EMPLOYMENT TAX: THE GOOSE THAT LAYS THE GOLDEN EGG

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Wage earners are, without question, the one group of taxpayers whose tax burden, and their compliance in paying tax, is often taken for granted by tax policy planners. Wage earners also happen to be the weakest lobby in comparison with industry, business people, farmers and peasants. Beside, collecting tax on salaries and wages is the easiest thing to do, given the system of deductions by employers. These facts appear to combine in a way which leaves the wage earner in the most unfavourable tax position. The objective of this article is to explain the current tax on employment income, and to stimulate some debate on Papua New Guinea's salary or wages tax.

SIGNIFICANCE OF THE TAX ON EMPLOYMENT INCOME

According to the 1980 census figures, Papua New Guinea had by that year 7% of the population in wage employment.[1] A report published in 1989 by the World Bank shows that the rise in wage employment since 1980 has been very small. Only 12.5% of the population is currently in employment.[2] A study carried out in 1988 for the Taxation Department aimed at establishing the exact number of people employed was forced to settle for an estimate. It estimated that the total number of people on the pay-roll in the country is between 280,000 and 300,000. Significantly, this estimate is only 17.8% of the adult population in Papua new Guinea. These figures show that the number of wage earners as a proportion to the country's four million people is very small. Like most developing countries, about 90% of the population is still engaged in subsistence production.

Notwithstanding their small number, wage earners are the backbone of direct taxation in Papua New Guinea. Since it was introduced on 1st January 1980, the salary or wages tax, which is the country's tax on employment income, is the biggest source of direct tax revenue. Tax deductions from salaries or wages account for more than 50% of the total tax collection. The other sources of direct tax revenue which contribute the remaining part of revenue include: tax on company profits, tax on dividends, tax on royalties, stamp duty, succession duties, betting tax, bookmaker licence fees, specific gains tax, telephone tax, and tax from Bougainville Copper Limited Company. Table 1 below shows the amount of tax realised from salaries or wages over the last 10 years.

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1. The *1980 National Population Census*, National Statistical Office - Port Moresby, PNG; see also *Population of Papua New Guinea*, UN Economic Commission for Asia and the Pacific, South Pacific Commission, Country Monograph Series No 7.2, Noumea, New Caledonia, 1982.

2. *PNG Opportunities and Challenges*, World Bank Report No 7707 - PNG, 21 April 1989, p.4.

TABLE 1

Salary or Wages Tax Deductions 1980-1989[3] (in million Kina)

Year	Total Tax	Salary or Wages Tax	% of Total
1980	225.0	76.2	34
1981	206.1	87.4	43
1982	181.5	101.7	56
1983	199.9	116.8	58
1984	242.1	124.4	52
1985	239.1	125.7	53
1986	242.9	139.0	57
1987	244.8	140.2	51
1988	267.1+	150.1	56
1989#	266.0	170.0	63

\+ The big increase in 1988 resulted from BCL tax which was nearly double the previous year amount because of favourable copper prices. But the effect of this on collections was countered by a reduction of the company tax rate from 50% to 45%.[4]

In achieving these 'impressive' collection statistics, the squeeze had to be tightened on wage earners. Considerations of equity or fairness which are usually part of overall tax policy have been deliberately put aside. Wage earners appear to have been singled out as easy prey for the taxman, and the tax which they are now forced to pay violates three fundamental principles of income taxation, namely: that income tax is an annual tax imposed on the taxpayer's annual earnings; that income tax is charged on the total income of the taxpayer; and that, in arriving at the taxable income, all expenditures incurred by the taxpayer in earning the income are to be deducted before the tax is applied.

Before examining the manner in which the tax on employment earnings violates the above principles, it is helpful to set out the general scheme of Division 2B of Part III of the *Income Tax Act 1959*. This is the part of the Act which imposes salary or wages tax. Division 2B, which consists of sections 65D to 65J, was enacted in 1979[5] and came into effect on 1st January 1980.

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3. See Chief Collector of Taxes, Annual Report, 1980-1988, Taxation Office, Port Moresby, PNG.

