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Commentary on Proposed Changes in the New Income Tax Act

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Contents

Salary & Wages Tax 3

Filing date 3
Salary packaging arrangements 3
Taxable values of employer-provided benefits 3
Exempt benefits and their limitations 4
Employee share scheme benefits 5
Independent contractors 5

Business income 6

Depreciation of depreciable assets 6
Foreign currency exchange gains or losses 6
Finance leases 6
Thin capitalisation 6
Cross border management fees 7
Long term contracts 7
Amalgamations/corporate reorganisations 7
Resident withholding tax 7

International tax 8

A reworked definition of a "permanent establishment" 8
Non-resident withholding tax 8
Foreign contractors 9
Foreign losses 9
Foreign tax credits 9
Tax treaties 9
Use of tax havens 10
International transportation tax 10
Foreign employment income 10

Sector specific 11

Insurance 11
Extractives industry 11
Fishing 11
Aviation and shipping 11
Superannuation industry 11
Technical assistance to the PNG Government 12
Trusts 12
Exemptions 12
Savings and loans societies 12

Capital gains tax 13

Appendix I 14

Appendix II 15

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Key Changes introduced by the New Income Tax Act

The re-write of the Income Tax Act by Treasury has been the subject of a consultation process that commenced in early 2020. Parliament did not pass the legislation with the 2023 Budget as expected and so our commentary is based on the ninth draft of the proposed New Income Tax Act.

As this commentary is not based on the final legislation, it should be used as a guide only. The new legislation may be effective from 1 January 2024 although this is not yet certain. Transition provisions and new Regulations are to be drafted and are not yet available. We have highlighted a number of key changes to be introduced by the new legislation below.

Salary & Wages Tax

Filing date

A welcome change will be the extension of the filing deadline from the 7th to the 15th of the following month.

Salary Packaging Arrangements

The new Act legislates the 60:40 rule which is currently applied as a rule of thumb by IRC for salary packaging arrangements. Under the new legislation the value of the prescribed benefits, being benefits prescribed in Regulations for the purpose of salary packaging, may not exceed 40% of the total salary or wages of the employee (excluding the salary packaged amount).

Taxable values of employer-provided benefits

The value of a non-cash benefit is included in the employment income of an employee for the fortnight in which the benefit is provided to the employee. To determine that value, non-monetary benefits provided by an employer are classified into six specific classes and an additional residual class for any other benefits that do not fit in the previous six. All benefits are taxable in an employee's hands but the value of the benefit differs according to the class of benefit derived. Technically all of these benefits are taxable under the current legislation but at different rates in some cases.

1. *Debt waiver benefit*

Where an employer waives a debt payable by an employee, the full value of the debt waived is taxable in the employee’s hands.

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2. *Housing benefit*

The value of employer provided housing is taxable in the employee's hands but only according to the amount prescribed by the Regulations. These Regulations are yet to be released by Treasury and may be higher than the current thresholds.

3. *Discounted interest loan benefit*

The value of an employer provided discounted interest loan is the difference between the amount that would be paid as interest if the loan agreement was entered into using the market interest rate and the amount of interest that is payable using the discounted rate.

4. *Motor vehicle benefit*

Where a motor vehicle (including maintenance and running expenses) is provided by an employer to an employee wholly or partly for the private use of the employee, the fortnightly value of the benefit is either:

- 10% of the cost of acquiring the motor vehicle divided by 26; or
- Where the motor vehicle is leased, 10% of the fair market value of the lease divided by 26;

Less:

- any payment made by the employee for the use of the motor vehicle or for maintenance and running expenses; and
- the proportion of the use of the vehicle by the employee in the conduct of employment; and
- the proportion of the fortnight that the vehicle was not provided to the employee for private use.

5. *Discounted goods or services benefit*

The value of goods and services transferred from or provided by an employer to an employee is taxable at the value of 75% of the selling price if the goods or services are ordinarily supplied to the employer's customers. In any other case, the value is the cost to the employer of acquiring the goods expenditure incurred by the employer in providing the service.

6. *Private expenditure benefit*

Where an employer incurs expenditure that gives rise to a private benefit to an employee, the value of that benefit is the amount of the expenditure incurred.

