LAW REFORM COMMISSION REPORT NO.12, NOVEMBER 1982, TRANSFER PRICING MANIPULATION.

By
B.D. BRUNTON

An observer of the Law Reform Commission over the past decade can detect a trend on the part of successive governments to give a low priority to law reform.

Perhaps the impotence of the State in the law reform field over the past few years is a sign of the times. 1982 was a depression year. Political leadership was more concerned with survival. Budget cuts, over-all reduction in the Public Service and government activities were the high priorities. On top of this the State faced serious social disorder - with tribal fighting in the rural areas - and continuous criminality in some of the larger towns. Within the Justice Department "Law and Order" issues demanded the most attention.

But even if these conditions had not existed there appears to be a lack of will amongst the senior Law Officers and the political leadership to sustain a regular programme of law reform.

Part of the problem lies in administrative and policy making ability. The Justice Department has a history of being a service department, rather than a policy-making institution. In the colonial days legal policy was made in Canberra and controlled either by the Australian Attorney General's Department or the Department of External Territories. Also the Justice function was one of the last powers to be handed over during the self-government process. The Australian presence, in Justice, was maintained in the form of Australians occupying senior positions within the Department.

Since Independence, the Justice Department has shown no sign of shaking off its colonial image and establishing itself as a truly national policy-making institution. This image is not entirely the fault of the Justice administration. The Department has had to deal with a series of cabinets ignorant and suspicious of the role of lawyers, and generally incapable of using lawyers within the framework of their broader development programmes. The Law Officers and senior advisers have also had to struggle with Ministers who were not trained lawyers, who have either been hostile to the idea of the rule of law as lawyers perceive it, or who have been unable to cope with the technical nature of the portfolio.

The hostility, indifference, inability to cope with lawyers and law, amongst politicians, can be attributed in part to the small number of qualified legal practitioners who enter parliament. But the very nature of politics in Papua New Guinea tends to relegate legal issues.

The essence of political life in this country has been its petit-bourgeois nature. Parliamentarians are generally small businessmen, small farmers, small investors or ex-bureaucrats. Their material interests are similar, concerned with commodity prices, agriculture, transport infrastructure and access to credit. Law, when it became part of their consciousness, takes the form of the "Law and Order" issue.

Perhaps these facts offer something of an explanation for the general political inertia of law reform. The placing of the Law Reform Commission's Twelfth Report on "Transfer Pricing Manipulation" in this context is both interesting and gloomy. It is gloomy for two reasons which are closely connected.

First, there is the heavy dependence of Papua New Guinea upon foreign investment to fund development. The form of this investment varies. Sometimes it is direct investment in which foreign companies bring in their own capital and expertise to fund a particular venture. Loan capital is another form. Foreign banks advance money to the State or to companies within the country.

Second, foreign investment creates within Papua New Guinea groups of people who survive because the investment has been made. Small traders, farmers, real estate speculators and public service managers develop a confluence of interest with the investors. Indeed all political parties advocate a form of development that is led by foreign investment. With this in mind, it is not surprising that the Law Reform Commission's proposals to control the ability of foreign investment to extract profit from their Papua New Guinea ventures have not been put into effect.

I WHAT IS TRANSFER PRICING?

Transfer pricing is an accounting phenomenon that involves the movement of value or profits from one country to another. Generally the value or profits are shifted by the manipulation of book-keeping entries, or through the fabrication of corporate structures and or accounting documents. Generally, but not always, a tax advantage is sought. Where taxation as a motive is involved, the strategy is to move profits from countries with high tax rates to countries with low tax rates, or no tax at all.

Under perfect conditions, value added in a high-tax country is not legally incurred in that country but, by means of dummy corporations, trusts, and accounting legerdermain, "materialises" in a

low or no-tax country and, in terms of the taxation laws of the country in which it was in fact produced, is incurred outside the jurisdiction. (Report: 9)

However taxation may not be the motive, or at least the sole motive for transfer pricing. Transfer pricing may occur for non-tax reasons or partly for taxation gains and partly to satisfy other objectives. Or transfer pricing may be motivated by a non-tax reason, but nevertheless result in a tax saving.

