BUSINESS PROFITS TAX REGULATIONS
EXPLANATORY NOTES

PART I
Preliminary

§ 101. Short Title

These Regulations may be cited as the Business Profits Tax Regulations.

§ 102. Authority

These Regulations are promulgated pursuant to Section 1472 of the Act.

§ 103. Definitions

This section provides definitions of commonly used terms in the Regulations.

Sub-regulation (a) sets out definitions of terms used in the Regulations. A term has the meaning set out in this Regulation unless the context requires otherwise. Sub-regulation (b) provides that a term used in the Regulations that is defined in Title 40 has the same meaning as in Title 40 unless context requires otherwise. The definition may be a specific BPT definition in Chapter 14, such as Section 1412 of the Act, or a definition in the general definition provisions in Chapter 10 of Title 40.

The following terms are key terms defined are in sub-regulation (a) other definitions are self-explanatory:

The definitions in this regulation apply unless the context requires otherwise. A different meaning is applied only if this is clearly required by the context. If a different meaning is applied, it is only for the purposes of the regulation to which it relates.

Act

"Act" is defined to mean the Business Profits Act in Chapter 14 of Title 40. The Act imposes Business Profits Tax on all persons that are registered for Palau Goods and Services Tax (PGST).

Cross-border transaction

"Cross-border transaction" means any one of the following types of transactions:

(1) A transaction between a resident of Palau and a person who is a non-resident – except if the transaction takes place wholly in Palau';

(2) A transaction between two residents that relates to a business carried on by one or both of the residents though a permanent establishment outside of Palau; or

(3) A transaction between two non-residents if the transaction relates to a business carried on by one of the non-residents through a permanent establishment established in Vanuatu.

This definition is used to identify transactions which are subject to the transfer pricing arrangements set out in Subpart A of these regulations.

General insurance business

"General insurance business" means the business of under taking all insurance activity other than life insurance. The term "life insurance business" is defined in paragraph (9) of the Regulations and set out below.

Instalment period

An "Instalment period" is defined by reference to a person's tax year. Instalment period is the period of three months ending on the last day of the third, sixth, ninth, or twelfth months of the person's tax year. Under paragraph (a) of the Section 1412 of Title 40 definition of "tax year", the tax year of a company is the accounting year of the company for the purposes of preparing its financial accounts. For example, if the tax year of a company is the period 1 July to 30 June, the company's instalment periods are:

- 1 July – 30 September;
- 1 October – 31 December;
- 1 January – 31 March; and
- 1 April – 30 June.

The tax year for any other person (such as an individual) is the calendar year (1 January – 31 December).

The term "instalment period is used in section Section 1464 of Title 40 which requires taxpayers to pay business profits tax in instalments in accordance with regulations.

Intangible asset

"Intangible asset" is, in broad terms an intangible asset 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. Section 1002(y) of the Unified Tax Act provides for the deduction for depreciation of these assets Part 2 of these Regulations sets out how the deduction is calculated and the rate of depreciation. This allocates the cost of the intangible to the tax years in which is it is "used up" in deriving assessable business income.

There are three broad categories of business intangibles:

(1) Intellectual and industrial property, such as copyrights, patents and trademarks, secret formulas, plans, etc.

(2) Limited term contractual rights that are uses wholly or partly to derive gross revenue. The term must exceed one year. For example, a right granted under a contract to act as an exclusive distributor for a period of three years is an intangible asset.

(3) Preliminary expenditure (separately defined in Paragraph (12) of the Regulations and is set out below.

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 Regulation 201. An intangible that is used solely to produce exempt income or for private purposes is not a business intangible and, therefore, no depreciation deductions are allowed for the cost of acquiring the intangible.

Life Insurance Business

A life insurance business is the business of issuing issuing of insurance policies that provide for the payment of money on the death of a person or on the happening of a contingency dependent on the termination or continuance of human lifee.

Membership interest

"Membership interest" includes a share and any other ownership interest in the company (such as the interest of a member in a company limited by guarantee or an unincorporated association) "membership interest" us defined by reference to the term "entity", which includes a company, a foundation, partnership, trust, or unincorporated body of persons (see Section 1614(f)(2)).

The definitions of membership interest is, broad to align with the broad definition of an entity. The following are examples of membership interest in an entity:

(1) A shareholder in a body corporate. A share in a body corporate is treated as a membership interest in the body corporate.

(2) A beneficiary under a foundation. The interest of the beneficiary in the foundation is treated as a membership interest in the foundation.

(3) A partner in a partnership. The interest of the partner in the partnership is treated as a membership interest in the partnership.

(4) A beneficiary or unitholder under a trust. The interest of a beneficiary and unit of a unitholder in a trust is treated as a membership interest in the trust.

(5) An ownership interest in a company limited by guarantee.

(6) An ownership interest in an unincorporated association or body of persons.

Option

"Option" means an agreement that gives the holder a right to buy or sell a particular asset (such as shares, commodities, or immovable property) on or before a future date at a pre-agreed price.