7. *Residual benefit*

A non-cash benefit provided by an employer to an employee that is not specifically covered is classified as a residual benefit. The value of a residual benefit is the fair market value of the benefit determined at the time it is provided, as reduced by any payment made by the employee to the employer for the benefit.

Exempt benefits and their limitations

Meals

The value of a meal or refreshment provided in a canteen, cafeteria, or dining room operated by, or on behalf of, the employer solely for the benefit of employees and that is available to all non-casual employees on equal terms is exempt.

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Leave fares

One leave fare per annum will continue to be exempt where provided to the employee and their dependents with additional leave fares available where certain conditions are met. Reimbursements are permitted.

Medical insurance premiums

The value of medical insurance premiums of the employee, but only if this benefit is available to all non-casual employees on equal terms.

School fees

The value of the annual fees payable to a school, college, or approved tertiary institution for the purposes of educating a student child of the employee, but only if this benefit is available to all non-casual employees on equal terms. Given the unlikely possibility that employers would be able to afford to offer school fees to all employees this is likely to reduce the availability of the exemption.

First home buyers' schemes

A subsidy provided by an employer to an employee, who is a citizen of PNG, towards the capital cost of purchasing a residential dwelling under a first home buyers scheme approved by the Commissioner General.

Employee share scheme benefits

Specific rules on the taxation of employee share schemes have been introduced to reduce much of the complexity associated with applying case law to this area of employment compensation. The new Act provides a set of rules for taxing the value of shares and share options issued to employees as part of their remuneration package. The new rules address the perennial issues of characterisation, derivation and valuation.

The value of a right or option to acquire shares granted to an employee under an employee share scheme is not included in the employment income or assessable income. However, an *actual* allotment of shares, including an allotment pursuant to the exercise of a right or option, is included in the employment income of an employee. The time of derivation is deemed to be the tax year during which the employee was allotted shares under the employee share scheme unless the employee is restricted from realising the value of the shares until some later date, if so the earlier of that later date or the date of disposal is the time of derivation. The value of the shares in the hands of the employee is the fair market value at the time of derivation less any cost of the shares to the employee.

Independent contractors

As is currently the case, independent contractors will continue to generally be regarded as employees subject to salary and wages tax.

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Business income

The central elements of corporate income tax remain unchanged. The general intention is still to tax a company's annual net *gain*. The core formula for calculating taxable income by finding the difference between assessable income and any allowable deductions for a taxpayer for a tax year remains. With a few exceptions, the general scope of receipts classified as assessable income and the expenses and losses classified as allowable deductions will be unchanged for most taxpayers. However, there are a few notable changes in the new legislation:

Depreciation of depreciable assets

Under the new Act, taxpayers are allowed to deduct a portion of the cost of a depreciable asset to the extent that it is used to derive income over time. The Act provides for five classes of depreciable asset, each with a prescribed rate, and will only permit two methods of depreciation: the straight-line method and the diminishing value method. The straight-line method applies by default to all classes of depreciable asset but a taxpayer can make an irrevocable election to use the diminishing value method in respect of class 1, 2 and 3 assets on a pooling basis. No tax depreciation can be deducted in respect of the construction of a building until that building is certified as complete.

Depreciation will be calculated under the straight-line method by applying the prescribed depreciation rate applicable to the class of depreciable asset in question against the cost of that asset. Of course, the total deductions allowed in respect of a depreciable asset must not exceed the cost of the asset. We have reproduced in Appendix II the proposed depreciation rate table included in the draft Act.

Foreign currency exchange gains or losses

The new Act proposes to match the exchange gains derived by a resident person against the exchange losses incurred by that resident person during the tax year. The net foreign currency exchange gain or loss is included in the business income or allowed as a deduction for the tax year as the case may be. This treatment is allowed in so far as the gains or losses attributable to the foreign currency transaction are not capital in nature and are realised.

Finance leases

The income tax consequences arising from finance leases will now follow the economic substance of such a transaction. Where a lease is characterised as a finance lease, the tax law will deem the lessee to have purchased the leased asset at the time of the lease and claim the tax depreciation.