The Law Reform Commission noted in its Report -:

> "Non-tax factors probably play an equally important role in the motives for transfer pricing manipulations. For example, transnational corporations in Papua New Guinea may be anxious to maximise their returns on investment in the supply of capital equipment and in providing loans and technical management services. They may also wish their subsidiary to record a lower profit in Papua New Guinea to resist the introduction of price controls, or discourage potential local investors taking up their options to buy shares. On the other hand, funds may simply be required to finance investment in a subsidiary located elsewhere. Another possible motive is that the interest rates for the investment of surplus capital in Papua New Guinea may be considered too low. Anxiety about potential tightening up of exchange controls or a devaluation of the kina may provide further incentives to manipulate transfer prices. Transnational corporations may as a risk-minimisation strategy consider it preferable to remit their profits out of a developing country into related companies in developed counties." (Report: 10)

Transfer pricing is a phenomenon associated with transnational corporations. Subsidiaries of a transnational corporation, located in different countries, have used various methods to shift profits between their separate entities. Traditional methods have included the use of loans, interest rates, and cash advances against future sales; the performance of services such as managerial functions, research and development and, particularly relevant in Papua New Guinea, the provision of consultants; the use of tangible property - shipping, aircraft, or high technology equipment; the transfer or use of intangible property such as patents, trade-marks, trade-names, copyright under licencing arrangements; and the sale of tangible property - whether raw materials, partly assembled goods, or fully manufactured articles.

Transfer pricing does not always occur within the corporate structure of a single transnational corporation. It is possible for two or more independent entities to come together in an arrangement that is generally of mutual benefit.

For example in Europa Oil (NZ) Ltd. v. Inland Revenue Commissioner (NZ) (1970) IATR 161, an independent petroleum importer and distributor in New Zealand came to an arrangement with Gulf Oil, an international producer and refiner of petroleum products. The arrangement sought to avoid cartel pricing and to give Europa a discount, first on refined products and later, when Europa developed its own refining capacity, on imported crude oil. The discount was arranged in such a way as to create a tax advantage for Europa.

Federal Commissioner of Taxation v. Commonwealth Aluminium Corporation (1980) ATC 4371 involved a similar arrangement. A nominally Australian bauxite mining company, which was in fact a joint venture between two British and American transnational corporations, entered into an arrangement with two independent Japanese alumina smelters. The arrangement sought to give the Japanese purchasers a discount on the cartel-imposed price for the bauxite sold to the Australian mining company.

The **Europa Oil** and the **Commonwealth Aluminium** cases have features that should not go unnoticed in Papua New Guinea. They involved co-operation or arrangements between transnational corporations and local investment. In New Zealand, Europa Oil was a company owned by New Zealand nationals.

In Australia, the Commonwealth Aluminium Corporation, as the name suggested, was a company seeking to establish its "national" identity as Australian. It strenuously maintained its Australian status, despite its ultimate ownership by British and American interests. These cases point to the nature of the problem Papua New Guinea faces when attempting to control transfer pricing. They show a relationship between transnational corporations and foreign investment when it becomes almost completely subsumed in a national identity and within the national economy, and how national investment becomes linked and intertwined with transnational interests.

These relationships are part of the conduit by which foreign investment is able to profit within Papua New Guinea, and by which foreign investment secures its legitimacy and maintains its position of dominance.

Further, any real attempt to control the ability of foreign investment to move its profits out of Papua new Guinea is a threat not only to the fundamental interests of the foreign investors and their allies, but to State interests as well.

A survey of the economy, eight years after Independence shows only a slow movement towards economic independence. In the Year 1974-75 45% of government expenditure was met by internally raised taxes and charges whereas in 1981 internally raised revenue was estimated to constitute 56% of the total needed to meet expenditure. In terms of figures, in 1974-75 the Australian grant in

aid was K156 million, but in 1981 was estimated to be K184. International borrowing also increased over the period. Total borrowings in 1974-75 were K60 million, but in 1981 were estimated to be K115 million. Since 1975 there has been little advance in real terms in localising manpower, capital, or urban food supply. Foreign capital remains the most dominant source of investment.

If one takes the view that the subservient role played by developing countries is a result of the division of the world into spheres of influence, in which monopolies and finance capital hold ultimate power, then it is possible to account for conditions in this country.

The interests of foreign capital are represented, protected, and furthered, in Papua New Guinea through government and commercial institutions.

