PRICES, MINING AND TAXATION

IN PAPUA NEW GUINEA

By B. D. Brunton*

I. *Introduction.*

A. The Problem

Papua New Guinea is currently undertaking a revision of its mining laws.[1] It is a revision encompassing legislation that controls the winning of petroleum and non-fuel minerals, and includes a restructuring of taxes imposed upon mining operations.[2]

This article is concerned with a single aspect of the revision of mining and tax laws going on in Papua New Guinea. It deals with the particular items of revenue that arise from sales of ore by mining companies to overseas refineries. It seeks to examine the effect of existing tax laws upon ore sales, and questions proposed models of control that are being discussed in Papua New Guinea.[2a]

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1. The Papua New Guinea *Post Courier* of 8 November 1977 reported the adjournment of debate in the Papua New Guinea Parliament on three pieces of resource legislation, the *Petroleum (Amendment) Bill*, the *Mining (Amalgamated) Bill* and the *Mining (Safety) Bill*. A *Statement of Intent* on Financial Policies Relating to Mining and Mining Tax Legislation was tabled in the Papua New Guinea Parliament on 17 November 1977 (see *Post Courier* 18 November 1977 and the *Melbourne Age* of the same date).

2. The revision is partially complete. The *Income Tax (Petroleum) Act* 1976 (No. 72 of 1976). and the *Income Tax (Additional Profits from Petroleum) Act* 1976 (No. 71 of 1976) were passed by the Papua New Guinea Parliament on 23 November 1976. These acts contained amendments to the *Income Tax Act 1959* (No. 26 of 1959).

2a. I have presumed throughout the article that Australian case law forms part of the law of Papua New Guinea. This presumption is adopted for convenience, to avoid a debate upon the rules of common law reception in Papua New Guinea. The Papua New Guinea *Constitution* adopted the rules of English Common Law and Equity as they stood on 16 September 1975, subject to the appropriateness and applicability of the rules to the circumstances of Papua New Guinea. However, in taxation matters, because the Australian and Papua New Guinea statutes are in *pari materia*, and because the legislation in Papua New Guinea is administered by Australians, for all practical purposes, Australian case law applies in Papua New Guinea.

As Third World Countries seek to meet the aspirations of their people in terms of government services, so they pay more attention to the administration of tax legislation. They become increasingly concerned with the collection of revenue to finance development. The tax rates in these countries move nearer to those of developed countries. Papua New Guinea, twenty years ago a tax haven, now has a rate of personal tax effectively higher than in Australia, although corporate tax is lower than the Australian rate. There are however, still countries in the world where tax rates are low, and advantages may be gained in allowing profits to be brought to account there, rather than in high tax jurisdictions. The method employed in international business to shift profits, so to speak, to achieve such advantages, is known as transfer pricing. Transfer pricing is achieved by the manipulation of book-keeping entries. The entries may represent either expenditure or revenue items. For example, a parent company may sell a patent to an overseas subsidiary at a price in excess of the market value. In the books of the subsidiary the sale is recorded as an expenditure incurred in the course of business and is tax deductible. To the parent company the excessive mark-up on the sale represents a repatriation of profit from the subsidiary. Similarly items of revenue can be manipulated to achieve tax advantages. For example, the parent company located in a low tax jurisdiction may require a subsidiary in a high tax jurisdiction to undercharge when the subsidiary sells its products to the parent, so that on a global basis the business can gain the maximum advantage from the low rate of tax applicable to the parent.

B. Transfer Pricing.

The traditional methods used to shift income and expenditure between related companies are (a) loans or cash advances against future sales, (b) performance of services, (c) use of tangible property, (d) transfer or use of intangible property, and (e) sales of tangible property.[3]

The use of interest free loans between U.S. parent companies and foreign subsidiaries, was at one time a longstanding practice. The use of tangible or intangible properties at less than fair economic rentals was also common. Intra-corporate under-pricing in the past enjoyed wide usage, witness the words of Higgins J. in 1962:

> A firm that carries on business in London as well as in Australia can easily hide the profits of its Australian business by increasing the invoiced prices of the goods sent to Australia.[4]

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3. D.P.Quint 'Assault on Multinationals: French and American Reallocation Provisions' (1974-75) *50 Notre Dame Lawyer* 662, 665.