An option may be a "put" option under which the holder of the option has the right (but not an obligation) to sell property at a pre-agreed price or a "call" option under which the holder of the option has the right (but not an obligation) to buy property at a pre-agreed price. Options are often used to reduce trading risk.

Another example of an option is when a company wishes to raise further capital through an additional issue of shares will often grant existing shareholders an option to acquire further shares in the company. Similarly, as an incentive to employees, a company may grant options over shares in the company to employees under an employee share scheme.

Preliminary expenditure

"Preliminary expenditure" means expenditure incurred by a person prior to the commencement of a business, other than expenditure incurred to acquire tangible real or personal property, or an intangible asset within the meaning of (A) or (B) of the definition. See above.

An amount is preliminary expenditure only if business to which the expenditure relates will be carried on wholly and exclusively in deriving gross revenue. Accordingly, for example, there is no deduction for preliminary expenditure if the whole or the part of the income from the proposed business to which the expenditure relates will be exempt income.

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

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

Property income

"Property income" means

(1) a dividend, interest, royalty, rent or annuity or

(2) a gain on disposal of an asset that gives rise to one of the incomes referred to in (a).

This definition is relevant for the purposes of Regulation 506 which deals with the use of tax havens.

Straight-line depreciation

The "straight-line depreciation" method is used to calculate the amount of depreciation deduction allowed under section 1002(y)(10) of Title 40. The amount of the depreciation deduction allowed under this method is calculated by multiplying "straight-line rate" specified in Regulation 202 by the cost of the relevant asset.

Transfer Pricing arrangement

"Transfer Pricing arrangement" means a transaction that meets all the following:

(1) the transaction is for the supply or acquisition of goods, services, money, intangibles or an asset;

(2) the transaction is between associates; and

(3) the transaction is a cross border transaction.

The definition of transfer pricing arrangement is used in Part V of these Regulations which provide rules to prevent international tax avoidance.

PART II
Depreciation

201. Depreciation of depreciable assets

Regulation 201 sets out how a person my work out their deduction for depreciation referred to in Section 1002(y)(10) of the Act.

Regulation 201 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.

The key terms used in this section are defined below.

Depreciable asset

"Depreciable asset" is defined in are defined in Subsection 1002(ll) to be a "capital asset" that

(1) has an ascertainable useful life exceeding one year;

(2) is likely to lose value as a result of normal wear and time, or the passing of time; and

(3) is used to derive gross revenue.

Capital asset

"Capital asset" is defined in Subsection `1002(jj) to be. Tangible or intangible asset of a business, other than inventory, that

(1) has a useful life exceeding one year; or
(2) does not have an ascertainable useful life.

Intangible assets

"Intangible assets" are defined in Regulation 103.

PART II
Depreciation

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 intangible assets - which generally are industrial and intellectual property, contractual rights, and capital expenditures (such as prepayments) that decline in value through use in deriving gross revenue or the passage of time.

Straight-line depreciation method

Sub-regulation 201(a) provides that a taxpayer may depreciate depreciable assets using the straight-line method.

Sub-regulation 201(b) reserved.

Rate of depreciation

Sub-regulation (c) provides that the rate of depreciation is set out in Regulation 202.

Assets used partly to derive gross revenue

Sub-regulations (d) applies when a depreciable asset or intangible asset has been used partly to derive gross revenue and partly for some other purpose. 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 Sub-regulation (b) in the normal way. That amount is then multiplied by the fraction that represents the business use of the asset during the year to calculate the annual depreciation deduction. In other words, the amount allowed as a deduction under Sub-regulation (a) is the proportion of the decline in value calculated under (b) that relates to the use of the asset to derive gross revenue.

Example 1 - Part private use

Assume George buys a computer on 1 January 2023 and uses the computer 75% of the time for business purposes and 25% for private purposes. The decline in value of the computer under Sub-regulation (b) for the 2023/2024 tax year is $1,000. This is based on application of Regulation 202 depreciation rate of 25% and assumes straight-line depreciation is chosen by George.

However, Sub-regulation (d) 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.

Sub-regulation (e) applies if a depreciable asset or business intangible is used for only part of the tax year in deriving gross revenue. 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 Sub-regulation (b) 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.

Example 2 – Part year use

Assume that in Example 1 above, George acquired the computer on February 1, 2023. This means that George used the computer to derive gross revenue for only 215 of the 365 days in the 2023/2024 tax year. Consequently, the depreciation deduction for the 2023/2024 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 2026/2027 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 2027/2028 tax year, the remaining value of the computer ($411) is allowed as a deduction in that year.

Sub-regulation (f) applies ensures that the total amount of deductions that can be allowed will not exceed the cost of the asset.

Sub-regulation (g) provides that if the net book value of a depreciable asset of the taxpayer at the end of the year is less than [$300], then the:

(1) undepreciated amount of the net book value of the asset is added to the taxpayer's depreciation for the that year to the extent that the asset is used to derive gross revenue; and

(2) the asset is treated as fully depreciated.