4. See Budget Estimates of Revenue and Expenditure, 1989, Department of Finance and Planning, Port Moresby, PNG.

5. Section 16 - *Income Tax (Amendment Act No.4) 1979, Act No.50 of 1979*. Before 1979, salaries and wages were taxed either under s.46, which imposes income tax on all receipts which fall within the general concept of income, or under s.47(1)(d) which imposes income tax liability on employment benefits. [PNG's s.47(1)(d) is nearly the same as s.26(e) of the *Australian Income Tax Assessment Act [1936]*.

WHAT IS TAXED AS EMPLOYMENT INCOME UNDER DIVISION 2B?

Division 2B of the *Income Tax Act* outlines the operation of salary or wages tax. Sections 65G and 65E impose tax on salaries, wages, and a wide range of other employment benefits. Section 4(1) defines what consists of "salary or wages" in the widest possible terms. It states *inter alia* that 'salary or wages means salary, wages, commission, bonus, remuneration of any kind or allowances paid in respect of or in relation to the employment of that person as an employee'.

Section 65E is more specific. It lists the items of income on which salary or wages tax applies. The section includes both cash and non-cash benefits. But section 65E is not exhaustive. It is enacted as a general guide only. For benefits not listed under section 65E, one has to fall back on the definition given by section 4(1) to see whether a particular payment or benefit is taxable as employment income. Section 65E specifically treats the following items as part of employment income to which salary or wages tax will apply:

- salary or wages [this refers mainly to the fortnightly amounts one receives as payment for services under a contract of employment];

- the value to the taxpayer of benefits granted in respect of employment including money, goods, meals, sustenance, use of premises, etc;

- transitional payments or gratuity defined in sections 65A and 65CB as including all amounts set aside in a contract of employment which are payable on termination of that employment;

- lump sum payment of gratuity, compensation, or other allowances covered in section 46B and sections 65B and 65C;

- the actual cost price of leave fares [subject to section 40AA, which exempts payment of tax where the amount paid is used for actual travel];

- the prescribed value of a motor vehicle or housing provided free of charge or at a reduced cost;

- the prescribed value of housing allowance, and the excess of housing allowance over housing expenditure;

- the prescribed value of domestic services paid for by the employer [eg. where the employer pays for a cook or a gardener]; and

- the prescribed value of electricity, water, or garbage disposal [where these the bills are paid by the employer].

Employment income which consists solely of salaries, wages, and cash allowances is not hard to deal with. The gross amount of the salary, wage or allowance is included in the assessable income of the taxpayer. There are some cash benefits which are subject to certain exceptions. For instance, leave fares will not be taxed as income if the employee applies the whole amount paid for actual travel.[6] An education allowance also will not

6. S.40AA.

be taxed as income provided the amount given by the employer is limited to the annual fees imposed by a school or college.

Benefits in kind such as the use of a company car or a company house are subject to different considerations. The courts have made it clear that, as a general rule, it is the value to the taxpayer which is to be treated as the taxable gain, not the market value of the benefit. The value to the taxpayer is calculated in money's worth, i.e. the cash equivalent.[7]

However, the PNG *Income Tax Act* requires that prescribed values be fixed for various benefits in kind.[8] The prescribed values for different kinds of benefits are set out in regulation 9A of the Income Tax Regulations made under section 65E.[9] As a matter of practice, the Taxation Office normally issues circulars notifying Group Employers of changes in the prescribed values. For example, Group Employers Circular No. 1 of 1989, issued by the Chief Collector of Taxes, circulated the prescribed values set under the regulations as they applied after January 1, 1990. The benefits for which taxable amounts have been set include accommodation, housing allowance, motor vehicles, domestic servants, public utilities, and electricity. The taxable amounts prescribed represent only a notional value of the benefit.

The values prescribed for accommodation relate to two types of housing, high covenant and low covenant housing. The value for each type is determined by reference to size and location as shown in Table 2 below.

TABLE 2

Housing Valuation

(a) Private Sector Housing Value of Benefit Per Fortnight (in Kina).

	Area 1	Area 2	Area 3
Furnished High Covenant House or Flat -			
3 or more bedrooms	K63	K43	Nil
2 bedrooms	K56	K38	Nil
1 bedroom	K50	K33	Nil
Unfurnished High Covenant House or Flat -			
3 or more bedrooms	K56	K35	Nil
2 bedrooms	K50	K33	Nil
1 bedroom	K44	K23	Nil
Low Covenant House of Flat -			
3 or more bedrooms	K30	K20	Nil
2 bedrooms	K25	K18	Nil
1 bedroom	K20	K16	Nil

7. *Tennant v. Smith* (1892) AC 150, per Lord Halsbury '... the thing sought to be taxed is not income unless it can be turned into money'.