4. *British Imperial Oil Co.* v. *F.C.T.* (1926-27) 38 C.L.R. 209. The English case *Gillette Safety Razor* v. *Commissioner of Inland of Revenue* [1920] 3 K.B. 358 is an early example of blatant tax avoidance by transfer pricing.

Later in the same case Starke J. commented:

> It is no secret that income tax has been avoided by companies and traders resident outside Australia setting up local companies to trade in Australia, and supplying them with commodities at prices that cannot return a profit here, but returning handsome profits to the company or trader setting up the local companies.[5]

In 1962 the Number One Taxation Board of Review when dealing with allegations of transfer pricing against a major multinational oil company in Australia said:

> ... there are a variety of ways in which the profit produced in truth by the Australian business might be diminished by diverting profit from it to the foreign business organisation. The methods frequently met with are: charging goods to the foreign controlled business at such an inflated price as to allow little or no profit to appear in its books, or purchasing from it at so low a price as to leave it little or no profit. Other methods include (1) leasing property or equipment owned by one company to the other without charge or for nominal or excessive charge (2) one company makes excessive charges to the other for services of an inadequate or nominal consideration. Such methods of diverting profit from or diminishing the taxable income of an Australian business controlled or owned through shareholders by non-residents have their attractions only because of such control or ultimate beneficial ownership.[6]

The use of transfer pricing as a tax saving device has been described from the taxpayer's point of view by Chown:[7]

> Optimum tax strategy is to attempt to transfer profits from jurisdictions where the effective tax charge is high to those where it is low, taking proper account in both cases of taxes ultimately payable and credits allowable in the country of residence of the parent company and of the shareholders ...

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5. *British Imperial Oil Co. Ltd.* v. *F.C.T.* (1926-27) 38 C.L.R. 153, 214.

6. *Case No. N69* (1962) 13 T.B.R.D. 270 at p. 278.

7. John F. Chown, Tax Correspondent Financial Times London.

> The technique is to over-invoice on a transfer from a low tax to a high tax company. Similar adjustments are possible with royalties, interest and management charges.[8]

The potential for economic damage to a nation from transfer pricing practices is large. Apart from loss of tax revenues, there is the inflationary effect due to overpricing of goods or services. This inflation is caused by wage demands chasing price rises. While this type of inflationary effect may be tolerable if price rises are reasonable, the evidence is that international cartels and monopolies are prepared to fix prices so high that they may be considered as extortionate. In 1968 investigations into transfer pricing, in Columbia, revealed overpricing in that country as high as 6,155% on patented drugs and 258% on electronic components.[9]

The *Hoffman-La Roche Case*[10] in the United Kingdom shows that it is not only the developing countries that are threatened by this type of depredation.

C. Economic Planning.

In Papua New Guinea there are policy links between minerals development, the taxation of mineral resources and economic planning. Economic planning in Papua New Guinea is more concerned with the distribution of national resources and machinery to achieve that objective, than it is with growth per se. This economic model based upon ideals of distribution and equality is well known in Third World Countries,[11] and reflects the disparity in those countries between the large numbers of very poor people, and the fortunate few who are very rich. The application of these general ideals is reflected in a declaration of economic strategy by the Papua New Guinea Government. The Government has said:

> The National Development Strategy calls for

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8. J.F. Chown. *Taxation and Multinational Enterprise* (1974) 94.

9. C.V.Vaitsos, *Intercountry Income Distribution and Transnational Enterprise* (1974). Appendix 5. 158-186.

10. *F. Hoffman-La Roche and Co.* v. *Secretary of State for Trade and Industry* [1973] 3 All E.R. 945 (C.A.) and [1974] 2 All E.R. 122 (H.L.). This case is discussed by A.M. Gordon in 'Patent Law and Drug Prices: Implications of the Roche Case' (1976) 4 *Syracuse J. Int. Law and Com.* 189.

11. Australian Broadcasting Commission *Transcript on the Political Economy of Development* (1977) 32-49 radio interview with Mahbub Ul Haq, Director of Policy Planning, World Bank; and also A. Paliwala, P. Bayne, J.Zorn, 'Economic Development and the Changing Legal System in Papua New Guinea' (1978) (unpublished manuscript).