This Regulation is intended to reduce taxpayer compliance costs by removing the need to calculate depreciation for assets when they have small net book values. Sub-regulation 202(b) provides that the depreciation rate for an asset that has a cost of less than [$300] is 100%. As a result, any asset purchased 100% for business, that costs less than [$300] is claimed as a depreciation deduction in full in the tax year the small asset was purchased.

Calculating a gain or loss on sale of capital asset

Section 1432(a) of the Act provides that if a person disposes of a capital asset, any gain on disposal is included in gross revenue and any loss is allowed as a deduction under section 1434(a).

A gain is computed as the consideration for the disposal reduced by the net book value of the capital asset at the time of disposal (1432(a)). A loss is computed as the net book value of the capital asset reduced by the consideration for the disposal (section 1434(a)). Section 30 provides that the "net book value" of a depreciable asset is the cost of the asset reduced by the depreciation deductions allowed in respect of the asset or intangible (section 1442).

§ 202. Depreciation Rates

The Depreciation rates are set out in the table contained in Sub-regulation (a).

The rates set out in the table are subject to Sub-regulation (b) provides that the depreciation rate for an asset that has a cost of less than [$300] is 100%. As a result, any asset purchased 100% for business, that costs less than [$300] is claimed as a depreciation deduction in full in the tax year the small asset was purchased.

Sub-regulation (c) sets out the straight-line depreciation rates applicable to intangible assets.

- for preliminary expenditure, 25%;
- for an intangible asset with a useful life of more than 10 years, other than an intangible asset referred to in Paragraph (1), 10%; and
- for any other intangible asset, 100% divided by the number of years in the useful life of the asset.

<u>Part III</u>
Banks and Insurance Companies

§ 301. Provision for unexpired risks

Sub-regulation (a) provides that a deduction is allowed for resident company carrying on general insurance business for the balance of the company's unexpired risk provision at the end of the year. The deduction is limited to insured risks in Palau.

Sub-regulation (b) provides that a non-resident company carrying on general insurance business through a permanent establishment in Palau is also allowed a deduction for the balance of the company's provision for unexpired risks at the end of the tax year. The deduction is limited to insured risks in Palau.

The amount of deduction allowed in (a) and (b) must not exceed the amount required for the provision under GAAP. (Sub-regulation (c))

Sub-regulation (d) requires that any amounts allowed under this section in prior year must be included in the gross revenue of current year.

The provision for unexpired risks is not defined in Regulations, however, the term generally means the amount set aside by the general insurer at the end of its tax year, in respect of loss and expense payments expected to be paid by the insurer after the end of its tax year under contracts of insurance entered into before the end of that year.

§ 302. Taxation of life insurance companies

Regulation 302 sets out the special taxation rules that apply to life insurance companies.

Sub-regulation (a) provides that the following amounts are allowed as a deduction in a tax year:

(1) the amount of initial reserves established in the financial accounts of the company for new life policies issued during the year. The amount must be in respect of individuals in the in Palau and the deduction allowed cannot exceed the amount required for the initial reserve under GAAP; and

(2) the amount of the annual additions made in the financial accounts of the company during the year to life policy reserves that relate to individuals in the Palau and the deduction allowed cannot exceed the amount required for the initial reserve under GAAP.

Sub-regulation (b) provides that when a life company cancels a life policy and a deduction has been allowed in respect of that policy under Sub-regulation (a), the amount the reserve that a deduction has been allowed (deducted reserves) relating to that policy must be included in the gross revenue of the company for the year.

Sub-regulation (c) sets out the tax impact of claim pay-outs. The following applies if pay-outs are made during a tax year:

(1) if the total amount of deducted reserves in relation to those claim pay-outs exceeds the total amount of claim pay-outs made during the year, the excess is included in the gross revenue of the company for the year; or

(2) if the total amount of claim pay-outs made during the year exceeds the total amount of deducted reserves in relation to those claim pay-outs, the company is allowed a deduction for the year for the amount of the excess.

§ 303. Loan loss provision of banks

Sub-regulation (a) provides that a bank is allowed a deduction equal to the additions made to the loss provision for the bank in the year. The addition to the provision must be calculated in accordance with GAAP.

Sub-regulation (b) limits the deduction allowed in (a) to additions to the loan loss provision relating to banking operations carried out in Palau.

<u>Part IV</u>
Rules Relating to Assets

§ 401. Jointly owned assets

This Regulation provides for the apportionment of a gain or loss made on disposal of a jointly owned asset, such as a jointly owned rental property.

Sub-regulation (a) provides that the owners of a jointly owned asset must apportion any income, gains, expenditures, and losses according to their respective interests in the asset. The Sub-regulation is relevant to the section 1002(o) definition of gross revenue and section 1432 (which, together provide for the inclusion of a gain arising on disposal of a capital asset in gross revenue) and the Section 1002(y) definition of "net income" and section 1434 (which together provide for a deduction for the loss on the disposal of a capital asset of a business).