The major capital exporting countries, United States, Australia, France, Britain, Japan maintain their diplomatic representatives. Events such as the Danica affair,and the demise of the Pangu Pati proposals for a tough Leadership Code in 1980 show that foreign governments are prepared to intervene in Papua New Guinea politically to protect their own interests.

Papua New Guinea also hosts direct foreign investment in the form of the subsidiaries of large transnational corporations. These corporations bring with them their traditional associations with finance capital. For example, the link between Riotinto Zinc and Rothschilds became apparent when the Bougainville Copper mine was established. The Ok Tedi mining project led by Australian, American, and German shareholders, with 20% state involvement, is to borrow US$788 from a wide group of international banks lead by Citibank N.A. Rothschilds are used as financial consultants.

There is a considerable amount of contact between Papua New Guinea officials and the representatives of foreign investment, businessmen, bankers or diplomats. Papua New Guinea trade officials regularly meet their Australia counterparts under the Papua New Guinea and Australia Agreement on Trade and Commercial Relations (PACTRA). Trade between the two countries is arranged in a very detailed manner. The National Investment and Development Authority conducts regular seminars and promotional activities overseas, in an attempt to woo foreign investment to this country.

The history of Papua New Guinea colonialism has left the country with large numbers of foreigners in positions of influence. There are still non-nationals occupying important advisory positions in government, although in the main national bureaucrats appear to be in the ascendancy. However, in technical departments and instrumentalities, the reverse is the case - with foreign engineers and technologists effectively running the institutions. A similar

situation exists in the private sector. There, in the main, foreign businessmen dominate but national administrators and enterpreneurs are becoming increasingly important.

Most politicians own businesses or investments. Business houses are careful to cultivate their relationships with leading politicians and bureaucrats and it has become a tradition that membership of the National Parliament should bring with it an introduction to business ventures and investment opportunities.

Although at times antagonisms between individual or groups of bureaucrats, politicians and businessmen are revealed, the overall relationship is one of mutuality of interest, with national businessmen in a parasitic role and national bureaucrats and politicians in positions of power, increasingly dependent upon imperial interests to maintain their status.

The reach of these interests within Papua New Guinea institutions compromises national administrators or at least reduces their effectiveness by confusing loyalities.

In this context the Report of the Law Reform Commission on Transfer Pricing Manipulation is an attempt by a rather insignificant part of the Papua New Guinea State apparatus to strengthen the national hand in the struggle with imperialism.

Papua New Guinea is a weak adversary in this struggle. Its modern economy is almost totally captured by foreign investment. Its budget relies heavily on an Australian grant in aid. The country "has one of the highest propensities to import (measured by the ratio of imports to the total value of goods and services bought) of any country in the world". The domination of foreign capital is reflected in an astonishing use of high technology and not surprisingly accompanied by a consequent dependence upon foreign manpower. The economy has been described as rating "among the most open and dependent in the world".

II THE CONSTITUTION AND ECONOMIC INDEPENDENCE

This dependence is in stark contrast to the values of the third goal, "National Sovereignty and Self Reliance" of the National Goals and Directive Principles set out in the nation's Constitution.

The thrust of the Third Goal is that the Papua New Guinea State is to maintain economic independence and is to keep its hands free. Internal economic interdependence is to be promoted. Citizens and government bodies are to have control of foreign investment capital. The State is to control and actively participate in major natural resource exploitation

Economic development is to use skills and resources available in Papua New Guinea and not become dependent on imported resources. Sovereignty is not be be undermined by dependence.

Section 25 of the Constitution says that it is the duty of all government bodies to apply and give effect to the National Goals and Directive Principles as far as it lies within their respective powers. Laws, or powers conferred by law, should be applied to give effect to the National Goals and Directive Principles, but also without failing to give effect to Parliamentary intention.

In practice, the National Goals and Directive Principles are not used as a focus or standard against which to rigorously judge official acts. Indeed there have been some major official or political decisions that have openly cut across standards set in the Directive Principles.

III THE LAW REFORM COMMISSION'S INVESTIGATIONS

The Law Reform Commission Report on Transfer Pricing Manipulation was an enquiry under a reference given by the Minister for Justice on 26 March 1976 to report on "the current state of the law in regard to contracts, commercial transactions, creditors' rights and hire purchase, corporations and business organisation, and any related economic legislation; and the changes needed in these laws if the economy is going to develop in the direction specified by our Constitution".