> a higher proportion of the nation's resources to be directed to development of rural areas.
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> Government policy will concentrate on the spreading of income earning opportunities through self employment. The strategy aims to reduce the present uneven distribution of incomes by efforts to generate income earning opportunities in all rural areas. Special effort will be made to create opportunities where income levels are lowest.[12]

This statement accepts the distinction between growth per se, and development. It is concerned with the mode of distribution of income, and the type of life-style implicit in that mode.

The political economy of the strategy is a response to unfavourable population growth, and likely limitations on government expenditure in Papua New Guinea.

Papua New Guinea has an estimated population of about 2.75 million. While the current workforce is about 1.25 million, only 200,000 people are in wage employment, the balance being subsistence farmers, with only tenuous links to the cash economy. Population expansion is at the rate of 3% per annum. If the Government's objective was to promote wage employment, then it is predicted by the Government that by a massive system of subsidies to industry, employment opportunities could be raised 5% per annum. Unfortunately this would only produce an increase to about 350,000 people in wage employment at the end of a ten year period. During the same period the total workforce would have risen to 1.75 million or thereabouts.[13] This option is not practicable because the estimated annual growth rate for government expenditure is expected to be less than three percent.[14] Papua New Guinea does not have the money to stimulate industry to the extent that would produce the necessary increase in wage employment. Therefore wage employment has been rejected by the Government in its economic planning. Current planning emphasises the promotion of self-employment in rural industry. This strategy has an effect upon the mining industry in Papua New Guinea. Modern mines are capital rather than labour intensive. The mine in Papua New Guinea operated by Bougainville Copper Limited conforms to these characteristics.

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12. Papua New Guinea, National Planning Committee of the Central Planning Office, 'The Post Independence Development Strategy' (27 October 1976) 17 hereinafter cited as 'the Development Strategy'.

13. *Id.* 19.

14. *Id.* 15.

The Bougainville Copper mine has a workforce of 4,000 which represents .32% of the total workforce in the country. On the other hand in 1976 Bougainville Copper paid K31.4 million in taxes. Taxes from the mine are paid to a Mineral Resources Stabilisation Fund, and during 1975-76 the Fund paid into the General Revenue Account K45 million. This represented 10.4% of the total revenue collected from all sources during that year.[15]

The Papua New Guinea Government has therefore adopted a strategy of encouraging minerals development because of its revenue producing capacity. The strategy for investment policy on large natural resources projects has been stated thus:

> The direct involvement of Papua New Guineans in these projects will be quite limited; these projects will be promoted because of their potential major contributions to government revenue. The increase in revenue will allow opportunities in other sectors and reduce reliance on foreign aid.[16]

The impact upon government revenue by the Bougainville Copper mine is significant. There are several areas in the country where other minerals exploration is proceeding.[17] Mining development elsewhere is more advanced at Ok Tedi. There a consortium led by the Broken Hill Proprietary Company is currently undertaking a major

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15. Taxes paid by Bougainville Copper for the financial year ending 30 June 1976 were K31.4 million, which included dividends, royalties, income and withholding taxes. See Bougainville Copper Limited 'Annual Report 1976.' Taxes paid by Bougainville Copper are not credited to General Revenue, but are paid directly to the Mineral Resources Stabilisation Fund. See PNG Chief Collector of Taxes '1975-76 Annual Report.' Payments from the Fund to General Revenue during 1975-76 were K45 million, while total revenue from all sources amounted to K433 million. The 10.4% represents the percentage of the payment out of the Fund, as against total revenue.

16. Development Strategy *op. cit.*

17. The PNG Government has called tenders for continued exploration for copper on Manus Island *(Melbourne Herald* 16 June 1977), and Nong River, Tifamin *(World Mining,* May 1977). Other known mineral areas include Freda River, Yandera, and several sites on New Britain (Plesyumi,Lae River, Yau Yau, Pelepuna).

feasibility study.[18] This project is expected to reach the production stage in 1984.[19]