Thin capitalisation

In general, when a foreign controlled resident company (i.e. 50% or more non-resident owned) is thinly capitalised, meaning it has a debt equity ratio in excess of 2:1 during a tax year, that company's interest deductions will be limited according to a specified formula. However, this general position is subject to certain exceptions and does not apply to foreign controlled financial institutions. The new Act expands the restriction to also apply to domestic interest and interest such as finance lease

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interest. It does not apply where the lender is tax resident in a Double Tax Treaty country with a non-discrimination clause.

Cross border management fees

In line with the OECD approach, the concept of a management fee is now subsumed within the overarching definition of a technical fee. During the consultation process draft versions of the legislation had proposed a restriction on management fees paid to associates in Double Tax Treaty countries even if they were arm's length in nature. However, the final legislation only restricts the management fee deduction if the technical fee is paid to a non-resident and is not arm's length in nature.

If the restriction applies, technical fees paid by residents or permanent establishments of PNG to non-resident associates are subject to a deduction limitation of 2% of the total assessable income derived by the payer during the tax year; or 2% of the total allowable deductions (ignoring the deduction for technical fees) allowed to the payer for the tax year.

Long term contracts

Under the new Act long term contracts must be included in assessable income for each tax year of the contract in accordance with the percentage of completion method under financial reporting standards.

Amalgamations/corporate reorganisations

The new Act introduces a section which deals with corporate reorganisations. Under the section, where the parties elect, no gain or loss is deemed to arise on the disposal of the asset for the transferor of the assets and the transferee is deemed to have acquired the assets in line with the values prescribed by that section of the Act. The new legislation is not as comprehensive as the existing legislation.

Resident withholding tax

The rates of resident withholding tax rates are unchanged in many cases:

- for interest - 15%
- for a dividend paid by a non-profit body/ a former non-profit out of income that is exempt income - 30%
- for dividends paid to individuals, partnerships and trusts - 15%
- prescribed royalties to customary landowners for certain resource projects, timber or fishing projects – 5%
- business income payments tax – 10%

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International tax

A reworked definition of a "permanent establishment"

The new domestic definition of a permanent establishment may classify a wider scope of activities as giving rise to a permanent establishment than the definition in the OECD Model, the UN Model and most of PNG's current tax treaties because the domestic definition does not incorporate any exclusionary paragraphs for preparatory or auxiliary activities. The implications of these changes will be felt by non-residents of non-treaty countries who will not be able to avail of the exclusionary provisions that are generally available to residents of countries within PNG's tax treaty network.

Of note, as it will have implications for cross border transactions including transfer pricing, the permanent establishment will generally be treated as a separate and distinct person (being an associate) from the offshore headquarters.

Non-resident withholding tax

Under the new Act the non-resident tax reorganises the various disparate rules on the taxation of PNG source dividends, interest, royalties, annuities, insurance premiums, natural resource amounts, management or technical fees and entertainment fees derived by non-residents. Under the current act, these receipts are taxed each according to separate liability rules and withholding and remittance procedures notwithstanding the fact that the policy aim, to tax non-residents on PNG source income, is broadly the same. In place of these separate rules, the new Act will introduce a uniform procedure for determining liability and withholding and remitting tax. The process of characterising a payment as a dividend or interest etc will only be necessary to determine the rate payable. The rates of non-resident withholding tax rates are unchanged in many cases:

- for an insurance premium - 3%
- for an amount paid to a non-resident entertainer or group of entertainers - 10%
- for a royalty;
  - paid to an associate - 30%
  - any other royalty - 10%
- for interest, a technical fee, annuity, or natural resource amount (being a royalty relating to natural resources) - 15%
- for a dividend paid by a non-profit body/ a former non-profit out of income that is exempt income - 30%
- for any other dividend or the repatriated profits of a PNG permanent establishment of a non-resident person - 15%

The big change above is that the current 17% management fee withholding tax is to be replaced with a 15% technical fee withholding tax. Under the new Act the definition of technical fees has been amended to include administrative, management, technical, professional and consultancy services. This leaves in no doubt the broad reach of this withholding tax.

The Act has also broadened the definition of royalty to include payment for the use of substantial equipment by providing that any consideration paid for the use of or the right to use any industrial, commercial, or scientific equipment qualifies as a royalty.