While 'transfer pricing' is not an entirely inappropriate subject within the terms of this reference, it may by some, be thought not to fall fairly within a general reading of the words. Transfer pricing does involve, "commercial transactions", but as a phenomenon it has wider implications. Undoubtedly the Commission's eagerness to undertake this reference stems from its composition at the time, which included Bernard Narokobi as Chairman, and Nahau Rooney and Meg Taylor as members. During 1976, when the reference was obtained, the Secretary to the Commission, was Dr. Abdul Paliwala, former Dean of the Faculty of Law. To him must go credit for the preparatory stages of the work. In 1977 the services of a consultant Dr. Yanayotis Roumeliotis, from the United Nations Centre on Transnational Corporations, were obtained.

The "Roumeliotis Report" as it came to be known was published in 1978 and circulated. In August 1980, Occasional Paper No.12 was prepared by a New Zealand lawyer Mr. Alasdair Finnie. Dr. Paliwala, Dr. Roumeliotis, and Mr. Finnie are no longer in Papua New Guinea. The Occasional Paper recommended that "A policy is required integrating the control of transfer pricing manipulations with Papua New Guinea's macro-economic policy". (occasional Paper No.12: 2)

It went on to note that:

> "A majority of government agencies opposed the establishment of a technical unit and a consultative committee to provide information on international market prices." (occasional Paper No.12 2)

Out of 16 government agencies asked to react to proposals to regulate and monitor transfer pricing, seven were strongly against a centralised information collecting unit, four had no view, one was partly in favour and four supported the idea. (occasional Paper No.12: 31-2)

The Law Reform Commission Report identifies a number of transfer pricing practices in this country.

It makes the point that at present the bureaucracy is so under-staffed, undertrained, or badly managed that existing laws are not properly administered. (Report: 13) Fish caught off-shore, logs cut for export and goods imported are not systematically checked.

The Bureau of Customs, it is reported, is concerned about regular misdescription and undervaluing of imported goods to avoid customs duty.

There is concern generally in government over consultancy fees and management charges. The Report noted that some expatriate plant-ation managers of foreign owned plantations receive high management bonuses. There was some questioning by government agencies of interest rates, capital equipment purchasing, and the licencing fees for imported technology. (Report: 12) But the impression the Report gives is that research by the agencies is at a preliminary stage. Several examples of underpricing of export commodities are noted. (Report: 11-12)

A single instance of underpricing of cocoa was identified in 1978 by the Cocoa Industries Board. A trading company in one port underpaid producers. The Board required the company to pay back its suppliers K37 per tonne for a nine month period.

The underpricing of fish, tuna, prawns is estimated to lose Papua New Guinea US$2.3 to US$4.3 million per annum in bait royalties, export levies, and company taxes. Before 1979 some Japanese limber prices were significantly underpriced. Guideline minimum export prices imposed by the State raised these prices, in some cases by almost 100%. Other timber irregularities noted in the Report involve sales to companies in South East Asia 25-30% under market price. Sales of high quality log species sold to Hong Kong were in particular cases 100 to 130% below the Japanese market price for these species, when on-sold to Japan. In 1977 one company was recorded as selling sawn timber at only 46% production cost.

IV THE RECOMMENDATIONS

The Twelth Report of the Law Reform Commission on Transfer Pricing Manipulations contains three recommendations.

First, the Report recommends that a "Task Force" of government officers and consultants be established to conduct specialised investigations into "areas" where transfer pricing manipulations are suspected. This task force is to be located in the Taxation Office.

Secondly, in order to allow the transmission of information about transfer pricing from this unit in the Taxation Office to other government agencies the Commission has recommended amendments to the secrecy provisions of the Income Tax Act.

Thirdly, the Commission has recommended that the Chief Collector of Taxes be given a general power to "seize retain and remove for inspection" the books and other accounting documents of a taxpayer.

V THE TASK FORCE

The main recommendation of the Law Reform Commission, was to establish a Task Force to monitor and control transfer pricing. The Task Force was to be located in the Taxation Office. There would appear to be two functions assigned to the Task Force.

The first, being regulatory in nature, to control transfer pricing by monitoring tax returns. Second, the Task Force could gather information, particularly on world market conditions, and operate as a central clearing house to other government agencies for market conditions. As already been noted, in the main, these recommendations did not find favour within the bureaucracy.