The relationship between the consortium interested in Ok Tedi and the Papua New Guinea Government is the subject of a formal agreement. The text of this agreement is set out in a schedule to an Act of the Papua New Guinea Parliament.[20] A similar agreement exists with Bougainville Copper Limited.[21] Both agreements contain a special clause giving the miners unique taxation conditions. Other miners are granted relief against types of capital expenditure under the *Income Tax Act* 1956 'Division 10 General Mining.' The relief is similar to that contained in 'Division 10 General Mining' in the Australian *Income Tax Assessment Act* 1936. The agreements however contain some new and controversial taxation concepts and the Papua New Guinea Government now wants to apply these to all miners. This is part of the review mentioned in the first paragraph of this section, and a Government *Statement of Intent* has already been tabled in the Papua New Guinea Parliament.[22] For the purposes of this paper the most important proposal contained in the *Statement of Intent* is the intention of the government to apply to all sales of ore an arm's length test. The nature of this proposal will be discussed below, but the relationship between the arm's length test and transfer pricing needs to be explained here.

D. Arm's Length and Transfer Pricing.

Transfer pricing by artificially depleting the profits of the transferor company decreases the amount of income tax that is potentially available for collection in the country in which the transferor is located. This is so whether or not the motive for the transfer is to gain some tax advantage.[23]

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18. Gutman has divided the history of a mining project into five distinct phases; (a) initial exploration (b) major feasibility study (c) construction (d) early production (e) matured production. During early production loan equity is paid off. I will use this scheme. (G.O. Gutman 'Objectives Strategy and Tactics in Negotiations for Mining Projects' in J.Zorn and P. Bayne (ed.) *Foreign Investment, International Law and National Development* 1975)

19. Development Strategy *op. cit.*

20. *Mining (Ok Tedi Agreement) Act 1975.*

21. *Mining (Bougainville Copper Agreement) Act 1967-74* (No.70 of 1967).

22. Papua New Guinea Government, 'Policies Relating to Mining and Mining Tax Legislation. Statement of Intent.' (June 1977).

23. G.L.Madere, 'International Pricing: Allocation Guidelines and Relief from Double Taxation' (1975) 10 Texas Int. L.J. 108,109.

The proposal to price ore sales on an arm's length basis is a device to measure the genuiness or otherwise of particular sales of ore. However, there is little innovation in this proposal as the use of the arm's length standard to assess international pricing arrangements is common in the tax treaties.

E. Approach to be Taken by this Article.

I have said that I intend to examine the effect of existing tax laws upon ore sales. If transfer pricing occurs in the contex of ore sales it would be likely to happen when a mining company subject to relatively high tax rates sold its ore to a refinery located in a country of low tax rates. More realistically to actual ore sales would be ore sales to a sales company related to both parties in a low tax jurisdiction like Hong Kong. Provided the mine was controlled by persons outside the jurisdiction, such a situation would attract the discretion of the Collector of Taxes under Section 197 'Business Controlled Abroad' of the *Income Tax Act 1959*, which is formed in identical terms to the discretion of the Commissioner under section 136 of the Australian *Income Tax Assessment Act 1936*. This article will attempt some assessment of the utility of that provision. It will examine the term 'arm's length', and discuss problems arising from the likely contexts in which it may appear. The article will discuss problems of compatibility between the discretion that presently exists under section 197, and the introduction of an arm's length standard. Finally the paper will assess the arm's length standard as a device for settling disputes over prices for taxation purposes.

II. *Section 197 and the Taxpayer's Ability to Impeach an Exercise of the Collector's Discretion.*

Section 197 of the *Income Tax Act 1959* is a provision that may affect all businesses in Papua New Guinea that are owned or controlled by non-residents. The provision, save for three minor drafting variations, is identical with section 136 of the Australian *Income Tax Assessment Act 1936*.[25]
Section 197 reads:

> Where business carried on in Papua New Guinea
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> (a) is controlled principally by non-residents;
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> (b) is carried on by a company a majority of the shares in which is held by or on behalf of non-residents; or

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24. See for example the schedules to the Australian *Income Tax (International Agreement) Act 1953*. The first Schedule to the Act, Article 7.

25. In the following discussion, the Papua New Guinea provisions are followed by the equivalent Australian provisions, in parenthesis, and the Australian *Income TaxAssessment Act* 1936 is abreviated to 'I.T.A.A.'