Sub-regulation (b) 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 is owned through a joint tenancy.

§ 402. Acquisition of an asset

This Regulation sets out when a person acquires an asset for the purposes of the Act.

Sub-regulation (a) 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 1444, 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. Accordingly, 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, Sub-regulation (b) provides that a person acquires the asset when the right is granted to the person. “Right” has its normal legal meaning. The reference to “right” is a reference to any right recognised by law. The main example is a right granted under a contract.

Example

> X Co is the manufacturer of a popular children's toy. X Co appoints A as the exclusive distributor of the toy in Palau for five years. A pays X Co $1,000,000 as consideration for the appointment. A's contractual rights are a capital asset for the purposes of the Act. A acquires the rights (i.e., asset) when they are granted, i.e., when the contract is entered into.

A common contractual "right" that would be subject to this Regulation is an "option". An option is a contract that gives the holder a right to trade in a particular asset (such as shares, commodities, or immovable property) on a future date at a pre-agreed price. An option may be a "put" option under which the holder of the option has the right (but not an obligation) to sell property at a pre-agreed price or a "call" option under which the holder of the option has the right (but not an obligation) to buy property at a pre-agreed price. Options are often used to reduce trading risk.

An example of an option is when a company wishes to raise further capital through an additional issue of shares by granting existing shareholders an option to acquire further shares in the company. Similarly, as an incentive to employees, a company may grant options over shares in the company to employees under an employee share scheme.

The rule in Sub-regulation (b) is consistent with the deemed disposal rule in Section 1444. Accordingly, on the grant of an option, the grantor is treated as having disposed of the option and the grantee is treated as having acquired the option.

Sub-regulation (c) applies when a taxpayer constructs or creates or arranges for the construction or creation of, an asset that the taxpayer owned when it is constructed or created. In these cases, the taxpayer acquires the asset at the time the construction or work done to create the asset commenced.

§ 403. Disposal of an asset

This Regulation sets out when a person has disposed of an asset in addition to the rules set out in the Act.

Sub-regulation (b) provides that in the case of succession or under a will, an asset is treated as disposed of by the deceased at the time the asset is transmitted.

Sub-regulation (c) makes it clear that the term "disposal" also includes disposal of part of an asset.

Sub-regulation (d) makes it clear that vesting at asset to an appointed person in Section 1612 is not a disposal of the asset for the purposes of the Act. An administrator, executor, receiver, trustee in bankruptcy, or liquidator, referred to as "the appointed person" in this regulation (and section 1612, appointed to manage, administer, liquidate, or wind up the affairs of a taxpayer, including a deceased taxpayer.

The acts done by the appointed person are treated as being done by the owner.

Sub-regulation (d) provides that the legal ownership of the assets of a trust are held by the person who is the trustee of the trust at any particular time. A change in trustees will not be a disposal of the assets of the trust.

§ 404. Cost of an asset

This Regulation provides for rules to assist determining the cost of an asset for the purposes of the Act. The Regulation supports the operation of the Act and is relevant mainly in calculating the gain or loss arising on disposal of a capital asset.

A gain on disposal of a capital asset is calculated as the consideration for the disposal less the net book value of the asset at the time of disposal (section 1444) loss on disposal of a capital asset is calculated as the net book value of the asset at the time of disposal less the consideration for the disposal (section 1434). The cost of a capital asset is the starting point in computing the net book value of an asset at the time of disposal (section 1441).

Sub-regulation (a) provides that the cost of an intangible asset is not reduced by adjustments made in the taxpayer's financial records as a result of the fair market value being less than the cost of the asset.

The acquisition of an asset by a person may result in the inclusion of an amount in the gross revenue of the person. Paragraph (b)(1) treats the amount included in assessable income 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.

Paragraph (b)(2) 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 payment made for the asset. This prevents the exemption being recaptured on a subsequent disposal of the asset.

§ 405. Cost when an asset has been damaged.

Regulation 405(a) provides that the cost of an asset that has been damaged is reduced by any amount received under an insurance policy, indemnity, or other agreement, settlement of a lawsuit, or under a judicial decision.

This ensures that a person might argue that the amount was received because of the insurance policy, judicial decision, or settlement, and not the reduction in the value of the asset. Sub-regulation (a) looks through the intermediate stage and treats the amounts as received in consequence of the reduction in the value of the asset that gave rise to a right to payment under the insurance policy, judicial decision, or settlement.

Sub-regulation (b) applies if the taxpayer receives compensation (as described in Sub-paragraph (a)) that exceeds the cost of the damaged asset. In this case:

(1) the owner of the damaged asset is treated as having made a gain equal to the amount of the excess at the time that the amount is received;

(2) the gain has the same tax treatment under the Act as a gain on disposal of the damaged asset; and

(3) the cost of the damaged asset is set at zero.

§ 406. Cost of split assets

Regulation 406 applies when a taxpayer disposes of part of an asset. The Regulation has the effect of apportioning the original cost of the undivided asset between the divided parts.