8. Ss.65E(1) and 299D(4).

9. Regulation 9A was amended by Act No.16 of 1989 to provide for new prescribed values applicable from 1 January 1990.

Mess or Barracks Style Basic Accommodation	K15	K10	Nil
(b) Government Housing Houses	K30	K30	Nil
Mess or Barracks Style Basic Accommodation	K4	K4	Nil

Notes:

Low Covenant housing is any unit of accommodation which, if sold to an arm's length purchaser, would realise K15,000 or less.

References to Areas 1 or 2 in the above table mean houses or other accommodation located in, or within 10 Kilometres of the boundaries of any of the following towns-

Area 1: Alotau, Arawa, Goroka, Kavieng, Kieta, Lae, Madang, Mt Hagen, Panguna, Popondetta, Port Moresby, Rabaul, Tabubil, and Wewak.

Area 2: Bulolo, Bwagoia, Daru, Kainantu, Kerema, Kimbe, Kiunga, Kundiawa, Lorengau, Mendi, Samarai, Vaninmo, Wabag, and Wau.

Area 3: Any place in Papua New Guinea not included in areas 1 and 2.

If, instead of providing accommodation, an employer pays housing allowance, the taxable value is the amount applicable to a furnished 3 bedroom high covenant house, or the amount of housing allowance derived, whichever is the less.[10]

The prescribed value for a motor vehicle provided by the employer to the employee varies depending on whether the employee has restricted or unrestricted use of the vehicle, and whether fuel is provided or not. Where use is unrestricted, and the employer bears the cost of fuel, the prescribed value is K60 per fortnight. Where the vehicle is provided without fuel, the taxable amount is K40 per fortnight. If the use of the vehicle is restricted, i.e. the vehicle is solely used by the employee during working hours for business purposes only and is garaged at the place of work, not being near the employee's residence, the employer must apply to the chief Collector of Taxes for a value to be prescribed.[11]

The taxable value for domestic servants (cook, gardener, or *'haus meri'*) is K24 per fortnight.[12] Where public utility expenses such as water and garbage collection are paid for by the employer, the taxable value is K4 per fortnight.[13]

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10. Somehow the Taxation Office has interpreted this as allowing it to tax the amount by which the housing allowance exceeds actual expenditure. This is clearly not what Regulation 9A(1) of the *Income Tax Regulations* when read with s.65E(1)(j) provides.

11. Regulation 9A(2) - *Income Tax Regulations.*

12. Regulation 9A(3) - *Income Tax Regulations.*

13. Regulation 9A(4) - *Income Tax Regulations.*

THE METHOD OF TAXATION

To arrive at the taxable income of an employee, all the employment earnings are added together to give gross taxable income. The appropriate tax rate is applied to this gross amount to obtain gross tax. From the gross tax is deducted the concessional rebate in respect of dependant(s). Also deductible from the gross tax is the amount allowed under section 214 being expenses incurred by the employee in producing income. After deducting the above amounts, the balance is the tax payable. I will discuss the operation of section 214 later.

The amount of rebates allowed for dependants are set out in Schedule 1 of the *Income Tax (Salary or Wages Tax) (Rates) Act 1979* (as amended). The maximum number of dependants allowed is six for low income earners with gross income of less than K154 per fortnight. For those earning above that amount, only four dependants can be claimed. The actual amount allowed for each dependant also depends on the income category of the employee. Dependant allowance can only be claimed if the employee has lodged a declaration with the employer claiming dependants. If no declaration is lodged, the full amount of the gross income will be taxed.