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Currently foreign contractors (essentially non-residents providing services in PNG) are subject to a 15% foreign contractor withholding tax based on gross revenue (unless a relief applies under a Double Tax Treaty).

Under the new Act, the foreign contractor provisions are repealed. If their activities are conducted through a permanent establishment in PNG, then they will instead be required to lodge an income tax return in PNG and will be subject to income tax at the rate of 30% on net taxable profits arising from PNG source income attributable to that permanent establishment.

In addition non-residents with a permanent establishment in PNG will be liable for an additional tax on repatriated profits. This is to ensure that the repatriated profits of a permanent establishment of a non-resident are taxed in approximately the same way as dividends paid by a domestically incorporated subsidiary of a non-resident. The amount of the repatriated profit is calculated according to a prescribed formula which is calculated as the function of a movement in net profits and net assets.

Therefore the effective rate of tax a foreign company with a permanent establishment in PNG will pay will be up to c. 40.5% (being 30% on the net taxable income attributable to the PNG permanent establishment and up to c.15% of the repatriated profit).

Foreign losses

The new Act provides for the ring-fencing of foreign tax losses into separate pools for foreign business income and foreign property income. Tax losses may only be carried forward for seven years.

Foreign tax credits

Taxpayers will continue to be able to claim a foreign tax credit (subject to the lower of the foreign tax or the PNG tax on that income) in respect of foreign income subject to tax in PNG however, ringfencing will apply. The new Act calculates the foreign tax credit separately for assessable foreign business income (e.g. income derived from business activities, dividends and interest derived from the investment of the capital of the business etc) and foreign property income (e.g. other dividends, interest etc). To claim the credit the taxpayer must have evidence the foreign tax was paid and was paid within two years from the end of the tax year in which the foreign income was derived.

Tax treaties

Relief under a Double Tax Treaty may still be available under the new Act. However, in an effort to prevent treaty abuse, under the new Act the relief otherwise available under a Double Tax Treaty is not available where 50% or more of the underlying ownership or control of that entity is held by an individual(s) who is/are not residents of that country for Double Tax Treaty purposes. Exceptions apply where the shares of the company are traded on the stock exchange of that country or the company carries on an 'active business' through personnel and premises in the other state and the income is attributable to that business or the tax treaty includes a limitation of benefits article.

The definition of active business is problematic as the supervision/administration of a group entities would not be included as an active business – it would be common practice for a holding company to

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perform such activities for group companies in a region. Some company groups also have treasury operations servicing a number of group companies for a host of efficiency reasons.

This could have a wide-ranging impact for certain offshore leasing or holding companies currently availing of treaty reliefs and providing services into PNG. Groups may need to review their current structuring arrangements.

Use of tax havens

Where a PNG resident holds a 50% or more interest in a tax haven entity a portion of the property income derived by the tax haven entity will be attributed to the PNG resident. A tax haven is defined as a foreign country that has an effect rate of corporate tax below 15%; or either does not tax foreign income of residents or taxes foreign income of residents only if the income is remitted into the country; or has laws providing for the secrecy of financial or corporate information that facilitate the concealment of the identity of the beneficial owner of any income or asset.

International transportation tax

The international transportation tax is intended to tax income derived by a non-resident enterprise from the carriage by ship or aircraft of passengers, livestock, mail, goods or merchandise from PNG to an international port. For international carriers' resident in non-treaty countries, a tax at the rate of 2.4% is imposed on the gross amount derived by them for the carriage. The tax does not apply to the extent that a PNG port is used as a port of transit between two places outside of Papua New Guinea.

For international carriers' resident in treaty countries, the tax issues are slightly more complex and enable various tax planning opportunities. As the shipping and aviation articles in PNG's tax treaties vary significantly, non-resident carriers should seek professional advice on the tax consequences of doing business in PNG.

Foreign employment income

Resident individuals will be exempt from tax on foreign employment income, including a pension related to foreign employment, where the income is subject to tax in the country of employment.

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Sector specific

The new Income Tax Act has some new provisions specific to certain sectors of the economy. We have highlighted some of the issues that may be of interest to participants in certain specific sectors.