Sub-regulation (a) provides that the cost allocated to the disposed part of the asset is calculated according to the following formula:

$$\mathbf{A \times {}^{B}/_{(B + C)}}$$

Component **A** of the formula is the cost of the original asset. Component **B** of the formula is the consideration for the part of the disposed part of the asset. Component **C** is the open market value of the retained part of the asset.

Sub-regulation (b) provides that the retained part of the asset is treated as a separate asset with a cost equal to the balance of the cost remaining after taking account of the cost allocated under Sub-regulation (a) to the disposed part of the asset.

Sub-regulation (c) provides that if the asset to which Sub-regulation (a) applies is a depreciable asset, the reference to the cost of the asset in component A of the formula is a reference to the net book value of the asset at the time of disposal. This ensures that cost of the asset is reduced appropriately by depreciation over the period the asset was held.

§ 407. Cost of merged assets

Regulation 407 applies if a taxpayer merges two or more assets (called "original assets) into a single asset (called the "merged asset"). Broadly, if a person merges two or more assets, the person is treated as having stopped holding the original assets and started holding the merged asset

Paragraph (a) provides that:

(1) the original assets are treated as having been disposed of at the time of the merger of the assets;

(2) no gain or loss is recognized in respect of the disposal of the original assets referred to in Paragraph (1);

(3) the taxpayer is treated as having acquired the merged asset at the time of the merger of the assets; and

(4) the cost of the merged asset is the total of the following amounts:

(A) the cost of the original assets at the time of the merger of the assets; and

(B) the costs incurred by the taxpayer in merging the original assets into the merged asset.

Paragraph (b) provides that where an original asset under Sub-regulation (a) is a depreciable asset, the reference to "cost" in Sub-regulation (a)(4) is a reference to the net book value of the asset at the time of the merger of the assets.

Sub-regulation (b) provides that if the asset to which Sub-regulation (a) applies is a depreciable asset, the reference to the "cost" of the asset in Sub-regulation (a)(4) is a reference to the net book value of the asset at the time the assets were merged.

§ 408. Cost of land and an improvement to land

Regulation 408 provides that buildings and other improvements on land must be treated as a separate asset if the buildings or other improvements are depreciable assets within the meaning of Sub-section 1002(jj) of the Act.

In such cases, Sub-regulation (b) provides that if the building or other improvement and the land are acquired for a single consideration, the consideration is apportioned between:

(1) the cost of the asset that is the building or other improvement, and

(2) the cost of the asset that is the land.

Sub-Regulation (c) requires the apportionment under Sub-regulation (b) must be done at the time of acquisition of the real property and according to generally accepted valuation principles for land.

§ 409. Consideration for an asset

This Regulation sets out the rules for determining the consideration for the disposal of an asset. The Regulation is relevant mainly in computing the gain or loss arising on disposal of an asset. A gain on disposal of a capital asset is calculated as the consideration for the disposal less the net book value of the asset at the time of disposal (section 1432). A loss on disposal of a capital asset is calculated as the net book value of the asset at the time of disposal less the consideration for the disposal (section 1434).

Sub-paragraph (a) provides that if two or more assets are disposed of by a taxpayer in a single transaction and the consideration for each asset is not separately specified, the total consideration is apportioned among the assets disposed of in proportion to their respective fair market values determined at the time of the disposal.

Sub-paragraph (a) provides that if a deposit is paid to the owner of an asset, and that deposit is wholly or partly deposited (because the proposed sale (or any other type of disposal of the asset) did not go ahead – the following will apply:

(1) the owner of the asset is treated as having made a gain equal to the amount of the forfeited deposit at the time that the deposit is forfeited; and

(2) the gain has the same tax treatment under the Act as a gain on disposal of the asset to which the deposit relates.

In such cases, if the owner of the asset was proposing to sell a capital asset of his business, for example the office car, a gain on the disposal of the car would be included in the owners gross revenue for BPT purposes. Accordingly, the amount of the forfeited deposited would be included in the owners gross revenue.

Sub-regulation (c) provides that if a taxpayer cannot provide documentary evidence of the consideration for the disposal of an asset by the taxpayer, the consideration is the fair market value (Section 1005) of the asset at the time of the disposal.

§ 410. Grant and exercise of an option

Regulation 410 provides that the consideration for the disposal of an asset by a person includes the consideration for the grant of an option in relation to the asset by the person. An option over an asset is itself an 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).

This Regulation applies if a taxpayer ("grantor") grants an option to another person ("grantee").

Grantor

In such cases, Sub-regulation (b) provides that the grantor will be treated as follows:

(1) the grantor is treated as having disposed of the option to the grantee at the time that the option is granted;

(2) the cost for the grantor for the option is limited to any non-deductible incidental costs incurred by the grantor in granting the option; and

(3) the consideration for the option is the amount received by the grantor for the option.

