessable foreign income for that year.

If a foreign loss is not wholly deducted in a tax year under subsection (2), subsection (3) provides that the excess is carried forward to the next following tax year and applied as specified in subsection (2) in that year and so on until the loss is fully deducted. However, subsection (3) limits the loss carry forward to three years after the end of the tax year in which the loss was incurred. This aligns with the net loss carry forward rule in Section 23. Subsection (4) applies if a resident person has a foreign loss carried forward for more than one tax year. In this case, subsection (4) provides that the foreign loss of the earliest tax year is deducted first. This ensures that each foreign loss gets the full benefit of the three-year carry forward period before it is exhausted.

Clause 9 amends Section 39 of the Act, which provides for the filing of an annual business profits tax return.

The Clause inserts new subclause (1B), which empowers the Secretary to require a person to file a business profits tax return for a tax year notwithstanding that no business profits tax may be payable by the person for the year. The power is to be exercised at the discretion of the Secretary. It may apply, for example, where a person is deriving exempt income.

Clause 10 amends Section 41 of the Act which provides for the payment of instalments of business profits tax by a person for a tax year. The instalments are an advance payment of the tax and are credited against the person's final business profits tax liability for the year.

Subsection (2) sets out the basic rule that the instalments payable by a person for the current tax year are calculated by reference to the person's business tax liability for the previous tax year. However, there are a number of exceptions to, or variations on, this and, therefore, subsection (2) is amended to state that it applies subject to the section providing otherwise.

Paragraph (b) amends subsection consequent upon the inclusion of new subclause (3E) (see below). Paragraph (b) provides that the operation of subsection (3) is also subject to subclause (3E).

Subclause (3A) sets out a mechanism whereby a person can apply for a downward adjustment in their instalments for a tax year. Subsection (3A) is amended so that a person can also make an upward adjustment in their instalments for a tax year.

New subclauses (3D) and (3E) are inserted, which empower the Secretary, on his or her own motion, to adjust the instalments payable by a person for a tax year. New subclause (3D) applies where the Secretary has reasonable grounds for believing that the business profits tax payable by a person for the current tax year will be less or more than that payable for the previous tax year. In this case, subclause (3D) empowers the Secretary to vary the amount of each instalment payable by a person for the current tax year. The determination of the amount of the instalments must be based on such evidence as may be available to the Secretary, and made to the best of his or her judgement.

New subclause (3E) applies where subsection (3) applies, i.e. where a person did not conduct business in the previous tax year and, therefore, has no previous business profits tax liability to base the instalments on for the current year under subsection (2). In this case, subsection (3) provides that the amount of each instalment is the 0.5% of the person's gross revenue for the instalment period. New subclause (3E) applies where the Secretary has reasonable grounds for believing that the business profits tax payable by a person for the current tax year will be less or more than that payable as determined in accordance with subsection (3). In this case, subclause (3E) empowers the Secretary to vary the amount of each instalment payable by a person for the current tax year. The determination of the amount of the instalments must be based on such evidence as may be available to the Secretary, and made to the best of his or her judgement.

Clause 11 amends Section 48 of the Act which provides for transitional rules applicable to the application of the business profits tax. The amendments provide for transitional rules applicable to the extension of the tax base to tax residents on worldwide income. This amendment ensures that the correct value of assets is used, after depreciation, to determine how much income is subject to tax. Nauru tax laws will be consistent with international standards. Nauruan residents will not be affected as the tax-free threshold is not being changed.

The amendment inserts new subclauses (6) and (7) (which apply to depreciable assets and business intangibles of foreign permanent establishments of resident persons), and new subclause (8) (which applies to other business assets of foreign permanent establishments of resident persons).

New subsection (6) applies where a resident person acquired a depreciable asset or business intangible for use in conducting a business through a foreign permanent establishment before

1 January 2021 and uses the asset or intangible to derive assessable foreign income on or after that date. In this case, the person must depreciate the asset or intangible from 1 January 2021 on the assumption that section 21 applied from the acquisition date of the asset or intangible. This means that a resident person conducting business through a foreign permanent establishment as at 1 January 2021 can claim depreciation deductions for the depreciable assets and business intangibles used in the permanent establishment only for the remaining useful life of the asset at the application date.

> **Example**
>
> X Pty Ltd, a resident company, acquired an item of plant on 1 January 2018 for a cost equal to $1,000,000 for use in its permanent establishment operations in Vanuatu. X Pty Ltd uses the calendar year as its financial account period and, therefore, also its tax year. X Pty Ltd still has the plant at 1 January 2021 and will use the plant to derive assessable foreign income from that date. X Co has been depreciating the plant on a straight-line basis in its financial accounts on the basis that the effective life of the plant is 5 years. This means that the depreciation rate is 20%.
>
> From 1 January 2021, X Pty Ltd will be liable for business profits tax on its Vanuatu operations. The application of section 48(5A) means that X Pty Ltd is treated as having depreciated the plant for the 2018, 2019, and 2020 tax years. This means that the net book value of the asset as at 1Janary 2021 is $400,000. Assuming that X Pty Ltd holds the asset for the 2021 and 2022 tax years, it can claim a deduction for $200,000 for each of those years. At the end of the 2022 tax year, the net book value of the plant is zero and no further depreciation deductions can be claimed.

New subclause (7) applies when a depreciable asset or business intangible referred to in subclause (6) is disposed of after 1 January 2021. Subclause (7) provides that Sections 17(1)(b) (gains) and 19(1)(d) (losses) apply only to the proportional part of any gain or loss on disposal that relates to the use of the asset or intangible to derive assessable foreign income after 1 January 2021.

> **Example**
>
> Assume that, in the example above, X Pty Ltd sells the plant on 31 December 2022 for $300,000. The net book value of the plant at that time is $200,000 (4 years depreciation at 20% straight-line). X Pty Ltd has made a gain on disposal equal to $100,000 ($300,000 – $200,000). The plant has been used for 4 years, but for only one of those years has it been used to derive assessable foreign income. Thus, the effect of section 48(5B) is that only 25% of the gain ($25,000) is included in business income under section 17(1)(b).
>
> Suppose, instead, that X Pty Ltd sells the plant for $100,000. X Pty Ltd has made a loss equal to $100,000 ($200,000 – $100,000). In this case, the effect

of section 48(5B) is that only 25% of the loss ($25,000) is allowed as a deduction under section 19(1)(d).

New subclause (8) applies where a resident person acquired a business asset (other than a depreciable asset or business intangible) for use in conducting a business through a foreign permanent establishment before 1 January 2021. In this case, subclause (8) provides that the cost of the asset is the fair market value of the asset on 1 January 2021. This may apply, for example, where the business asset is a financial asset issued by a non-resident entity, such as shares in a non-resident company. This ensures that any gain that arises on a disposal of the asset after 1 January 2021 is taxed only to the extent of the increase in value from 1 January 2021.

The application of new subclause (8) is subject to new subclause (9), which provides that subclause (8) does not apply to an asset the disposal of which can give rise to income or a gain derived from sources in Nauru. This will apply, for example, where a resident person acquires real property in a Nauru as an asset of foreign permanent establishment of the person.