Insurance

A general insurance company may take a tax deduction for the balance of a company's provision for unexpired risks as at the end of a tax year, subject to the proper application of financial reporting standards.

Additionally, a life assurance company continues to be exempt from tax in respect of premiums received for policies of life assurance issued or consideration received for annuities granted. The new Act includes specific formulae to calculate the other assessable income of a life assurance company.

Extractives industry

The repealed legislation will continue to apply to those projects that are subject to a fiscal stability agreement, to the extent provided for by the applicable agreement. The broad framework of the old Act is maintained. Projects are still ring fenced, accelerated depreciation is still allowed for exploration and development expenditure and an additional profits tax is still imposed. However, the new Act should be reviewed in detail to gain a full understanding of its reach and implications.

Fishing

The income derived by non-residents carrying on fishing operations in PNG territorial waters and their non-resident employees is exempt where the State is entitled to receive payment in relation to those fishing operations in accordance with an international agreement. So too are any royalties paid by that non-resident for the charter of the fishing vessel if the international agreement provides for such charter.

Aviation and shipping

The income of a non-resident person operating a ship or airline in international traffic is exempt but only if an equivalent exemption from income tax is granted to PNG resident persons by the country in which the non-resident person is resident.

Superannuation industry

Contributions made by employers to approved superannuation funds will be allowable deductions insofar as they do not exceed 15% of the taxed employment income of the employee for the tax year. Approved superannuation funds will continue to pay income tax at the rate of 25%. Payouts by a fund to a member is exempt income in the member's hands to the extent that it represents a taxed contribution. Any other part of the payout is taxable at a rate between 2% and the individual's marginal tax rate depending on the specific circumstances of the payout.

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Subject to certain conditions, income derived by a person to the extent provided for under an agreement entered with the Government for the provision of financial, technical, humanitarian, or administrative assistance is exempt.

Trusts

The new Act legislates for a 'look through' approach. A beneficiary entitled to an amount derived by a trustee is treated as having derived that amount and is also treated as having incurred any expenditure or loss related to the derived amount. The beneficiary will be taxed at their marginal rate on that income.

A trustee is liable to pay income tax on the taxable trust income of a trust. The taxable income of a trust refers to the total assessable income of the trust reduced by any amount derived by the beneficiaries of the trust and any allowable deductions.

The new Act includes specific provision for Landowner Resource Trusts.

Exemptions

The categories of exempt income, which under the current Act were contained in various provisions throughout the legislation will (with a few exceptions) be consolidated in a single schedule for ease of reference. Historically there have been issues with exemptions being legislated in Acts other than the Income Tax. The legislature have attempted to consolidate these various exemptions within the new Act. Exempt income will not be included in a taxpayer's assessable income. Finally, there is an obligation on recipients of exempt income to maintain evidence of the exempt character.

Savings and loans societies

Savings and loans societies (mutual associations) will no longer be exempt from income tax. Amounts paid by mutual associations to their members for goods and services are included in the business income of those members.

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Capital gains tax

As anticipated, Capital Gains Tax will be introduced as part of the new Income Tax Act re-write.

Capital gains tax will commence on the date specified by the Treasurer by notice in the National Gazette.

It will only apply to PNG real property. As an anti-avoidance measure, it will also apply to interests in partnerships, trusts, or companies where more than 50% of the value of the interest is derived, directly or indirectly, from PNG real property; and to options or rights to acquire either of the two previously mentioned asset classes. Together these are described as "taxable assets".

Specifically excluded from the scope of the tax is:

- PNG real property to the extent that it is the principal place of residence of an individual; and,
- a taxable asset that is used by a person solely to derive exempt income; and,
- a gain derived or loss incurred on the first commercialisation of customary land.

A capital gain arises upon the disposal of a taxable asset where the consideration for the disposal of the asset exceeds the cost of the asset at the time of the disposal, and the capital gain is the amount of the excess. The tax is 15% of the gain, subject to any capital losses carried forward. Capital losses can be carried forward but not backward, even within the same year.