(c) is carried on by a company which holds or on behalf of which other persons hold, a majority of the shares in a non-resident company,

and it appears to the Chief Collector that the business produces either no taxable income or less than the amount of taxable income that might be expected to arise from that business, the person carrying on the business in Papua New Guinea is not withstanding any other provision of this Act, liable to pay income tax on a taxable income of such an amount of the total receipts (whether cash or credit) of the business as the Chief Collector determines.[26]

Section 197 contains two phrases that authorise the Chief Collector of Taxes to exercise a discretion. In the first phrase the Collector must decide whether or not 'it appears ... that the business produces either no taxable income or less than the amount of taxable income that might be expected to arise from that business ....' In the second phrase a '.... person carrying on business in Papua New Guinea is .... liable to pay income tax on a taxable income of such an amount of the total receipts .... of the business as the Chief Collector determines'. Both phrases indicate that the Collector has been given power to determine an issue; or to give the power its legal description - to exercise a discretion.

This section is concerned with assessing the viability of an administrative discretion as a method of ensuring the adequate collection of revenue. In particular it is concerned with the collection of revenue in circumstances that would attract section 197. The assessment of the viability of a discretion in these circumstances will involve an examination of the legal restraints which affect the Collector in the exercise of his discretion, or more importantly after the exercise has taken place. If the exercise of the discretion can be impeached after it has taken place, then a discretion may not be an efficient method of securing the collection of revenue. Therefore the extent to which the discretion can be impeached is important.

There are three types of legal process which a tax payer may use to impeach a decision made under the *Income Tax Act* by the Chief Collector of Taxes. They are:

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26. The drafting variations in Papua New Guinea provision are: in the first line, the Australian Act substitutes 'a' with 'any'. In the final paragraph of the section, following the words 'the amount of taxable income', the Australian Act substitutes 'that' with 'which'. The Australian provision, final paragraph, is drafted in the future tense and appears prima facie mandatory by the use of the words 'shall .... be'. The P.N.G. version is drafted in the present tense in line with the decision in *Texas Co. (Australasia) Ltd.* v. *Federal Commissioner of Taxation* (1939-40) 63 C.L.R. 382.

(a) by a review of the decision before a Review Tribunal

(b) appeal or reference to the National Court;

(c) by an exercise of the supervisory jurisdiction of the National Court.

The authority for a Review Tribunal to review a decision of the Collector is contained in the *Income Tax Act*. Similarly the authority for the National Court to consider a tax matter on appeal is contained in the *Income Tax Act*, although the extent to which the Court may review a decision is a matter detailed by case law. The supervisory jurisdiction of the National Court originates from the Court's inherent power, conferred under section 155 of the *Constitution*, to make 'orders in the nature of prerogative writs and such other orders as are necessary to do justice in the circumstances of of a particular case'.[26a]

A. The Review Tribunal.

A taxpayer who is dissatisfied with an assessment made by the Collector under the *Income Tax Act* may lodge a written objection with the Collector, within sixty days of original assessment.[27] The Collector is obliged to consider this objection and to advise the taxpayer in writing of his decision to either allow or disallow the objection.[28] If the taxpayer is dissatisfied with the Collector's decision on the objection, he may request the Collector to either refer the decision for review by a Review Tribunal, or to treat the objection as an appeal and have it forwarded to the National Court.[29]

The Review Tribunal is constituted by a single member appointed by the Minister of Finance.[30] The Tribunal has wide powers of determination which include all the powers and functions of the Chief Collector.[31] This ability of the Tribunal to consider matters anew, in the place of

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26a. P.N.G. *Constitution*, s.155(4).

27. *Income Tax Act 1959*, s.245(1) (I.T.A.A. s. 185).

28. *Income Tax Act 1959*, s. 246 (I.T.A.A. s. 186).

29. *Income Tax Act 1959*, s. 247 (I.T.A.A. s. 187).

30. *Income Tax Act 1959*, s. 240 (cf. I.T.A.A. s.178(2)). The position has been vacant since September 1975, owing to difficulties in securing the services of a suitably qualified person. Papua New Guinea Chief Collector of Taxes, *Annual Report 1976-77*, *10*.

31. *Income Tax Act 1959*, s. 253(1).

the Collector, has particular advantages for the taxpayer who wishes to challenge the exercise of a discretion by the Collector.[32] In most cases such challenges involve an examination of the Collector's deliberation on matters of fact, to which the National Court will not readily accede. The Tribunal therefore has advantages in cases where the taxpayer is alleging that the Collector failed to give adequate consideration to the circumstances of his or her case.