Grantee

Sub-regulation (c) provides that the following applies to the grantee on the grant of an option:

(1) the grantee is treated has having acquired the option at the time that the option is granted; and

(2) the cost for the grantee for the option is the consideration given for the option and any non-deductible incidental costs incurred by the grantee in relation to the grant of the option.

Exercise of option by Grantee

Sub-regulation (d) provides that when a grantee exercises an option:

(1) the grantor's consideration for the asset transferred by the grantor on exercise of the option does not include the consideration given for the option (provided the grantor has been subject to business profits tax on any income or gain made in respect of the grant of the option); and

(2) the cost for the grantee for the asset transferred on exercise of the option includes the amount specified in Sub-regulation (c)(2), which is the consideration given for the option and any non-deductible incidental costs incurred by the grantee in relation to the grant of the option.

(e) If an option expires without being exercised by the grantee, the grantee makes a loss equal to the amount specified in Sub-regulation (c)(2), which is the consideration given for the option and any non-deductible incidental costs incurred by the grantee in relation to the grant of the option.

Example

John grants Jane an option to acquire commercial premises owned by John that has a net book value of $2,000,000. The exercise price under the option is $5,000,000 and the price paid for the option is $2,50,000. Jane subsequently exercises the option. The commercial premises and option are capital assets of John.

John has made two gains:

(1) A gain of $250,000 on grant of the option. The consideration received is $250,000 and there is zero cost.

(2) A gain of $3,000,000 on disposal of the land. The consideration received is 5,000,000 and net book value is $2,000,000.

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 business.

§ 411. Disposal of asset to an associate

Subject to Subpart A of Part V (which is discussed below), if a taxpayer (referred to as the "transferor") disposes of an asset to an associate (referred to as the "transferee") Regulation 411 provides that:

(1) the transferor is treated as having disposed of the asset for consideration equal to the fair market value of the asset at the time of the disposal; and

(2) the transferee is treated as having acquired the asset for consideration equal to the amount determined under Paragraph (1), which is the consideration equal to the fair market value of the asset at the time of the disposal.

(3) This Regulation is intended to ensure that tax is appropriately paid when assets transferred between associates by ensuring that fair market value of the asset is used to value the asset being transferred. This Regulation is needed to minimise the risk of associates manipulating the stated price of an asset to minimise tax.

PART V
International Tax Avoidance

Subpart A
Transfer Pricing

§ 501. Application of arm's length principle

This Subpart, (Subpart A) of these Regulations provide for the effective application of transfer pricing rules.

The effect of these Regulations is that a person who enters into a transfer pricing arrangement (as defined in Paragraph 103(15) of these regulations, must ensure that income, expenditures, gains and losses are worked out on arm's length principles.

The income, expenditures, gains, or losses arising from the transfer pricing arrangement must be consistent with those reasonably expected to arise under conditions (arm's length conditions) that apply in a comparable transaction between persons who are not associates dealing wholly independently with each other.

Sub-regulation (b) sets out what must be taken into account when examining the arm's length conditions.

Sub-regulation (c) provides that the circumstances will be comparable (for the purposes of Sub-regulation (a), if they are the same as the actual conditions of the transfer pricing arrangement, or, if there are differences, they are not material or adjustments can be made to eliminate material differences.

Sub-paragraph (d) provides that if a taxpayer does not determine the income, expenditures, gains, and losses arising under a transfer pricing arrangement in accordance with the arm's length principle, the Director may make such adjustments as necessary to ensure that the income, expenditures, gains, and losses arising under the arrangement are in accordance with the arm's length principle.

These Regulations must be applied consistently with international transfer pricing standards as well. If there is any inconsistency between the Act and Regulations and those international standards, the Act and the Regulations will prevail.

The Director may publish guidelines on the application of the arm's length principle to provide information on particular transactions.

Non-resident persons, in particular, may use transfer pricing as a means of reducing amounts derived from sources in Palau. For example, a non-resident parent company may supply goods or services to a Palau subsidiary for a price that is greater than the arm's length price so as to reduce the net income (and, therefore, Palau tax liability) of the subsidiary. Similarly, a foreign head office of a non-resident company may deal with a Palau permanent establishment of the company in such a way as to reduce the non-resident's net income in Palau. For this reason, Regulation 501 provides for transfer pricing adjustments to be made to ensure proper application of the arm's length principles.

§ 502. Transfer pricing methods

The "arm's length" conditions referred to in Regulation 501 are those that might notionally be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.

A taxpayer who has entered a transfer pricing arrangement must determine income, expenditures, gains and losses under the arrangement and they must be determined in accordance with the arms' length principle using the appropriate and reliable transfer pricing method(s) in the circumstances. Sub-regulation (a) requires that the transfer pricing method(s) used should be the most appropriate and reliable in the circumstances.

Sub-regulation (a) also sets out the things to have regard to when working out which transfer pricing method or methods should be used (paragraphs (1) to (4)).

The internationally accepted arm's length methodologies are based on the concept of comparability — comparing the prices/margins achieved by associated enterprises in their dealings with each other to those achieved by independent enterprises for the same or similar dealings.