Unfortunately assets acquired prior to the commencement of capital gains tax will nevertheless be subject to the tax on disposal. However, for these assets vendors can elect either to use the cost of the asset or the fair value at the time capital gains tax commences.

Due to the central role of valuations in computing the tax, owners of PNG real property must maintain sufficient records to substantiate the acquisition and disposal of taxable assets and the records necessary to calculate any capital gains tax.

The vendor must lodge a capital gains tax return and pay the tax due within 21 days from the disposal of the asset.

Purchasers are required to deduct 10% of the consideration payable to non-resident vendors unless the vendor produces a notice from the IRC giving clearance to pay the gross. Transfer of title may not be registered unless a certificate is issued by the Commissioner General confirming tax is not due, the tax has been paid or there are arrangements in place to pay the tax.

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Appendix I

CFO / Head of Tax checklist

Leaders within finance and tax functions should consider the impact of the following proposed changes as a priority

	Detail	Checklist
1	**CGT is introduced** • The introduction of CGT implies that valuation of assets that are chargeable are critical going forward. It will be important to plan to get valuations for the value of such properties for when a decision is taking to dispose them off.	☐
2	**Cross border transactions** • With stringent provisions proposed with the view of curbing treaty shopping by multinational entities, a review of current structuring arrangements is advised in advance of its introduction.	☐
3	**Employee Benefits** • Consider the implication of school fees becoming taxable under the new Act and review options of further grossing up the amounts to compensate staff for this burden • Review impact of proposed provisions on employee share schemes and explore ways of aligning existing schemes to be more tax efficient	☐
4	**Management fees** • Be aware of the proposal of the new income tax act to subsume the concept of a management fee within the concept of a technical fee and its consequent impact on the withholding tax rate.	☐
5	**Finance leases** • Be aware of the new provisions relating to finance leases and assess its impact when entering a new lease transaction	☐

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Appendix II

Proposed Depreciation Rates

Class	Depreciable Asset	Straight-line Rate	Diminishing Value Rate
1	Motor vehicles; buses and minibuses with a seating capacity of less than 30 passengers; goods vehicles with a load capacity of less than 7 tonnes; computers and data handling equipment; software; and construction and earthmoving equipment	25%	40%
2	Buses with a seating capacity of 30 or more passengers; goods vehicles designed to carry or pull loads of 7 or more tonnes; specialised trucks; tractors; trailers and trailer-mounted containers; and plant and machinery used in manufacturing, mining, forestry, or farming operations	20%	30%
3	Vessels, barges, tugs, and similar water transportation equipment; aircraft; office furniture, fixtures, and equipment; and any depreciable asset not included in another	12.5%	20%

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	Category (other than a business intangible)		
4	Structural improvement	5%	-
5	Business intangibles	Rate determined under Clause (3)	-

- The rate of depreciation applicable to a depreciable asset that has a cost of less than K1,000 is 100%.
- The straight-line rates of depreciation applicable to business intangibles are -

(a) for preliminary expenditure, 25%;

(b) for a business intangible with a useful life of more than 10 years, other than a business intangible referred to in Paragraph (a) or (c) of this clause, 10%;

(c) for a long-term lease, is 100% divided by the term of the lease remaining at the date of acquisition; and

(d) for any other business intangible, 100% divided by the number of years in the useful life of the intangible.

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Zanie Theron

Advisory

Managing Partner

ztheron@kpmg.com.au

Ces Iewago

Advisory

Partner

ciewago@kpmg.com.au

Herbert Maguma

Audit & Assurance

Head of Audit Partner

hmaguma@kpmg.com.au

Karen McEntee

Business & Tax Advisory

Partner

kmcentee@kpmg.com.au

Pieter Steyn

Audit & Assurance

Partner

psteyn@kpmg.com.au

Charles Judd

Advisory

Principal Director

cjudd@kpmg.com.au

Wayne Osterberg

Advisory

Director

wosterberg@kpmg.com.au

Rachel Armstrong

Advisory

Director

rarmstrong@kpmg.com.au

Llewelin Gwekwete

Audit & Assurance

Director

lgwekwete@kpmg.com.au

Visit Us Today

KPMG PNG
Nambawan Plaza Lvl B2

OPH Precinct (OPH 2)
McGregor Street

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