An alternative model to the regulation of transfer pricing by a government institution was seen in the idea of market participation. Both the Primary Industry Department, and the Forestry Department favoured establishing State Export Marketing Corporations, which would allow Papua New Guinea to market its own fish and timber resources on international markets. A Fish Marketing Corporation has been established, but the Commissions Working Paper noted that the idea of the State marketing timber resources was delayed by the Finance Department which favoured joint ventures involving the participation of foreign capital. The Finance Department was not alone in its view. Other government agencies favoured the idea of joint venture marketing corporations as against marketing corporations wholly owned by the State. The Finance Department placed its faith in joint ventures because

> "experienced overseas companies which are not involved in or related to end users ... would .... help to obtain reliable market price information, and enable both minimum guideline prices and export taxes to be set at correct levels" (Occasional Paper No.12: 42)

The Occasional Paper, but not the Report, observes that the cost of reducing the risk of failure of a state owned marketing organisation, is the likelihood of lower returns from a marketing venture which is controlled in part by foreign capital. (Occasional Paper No.12: 44)

SECRECY

The second recommendation of the Law Reform Commission was to amend the **Income Tax Act** by adding a new section, Section 9A.

Clause 9A as recommended by the Commission would, in essence read:

> "... where the Chief Collector ... believes ... a taxpayer has engaged in transfer pricing ... he may ... communicate only such information acquired ... as is necessary to enable any Minister or officer of government, who has responsibility for the administration of any other Act that has application to the taxpayer".

Under the **Income Tax Act** as it is presently formed, Section 9 (on penalty) prevents the disclosure of information under the Act by tax officials to anyone. Special provision is made under Section 9(4)(b) for the Collector to pass tax information to a Review Tribunal constituted under the Act. By virtue of Section 9(4)(d) the Chief Collector may pass information to the Federal Commissioner of Taxes in Australia. Under the Australian **Income Tax Assessment Act**, Section 16(4)(ca) there is a reciprocal provision allowing the Federal Commissioner to pass information to the Chief Collector. But apart from these limited exceptions taxation information is secret. In particular, information cannot be passed to any Cabinet Minister (Section 9(6)) and Taxation Officers are forbidden from divulging taxation information in any Court of Law, other than before a court hearing a taxation case (Section 9(3)).

The main reason advocated for maintaining the secrecy of taxation information is that taxpayers are less likely to tell the truth about their business affairs to the Chief Collector, if they think such information would be made public, or could fall into the hands of their competitors, or enemies.

Criticism of the secrecy provisions includes -:

(a) in a democracy, elected political leadership has a right to know about taxation matters especially in cases which are strategic to the economic well-being of country;

(b) the Police and other law enforcement agencies should have access to taxation records. The experience in Australia of various Commissions of Inquiry and Royal Commissions into drug abuse and drug trafficking has shown that Police are hamstrung in their investigations into organized crime, whitecollar crimes (frauds), and drug trafficking, if they cannot get at tax records;

(c) taxation officials need to be watched and publicity is the best watch-dog. There is evidence of a mutuality of interest between business interests, conservative political interests, and taxation administrators. Taxation officials have resigned from their positions and set up business as tax advisers to the tax avoidance industry. In Western Australia government lawyers responsible for taxation matters deliberately hampered tax investigations and action against tax avoidance schemes. In Victoria, when Mr. McCabe, in a Report to the State Government, disclosed the names of known tax avoiders, his own return was made public, presumably by disgruntled tax officials.

Clause 9A(2) of the Commission's recommended amendments to the **Income Tax Act** stipulates that generally the communication of 'transfer pricing' information is to be at Departmental Head or Ministerial level. Clause 9A(3) exempts Clause 9A(1) from the penal provisions of Section 9 of the Act, and Clause 9A(4) directs that all information received under Clause 9A is to remain confidential, if not used under another Act. The recipients of information are obliged to take all reasonable precautions to keep such information confidential.

If one takes the view that secrecy is essential to tax administration then there would appear to be need for further protection of the taxpayer.

The term "transfer pricing" is unclear as a matter of law, and if it is to be used needs to be defined. In Australia the Government repealed Section 136 of the Income **Tax Assessment Act** which was meant to control transfer pricing. In its place has been substituted "Division 13 - International agreements and determination of source of certain income". The technique in this legislation is to use detailed descriptions of pricing arrangements, and to apply an arm's length criterion to such transactions, rather than use the broad and undefined concept of 'transfer pricing'

A further matter which may need attention is the lack of sanction against officials who obtain certain 'transfer pricing' information.