Sub-regulation (c) lists the accepted methodologies:

- the comparable uncontrolled price (CUP) method
- the resale price method
- the cost plus method
- the profit split method, and
- the transactional net margin method.

Sub-regulation (d) allows a taxpayer to use a transfer pricing method that is not listed in Sub-regulation (c) if none of the listed methods can reasonably applied and the method used by the taxpayer is consistent with what the outcome would be if the arrangement entered was between independent persons dealing at arm's length.

Sub-regulation (e) explains the meaning of terms used in Paragraph 501(c).

§ 503. Transfer pricing documentation

Regulation 503 sets out the documents that must be kept in respect of transfer pricing arrangements. These documents are in addition the normal records that need to be kept and maintained. The records should demonstrate matters such as the arm's length conditions, the actual conditions, the comparable circumstances, the particulars of the method used and its effect in the particular circumstances.

Sub-regulation (b) provides that the records must be prepared by the due date for filing the taxpayer's business profit's return for the year.

Sub-regulation (c) provides that the Director may provide for simplified transfer documentation for any of the following:

(1) distributors;
(2) persons with low levels of cross-border transactions;
(3) small and medium enterprises;
(4) low value intra-group services;
(5) loans; and
(6) technical services.

Sub-regulation (d) makes it clear that the simplified transfer pricing documentation requirements under Sub-regulation (c) must not apply to royalties, license fees, research and development arrangements, and other intangibles. Full documentation, consistent with international standards must be kept for these items.

Sub-regulation (e) imposes a penalty on taxpayers who fail to keep documentation as required under this Regulation. The maximum penalty is equal to [$50,000].
and• explain the particular way in which the transfer pricing provision applies (or does not apply), and why the application of the provisions in that way achieves consistency with the relevant OECD guidelines and regulations.

<u>Subpart B</u>
Other International Tax Avoidance Rules

§ 504. Thin capitalization

The thin capitalisation ("thin cap") rules in Regulation 504 are intended to prevent multinational enterprises shifting profits out of Palau by funding their Palauan operations with high levels of debt and relatively little equity in order to reduce their Palauan net income (and tax payable thereon).

The thin cap rules achieve their purpose by limiting deductions for interest expense and borrowing costs (“debt deductions”) where debt-to-equity gearing ratios exceed prescribed debt limits.

Sub-regulation (a) provides that the thin capitalization rules will apply to foreign controlled resident companies other than financial institutions. A resident company will be foreign controlled if 50% of the membership interests are held directly or indirectly with an associate or associates.

If the foreign controlled resident company has a debt to average equity ratio of more than 2 to 1 for a tax year a deduction is denied for the interest paid by the company in accordance with the formula set out in Sub-paragraph (b).

Sub-regulation (c) outlines how the thin capitalisation rules will apply to a non-resident company with a permanent establishment in Palau.

Sub-regulation (d) sets out the calculation of the average debt of a foreign controlled resident company.

Sub-regulation (e) sets out the calculation of the average equity of a foreign controlled entity.

§ 505. Recharged technical fees and royalties

Non-resident is payable the gross amount of interest, a royalty, technical fee, or insurance premium derived from sources in the Republic in accordance with Section 1422 of the Act. For the purposes of non-resident tax, a royalty includes payments for the lease of commercial equipment (see Section 1412).

This Regulation is intended to prevent associates from avoiding withholding tax by Sub-regulation (a) specifies that the recharge rules in this regulation will apply if the following applies:

(1) A non-resident of Palau (the supplier) supplies technical services or leases equipment to either a resident of Palau carrying business in Palau, or a non-resident of Palau carrying on business in Palau through a permanent establishment (the recipient); and

(2) Instead of making the payment directly to the supplier, the payment to the supplier is made by a non-resident associate of the recipient and the technical fee or royalty is re-charged to the recipient by the associate.

When the regulation applies, Subparagraph (b) will apply the tax law as if the non-resident associate is supplying the technical services or leased equipment to the recipient and the recharged amount is the technical fee for the services or royalty for the leased equipment, as the case may be.

Part VI
Administration of Business Profits Tax

§ 601. Installments of business profits tax

Sub-regulation (a) provides that the due date for payment of instalments of Business Profit Tax for a tax year (for the purposes of section 1464 of the Act) are by the 15th day of the month following the end of the 3rd, 6th, 9th, and 12th months of the year

An individual's tax year will end on 31 December. Accordingly, the instalments are due on the 15th day of April, July, October and January.

The due date for entities such as companies will depend on the particular entity's tax year.

If a company's tax year ends on June 30, instalments will be due on the 15th of October, February, June, and October.

Sub-paragraph (b) provides that the amount of each installment is 25% of the taxpayer's assessed business profits tax liability for the preceding year, after taking into account any foreign tax credit allowed for that person that year.

The above calculation is subject to the operation of Sub-regulation (c) and (d).

Sub-regulation (d) sets the instalment rate as 2% of the persons total gross revenue for the previous year, if they had not business tax liability that year.