The tax rates applicable to gross earnings are set out under Schedule 1 of the *Income Tax (Salary or Wages Tax) (Rates) Act 1979* (as amended). The rates range from 5% for employees earning K154 per fortnight to 29% for those earning K800 per fortnight. Earnings in excess of K800 per fortnight are taxed at 29% (i.e. K236.92) on the first K800 plus 45% for each K1 by which fortnightly earnings exceed K800. An employee who earns K1000 per fortnight would be assessed as follows:

1000 (K800 x 29%) = K231 + (K200 x 45%) = K90 = K321 = 32%

The effective tax rate on that employee is 32%. This example assumes that the employee has lodged a declaration and that no dependants or other rebates are claimed. Where such are claimed the effective tax rate will be proportionately reduced. If, on the contrary, no tax declaration is lodged with the employer, the tax rate is much higher.

The tax rates used for employment earnings are highly progressive. The higher the taxable income, the higher the rate of tax applicable to that income.

THE INEQUITY IMPLICIT IN SALARY OR WAGES TAX

(a) The Fortnightly Deductions:

The salary or wages tax is payable each fortnight.[14] The tax is deducted by the employer[15] from the employee's earnings so that only the after-tax pay is given to the employee or credited to the employee's account. This system of collecting tax is known as Pay As You Earn (PAYE).

The PAYE collection system has three basic advantages. In the first place, it is efficient because it nets the tax before the taxpayer lays his hands on the income, thus effectively preventing tax evasion. Secondly, it is economical because it transfers much of the cost of collecting the tax from the Taxation Office to employers, who are obliged by law to make the deductions. An employer who fails to deduct tax from an employee's pay, or

14. S65I.

15 S299D.

having deducted, fails to remit the tax, is liable to a maximum fine of K2,000. The law also makes the employer liable for any tax which is not deducted, or for making incorrect deductions of tax from the employee's wages.[16] Thirdly, PAYE deductions enable the Taxation Office to collect the money throughout the year of income. As the words "Pay As You Earn" signify, the employee pays the tax as soon as he earns the income. This is significant because collecting tax at the time the income is earned only applies to employment income. Income tax on income other than employment (eg. income from trading, income from property, income from mining and petroleum operations, etc.) is assessed on an annual basis. This means that often tax is not due until an assessment is made at the end of the year of income following receipt of a tax return from the taxpayer (in some cases though there is a requirement for payment of provisional tax).

For the taxpayer, of course, there is financial advantage in retaining the money until the end of the year. Indeed, too, the taxman seeks the same advantage in wanting to have the tax paid as soon as the liability accrues. But the advantage of paying tax at the end of the year should not be overstated. The fact that for wage earners a large payment of tax at the end of the year could leave many hopelessly out of pocket must be conceded. That notwithstanding, the State benefits from having this money ahead of time, something that should be recognised and rewarded by tax concessions.

However, there is a far more serious inequity involved in the collection of salary and wages tax. Section 4(1) of the *Income Tax Act* declares the fortnightly deductions to be a final tax in respect of the employee's tax liability on that income. The implication is that once the tax has been deducted the matter is closed. There is no final assessment of the employee's tax liability at the end of the year. In other cases where an advance tax in the form of provisional tax is required to be paid, the taxpayer's final tax liability is not affected because an adjustment of tax payable is made at the end of the year of income.

In countries where employment income is assessed on an annual basis, the tax payable is determined by reference to the annual income of the employee. The advantage of annual assessment is that the taxable income of the employee is calculated over a 12 month period. Where the employee has not worked for whole year, the income for the period over which he was employed would be spread over 12 months [26 fortnights] to arrive at the fortnightly pay on which the appropriate rate of tax is applied. Given that progressive rates are used, spreading the income earned say in 10 fortnights over the whole year would lower the taxable amount, and with it the rate of tax and the tax payable on that income. The same result would follow for an employee who has worked at a lower pay for part of the year, but gets a salary increase later in the year.

Many countries which use the PAYE collection system have provision for the tax deductions to be adjusted at the end of the year to arrive at the final tax on the employee's income. In Australia, the employee, not withstanding the weekly deduction of tax, the employee is required to file a tax return at the end of the year. The tax return must be accompanied by a group certificate filled by the employer and indicating the gross wages earned and the total tax deducted. Since the deductions are based on the assumption that the employee will work for the whole year, and at the same level of earnings, substantial tax refunds result where these assumptions are not borne out.

Papua New Guinea does not have comparable provisions in its *Income Tax Act*. As stated before, the tax deducted each fortnight is a final tax and no adjustments are permitted at the end of the year. Where a person is employed only for part of the year and pays tax at the normal rate attaching to that level of income, but if spread over 26 fortnights his income would not attract any tax, or would attract much less tax, it is tough luck for him. The higher tax deducted stands.