It is clear that Task Force officials will receive information that is not strictly a matter of tax or taxation concern. The legislation should make it clear that Task Force officials are bound by Section 9 for all purposes.

Further, the recipients of taxation information received for transfer pricing purposes are not bound by Section 9 of the Income Tax Act. If this information is not used under another Act, it remains confidential. But there is no specific sanction in the proposed amendments against the recipients if they do disclose the information. Presumably, officers of the Public Service would be liable to be disciplined under the Public Service Regulations. However these Regulations do not apply against Cabinet Ministers and Departmental Heads.

It is possible to take the view that secrecy is not essential to tax administration, or that some relaxation of the secrecy provisions is necessary. This view is now gaining strength in Australia. If such a view is held, then the Law Reform Commission proposals in respect of amendments to the secrecy provisions of the Income Tax Act are conservative and limited.

VII SEIZURE OF TAX RECORDS

In its Report the Law Reform Commission recommends substantial amendment to Section 365 of the **Income Tax Act.**

Section 365 of the Act allows tax officials to enter the homes and offices of individual taxpayers for the purpose of making extracts of taxation records held by the taxpayer.

The Law Reform Commission now proposes to allow the Chief Collector power to "seize, retain and remove for inspection" a taxpayer's tax records from his home or his office.

It is probable that this amendment is the result of the Commission trying to appease the Taxation Office. The amendment has no direct bearing on transfer pricing. It has the appearance of an after-thought, and is a matter of general application. Also it is a general power long covetted by taxation officials in order to prevent the falsification of taxation records, and the practice of running two sets of accounting records - one being particularly to satisfy taxation officials - the other to service the needs of the taxpayer.

Transfer pricing does present taxation officials with evidentiary problems, but these problems are of a different nature from those generated by domestic tax avoidance and evasion. Transfer pricing is an international phenomenon and the evidentiary problem arises because only so much of the evidence is within the jurisdiction. Where transfer pricing arises from the manipulation of prices and so called world markets, information on the market will most

likely be outside the jurisdiction. Where transfer pricing arises because of inter-corporate accounting manipulation, between the various arms of a transnational corporation, it is likely that incriminating evidence will not be available within the jurisdiction. Either the subsidiary within the jurisdiction will not be supplied by its headquarters with damning information, or it will be kept totally in the dark as to the transactions, on the basis that what it does not know it cannot possibly divulge. Hence an amendment which allows taxation officials power to search and seize records within the jurisdiction is not likely to be particularly helpful in dealing with a well organised transfer pricing scheme. Far more appropriate to the needs of a developing country would be an international convention that would allow subpoenas to run outside the jurisdiction.

Of equal importance to the objections of substance in relation to the proposed amendment to Section 365 of the Income Tax Act, is the objection of form, namely that the amendments are unconstitutional under Section 44(a)(vi) and (b), and 38 of the Constitution.

Clause 365 seeks to give power to the Chief Collector to seize, retain and remove for inspection taxation records.

Section 44(a) of the Constitution reads -:

> "No person shall be subjected to the search of his person or property or to entry of his premises, except to the extent that the exercise of that right is regulated or restricted by a law -
>
> (a) that makes reasonable provision for a search or entry -
>
> (vi) for the purpose of inspecting goods or inspecting or taking copies of documents, in connexion with the collection, or enforcement of payment of taxes or under a law prohibiting or restricting the importation of goods into Papua New Guinea or the exportation of goods from Papua New Guinea"

Thus the Constitution will only allow the "taking of copies of documents" in connexion with the collection or enforcement of payment of taxes. It will not allow the seizure, retention or removal of the documents themselves.

The Commission's proposal on seizure are defective at a very elementary level, and would need a Constitutional amendment if they were to be implemented.

Section 44(b) of the Constitution also requires that any restriction on the freedom from arbitrary search and entry must be by a law:

"that complies with Section 38 (general qualification on qualified rights)."

The Income Tax Act is a pre-Independence statute and does not comply with Section 38 of the Constitution. At the very least, all post-Independence amendments which affect the qualified rights must comply with Section 38.