Sub-regulation (d) allows a taxpayer to request a variation on the instalment payable.

The taxpayer may make an application (in the approved form) if they have reasonable grounds to believe that:

(1) the business profits tax payable by the taxpayer for the current tax year will be less than that payable for the previous tax year (in this case, an application must include an estimate of the taxpayer's business profits tax liability for the current year.; or

(2) the taxpayer will have a nil business profits tax liability or a net loss for the current tax year.

If approved, by the Director, the varied instalment becomes the amount required to be paid each quarter.

Sub-regulation (g) makes it clear that each instalment paid by a taxpayer is a tax credit against the business profits tax liability of the taxpayer.

Any excess credit is to be refunded to the taxpayer within 30 days after the taxpayer files their business profits tax return for the year.

§ 602. Penalty for under-estimating installments of business profits tax

Regulation 602 provides for a penalty to be applied if all of the following conditions are satisfied:

(1) A taxpayer has applied for a variation of their business profits tax instalments in accordance with Regulation 601(d) or a tax year; and
(2) The Director has agreed to the variation based on the taxpayer's estimate of their business profits liability; and
(3) The actual business profits tax payable for the year exceeds the total instalments paid by the taxpayer by more than 20% (this is called the "tax shortfall").

If all of the above conditions are satisfied, the taxpayer is liable for a penalty equal to 10% of the tax shortfall.

Part VII
Transitional Rules

§ 701. Transitional Rules

Sub-regulation (a) applies when a person acquired a depreciable asset or business intangible before the commencement date of the Act and uses the asset or intangible to derive gross revenue on or after that date. "Commencement date" is defined in Paragraph 103(3) of the Regulations to mean January 1, 2023. In this case, the person must depreciate the asset or intangible after the application date on the assumption that the Act applied from the acquisition date of the asset. This means that a person conducting business at the application date must determine the net book value of their depreciable assets and business intangibles as at 31 December2022 on the assumption that the depreciation provisions in the Act have applied from the acquisition of the asset or intangible. The person then depreciates the asset under Regulation 202 based on the net book value and remaining useful life of the asset at the application date.

Sub-regulation (b) applies when a depreciable asset referred to in Sub-regulation (a) is disposed of after 1 January 20123. Sub-regulation (b) provides that the proportion of any gain or loss on disposal that relates to the use of the asset or intangible to derive assessable business income after 1 January 2023 is subject to tax.

Sub-regulation (c) provides set out how depreciable assets of financial institutions. A depreciable asset of a financial institution subject to tax under repealed Section 1203 of Title 40 acquired before January 1, 2023 continues to be depreciated under the depreciation rules applicable for the purposes of the repealed Section 1203 of Title 40. If a depreciable asset to which this Sub-regulation applies is disposed of after the commencement date, the Act applies on the basis that depreciation deductions allowed for the purposes of repealed 1203 of Title 40 are depreciation deductions under the Act.

Sub- regulation (d) sets the cost of a business asset, other than a depreciable asset, acquired by a taxpayer before the commencement date as:

(1) at the election of the taxpayer, the cost of the asset; or

(2) where Paragraph (1) does not apply, the fair market value of the asset at the commencement date.

Sub-regulation (e) provides that for a financial institution subject to tax on net income under the repealed Section 1203 of Title 40, a reference in Section 1432(b) of the Act to a previously deducted expenditure, loss, or bad debt includes a reference to expenditure, loss, or bad debt deducted in calculating net income for the purposes of the repealed Section 1432(b) of the Act.

(For the purposes of the Act, if the tax year of a company commences on a date other than the commencement date, the period from the commencement date to the start of the first full tax year under the Act is treated as a separate tax year.

Sub-regulation (f) provides that the accounting year of a company commences on a date other than January 1, 2023, then the period from January 1, 2023 to the start of the first full accounting year under the Act is treated as a separate accounting year.

For example, if a company's accounting year is July 1 to June 30, the period 1 January 2023 to June 30, 2023, is a separate accounting year. Consequently, the company is required to report its net income and pay tax for this period.

Sub-regulation (g) provides that if Sub-regulation (f) treats the first tax year of a company under the Act is a separate tax year, the amount of an installment of business profits tax payable by the company under Regulation 601 for an installment period in that separate tax year is 2% of the company's total gross revenue for the installment period.

Example

X Co uses the period July 1 to June 30 as its financial accounting period. This is also its tax year under the Act. The effect of sub-regulation (f) is that the period January 1, 2023 to June 30, 2023 is a separate tax year. X Co's first full accounting year (and, therefore, tax year) under the Act is the period July 1, 2023 to June, 30, 2024 The effect of Sub-regulation (f) is that, for the periods January 1, 2023 to June 30, 2024 instalments of tax are based on 2% of turnover during the relevant instalment period.

Regulation 601 allows a person to vary the amount of the instalments payable. This will be particularly relevant if the person believes that they will have a zero business profit tax liability (or a net loss) for their first accounting year under the Act.