16. Ss299D and 299G(7).

(b) Employment Income is Taxed Separately:

Before the enactment of Division 2B in 1979, the assessment of income tax from all sources was regulated by section 46. The section provides in part that:

> s 46(1) The assessable income of a taxpayer shall include:
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> (a) where the taxpayer is a resident - *the gross income* derived directly or indirectly *from all sources* whether in or out of Papua New Guinea; (underlining supplied).

This provision is in line with the principle that a taxpayer's liability to income tax is on a total income basis. Where a taxpayer obtains assessable income from more than one source, the amounts from all the sources should be taken together in ascertaining the taxpayer's tax liability.

Since the basis of assessment is total assessable income, it was possible to invoke sections 66 and 68 to reduce the tax burden on the total income. Section 66 provides that:

> In calculating the taxable income of a taxpayer, the total assessable income derived by him during the year of income shall be taken as a basis and from it there shall be deducted all allowable deductions.

Section 68 spells out what deductions are allowable. It provides in part that:

> [A]ll losses and outgoings, to the extent to which they are incurred in gaining or producing the assessable income..., are allowable deductions....

Theoretically, an employee who has other sources of income apart from his salary could use losses incurred in deriving the other income to reduce the tax on employment earnings. For example, if an employee owns a cab and sustains a loss because business is bad, or because the cost of maintaining the vehicle exceeds returns from the taxi business, he can use these loses to reduce the taxable amount from employment.

However, when the salary or wages tax was introduced in 1979, amendments were made to the Act which effectively prevent the deduction provisions from affecting tax on employment income. Section 46A(c), enacted in November 1978,[17] provides that employment income should be taxed separately. Where an employee has income other than salary or wages, the other income should be ignored for the purposes of computing the employee's liability to salary or wages tax, subject to section 214(4) which enacts special rules for rebates on non-salary losses.

But while the legislature has squeezed the wage earner in this way, other taxpayers still enjoy the privilege of being taxed on a total income basis. For example, a trader who owns a service station and a stationary shop can use losses incurred in one business to reduce the overall tax on the other profitable venture. What wrong has the wage earner done to deserve the different treatment?

Ironically, since employment income is not taxed on a total income basis, a wage earner who is able to take two or three jobs at the same time, can obtain some tax advantage. Under the prevailing system of final tax on each fortnightly deduction, each employer

17. See Act No.69 of 1978 s2, and Act No.22 of 1980, s61.

would deduct tax only on that part of income earned from his establishment. Because the income is spread in this way the total deductions will be much less than would be the case if all the earnings of the employee were subjected to adjustment or assessment at the end of the year of income. The only catch is that an employee is not allowed to lodge more than one declaration. Therefore, assuming that no declaration is lodged on the second employment, that income will be taxed at a higher marginal rate. Nonetheless, it is still true that an employee, who takes an evening or night job with another employer instead of working overtime for the same employer, is better off in tax terms.

(c) Deduction of Expenditure Incurred in Producing Employment Income:

Usually, income tax is charged on the net income of the taxpayer. Any expenditure which he/she incurs in producing income must be deducted from the gross amount to arrive at the taxable amount. Sections 66 and 68, which have been cited above, make this quite clear. The rationale for allowing the deduction of expenditures incurred is fairly obvious. What is truly income from normal accounting principles is the excess of returns on outlays. A person whose outlays exceed revenue makes a loss. Therefore, it makes sense for the *Income Tax Act* to allow expenditures incurred in deriving income to be deducted before charging the tax.

Most common law countries have deduction provisions similar to those contained in the *Income Tax Act* of Papua New Guinea. In construing these deduction provisions, the courts have been very generous to the taxpayer. They have continually stated that it is the taxpayer, not the tax office or the courts, who should decide how much to spend in earning income.[18] The tax office should accept the result of the taxpayer's activities as they find it. If as matter of law the expenditures which the taxpayer has incurred are deductible, the whole amount expended must be allowed.[19]

As a result, sections 66 and 68 are normally relied in claiming the deduction of such expenditures as business advertising, business entertainment, transport costs, and other expenditure incurred in producing income or in the course of carrying on a business for the purpose of producing income.