In summary, the Law Reform Commission's proposals in respect to Section 365 of the Income Tax Act are ill-conceived and unconstitutional. They need to be thought through again.

VIII AN IMPORTANT OMISSION

The Law Reform Commission Report on Transfer Pricing Manipulation is defective in that it failed to examine an omission in the Income Tax Act which should have been apparent to the Commissioners.

This omission concerns the failure of the Commission to identify the need, as it existed in 1980 and 1981, to reform Section 197 of the Income Tax Act.

Section 197, in the words of the Commission's Occasional Paper on Transfer Pricing Manipulation was the "main weapon against transfer pricing manipulations by foreign controlled business operating in Papua New Guinea in circumstances when they allegedly produce no taxable income or less taxable income than might be expected" (Occasional Paper o.12: 28).

The Occasional Paperwas published in August 1980. On 12 August 1980, the Full Court of the High Court of Australia handed down judgment in **FC of T v. Commonwealth Aluminium Corporation Ltd.** 80 ATC 4371. (A commentary on that case is available in 1981 MLJ 138). The case had been before the Courts since 1979.

In their judgments the Judges of the High Court exposed a serious deficiency in the rules which were embodied in the Australian equivalent of Section 197 of the Income Tax Act. These deficiencies were probably known to the private bar in Australia during the early 1960s and were apparent to the Australia tax authorities in the early 1970s. However by a combination of mismanagement, vested interest, and politics, Section 197 was allowed to remain on the statute books both in Australia and Papua New Guinea. In November 1981, over a year after the High Court judgment in the **Commonwealth Aluminium Case**, the Law Reform Commission wrote when referring to a survey of existing control measures reviewed in the Occasional Paper -:

> "It (the Occasional Paper) concluded that although the existing legal, administrative and other controls at each agency's disposal to monitor and control transfer pricing

manipulations are considered in general to be adequate, their enforcement has been rare and unsystematic." (Report :13) (emphasis added).

In fact at the time of writing the Report, Section 197 of the **Income Tax Act** (the taxation office's "main weapon against transfer pricing") had been exposed by the High Court of Australia as having "serious deficiencies". (AFTR para. 99-447 New Developments 454-3-82), and could not be considered adequate.

Four months later, on the 24 March 1982, the Federal Treasurer introduced into the Australian Parliament the **Income Tax Assessment Act Amendment Bill** 1982 which replaced Section 136 of the Australian Act (the equivalent of Section 197 of the **(Income Tax Act)**.

A new division "Division 13 - International agreements and determination of source of certain income" was inserted. In great detail these amendments defined the nature of transfer pricing transactions and set an 'arm's length' criterion to control them.

On 24 November 1982, in Papua New Guinea, the National Parliament passed into law the **Income Tax (Budget Provisions) Act 1982** which contained amendments identical to those made in Australia.

The failure of the Law Reform Commission to take up the Section 197 issue is difficult to understand as the Report was released more or less contemporaneously with the Budget Session in 1982. By mid-1981 the Commission and the Taxation Office knew about the **Commonwealth Aluminium Case**, and it was referred to by Commission's Senior Research Officer, Mr. Finnie, in his paper **Transfer Pricing Manipulations in Papua New Guinea**, presented at the 1981 Waigani Seminar.

IX CONCLUSION

The real problem of controlling transfer pricing is a matter of controlling foreign investment in Papua New Guinea. It is the problem of disengaging Papua New Guinea from its dependent relationships with imperialist interests. In the long run, only by an alteration of this relationship can the country hope to control or avoid transfer pricing. Disengagement raises questions of the degree to which a developing country can opt out of its predicament, or to which it ought to withdraw. These are separate issues.

The history of this Law Reform Commission **Report** draws attention to the marginal importance of the Commission in policy formulation. Although the Commission is an institution established under Schedule 2.13 of the **Constitution** it may be seen to be ignored at those levels of government where decisions to implement legislative change are made. At present political and economic interest at this level of government is such that it will not or cannot allow any substantial

substantial clog on foreign investment. The Law Reform Commission Report shows the strength of these interests and the indifference of some government institutions towards transfer pricing.

Finally there is the problem of the Commission itself. By failing to identify the weakness of Section 197 of the Income Tax Act, and by allowing the initiative for reform in this area to pass to the Finance Department and Taxation Office in such an important matter, the marginal status of the Commission as a reforming agency may be seen as being confirmed.