But for Papua New Guinea, the deduction rules which apply to income generally do not apply to employment income. Section 66A, enacted at the same time as the salary or wages tax provisions, states that the deduction provisions under sections 66 and 68 do not apply to employment income. Wage earners are not allowed to claim for expenses which they incur in earning their wages. Expenditures like the cost of going to or from the workplace, work uniforms, protective clothing, tools, or expenses on self education, which would be allowable deductions in other common law countries, are not deductible here. A professional person who buys books, incurs transport expenses in performing his duties, pays money to attend a work related seminar or workshop, or pays membership subscription to a professional organisation can not, generally speaking, claim these expenses against his taxable income.

It is claimed that the rationale for not allowing expenses for earning wages to be deducted from gross wages is that tax rates on wages have been reduced to allow an automatic deduction of K200 per annum to compensate expenses the employee incurs in earning the income.[20] Given the high rates of taxation in the country, this explanation is

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18. *Tweedle v. FCT* (1942) 2 AITR 360.

19. *Id.*, per Williams J, p.364.

20. See Chief Collector of Taxes' Annual Report-1988, p.22.

a little hard to believe. It is conceivable that deduction of expenses from wages has been curtailed purely for the purpose of maximising tax revenue.

But, even assuming that employment expenses have been taken into account in the manner stated above, the amount of K200 per annum is unrealistic. A university lecturer who has to buy books, attend conferences (often at his own expense), stay up at night marking assignments or preparing lectures (and in the process running up his electricity bill), spends far more than K200 in one calendar year. There are numerous employees in similar situation.

Section 214 of the *Income Tax Act* gives limited scope for deduction of employment expenses. Subsections (1) and (5) of section 214 allow a wage earner who spends more than K200 in deriving income to lodge a tax return and claim a rebate. The lodgement of a return is deemed to be an objection to the fortnightly assessment and, if rejected by the Taxation Office, can be referred to Income Tax Review Tribunal as an appeal. But assuming that the Taxation Office is satisfied that the expenditure was actually incurred in gaining the employment income, subsection (3) limits the amount allowable to only 30% of the amount in excess of K200.

By way of example, assume a university lecturer buys books worth K400 in the year. He attends three work related seminars held in the country for which he spends K150 in participation expenses. He spends a further K250 on fuel expenses in search for material needed for his teaching. Thus his total expenditures would be K800 for the year. A claim for rebate under section 214 would be calculated as follows:

K800 - K200 = K600 x 30% = K180

The allowable rebate would be only K180 compared with a tax saving of K280 in the case of an employer.

The inequity implicit in these provisions is very obvious. While the wage earner is restricted in this way, a person deriving income from business is allowed to deduct all expenditures incurred in earning assessable income. For business income, the Act looks only to the amount actually spent. The expenditure need not be reasonable or necessary, it is enough if it has been incurred for the general purpose of the business.[21] The amount of expenditure, once ascertained, must be allowed as a deduction.

CONCLUSION

As demonstrated by the statistics at the beginning of this article, tax on employment income is indeed the goose that lays the golden egg. But even geese do not like a greedy owner. In many countries now, particularly in Europe, Australia and the United States, the trend in tax policy is to reduce the tax burden on wages. Maybe Papua New Guinea should start thinking in terms of improving the performance of other sources of tax revenue so as to ease the pressure on the wage earner.

When the tax system allows industry and business people numerous concessions, allows the farmers substantial incentives, and fails to extend the payment of income tax to peasants who constitute nearly 90% of the population, the fairness of the tax system is greatly compromised. Particularly, the failure to tax peasants needs to be addressed urgently. Papua New Guinea is endowed with vast natural resources. Because of their ownership of the land, tribal communities are deriving substantial cash payments in royalties and compensation payments for the use of their land by foreign companies who carry out mining, petroleum and forestry operations. The age-old argument that it is hard

21. *Tooheys Ltd v. C. of T. (1922) 22 SR (NSW) 432, at 440; Thomas v. FCT* (1972) 72 ACT 4091.

to tax peasant societies because they are not within the cash economy does not strictly apply to Papua New Guinea. In order to head off possible confrontation in the future, equity requires that the tax burden should be more evenly distributed to catch such payments.