The procedures adopted by the Tribunal allow for a fair hearing, without excessive formality. Section 250 of the *Income Tax Act* [33] confines the issues before the Tribunal to those grounds stated in the objection. This provision also places the onus of proving that the assessment was excessive upon the taxpayer. These rules would not constitute an insurmountable obstacle to a determined taxpayer with access to substantial legal and financial advice. While an individual taxpayer may rely on his tax agent or solicitor to draft his objections, a large multinational company may well engage experienced counsel to carry out this task. A wealthy corporate taxpayer will have access to expert advice and witnesses who will assist in presenting the taxpayer's case before the Tribunal. A case that is well supported by evidence will have the effect of requiring the Collector to present his case in reply. In a major case the Collector will call witnesses to refute the testimony of the taxpayer's witnesses. The taxpayer's counsel then has the opportunity of cross-examining the Collector's witnesses. Tactics of this nature were used in *Case No. N69*,[34] which involved a multinational oil company challenging the exercise of a discretion by the Federal Commissioner of Taxes, under section 136 of the Australian *Income Tax Assessment Act*. The challenge was made before the Board of Review and was successful.

The proceedings of the Review Tribunal are held in camera unless the taxpayer agrees to them being held in public.[35] The taxpayer's name is not included in any written decision of the Tribunal. The Collector may not release to the public,[36] or even to his own minister, any information

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32. A.R.Castan 'Challenging the Commissioner', in R. Baxt (ed.) *Recent Developments in Tax, Law and Practice*, (July 1977), 6/11.

33. *Income Tax Assessment Act 1936*, section 190.

34. (1969) 13 T.B.R.D. 270.

35. *Income Tax Regulations 1959* (P.N.G.) Reg.38(2). The P.N.G. Regulations are a re-enactment of the Australian Regulations, and the numbering in both countries is the same.

36. *Income Tax Act 1959*, s.9(2) (I.T.A.A. s.16(2)).

concerning the taxpayer's affairs.[37] In a Third World country like Papua New Guinea, such protection has particular advantages to foreign taxpayers. In those countries foreign investment is tolerated by politicians and leaders with varying degrees of resentment. Even a government publicly favouring foreign investment may be forced to take drastic action against a foreign investor who, in popular opinion, abuses the host country's hospitality. In these countries there are politicians who regard 'tax avoidance' as 'tax evasion', and as an abuse of national integrity. The cloak of secrecy around the Review Tribunal's proceedings is an important advantage to a foreign taxpayer, who may otherwise have to litigate in open court.

The Tribunal has wide powers to order its own proceedings to ensure that the taxpayer is given a fair hearing.[38] It is an administrative body and its procedure is not meant to be formal or technical.[39] It is difficult for a taxpayer to persuade the Tribunal to grant discovery, or to issue a subpoena against the Collector. Pre-trial processes such as these may not be had as of right by the taxpayer. The Australian experience is that the Chairman of the Board of Review cannot easily be persuaded to exercise his power of informing himself about the acts of the Commissioner. The Board reasons that since it has all the powers of the Commissioner, documents that were before the Commissioner when he made a decision are irrelevant to the Board when it makes a decision, unless of course, the Commissioner cares to put them before the Board. Documents not before the Board are irrelevant 'since it is the documents before the Board that will form the basis of the decision of the Board'.[40]

The Tribunal can, and does, take evidence on oath.[41] As a matter of practice the course of evidence and the rules of evidence, at least when counsel appear before the Tribunal, follow the practice and rules in the National Court.[42] But a taxpayer cannot demand rights of cross-examination of the Collector's witnesses, when these witnesses are themselves taxpayers in competition with the taxpayer.[43]

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37. *Income Tax Act* 1959, s.9(2)(I.T.A.A. s.16(2)).

38. *Mobil Oil Australia* v. *F.C.T.* (1963-65) 13 A.T.D.135, 146-47.

39. *Sutton* v. *F.C.T.* (1958-59) 100 C.L.R. 518, 523-24.

40. Castan *op.cit.*, 6/13. Castan points out that the Commissioner could well have material that the taxpayer needs for his case.

41. *Income Tax Regulations* 1959 (P.N.G.), reg.39(1).

42. Personal communication from a Melbourne Barrister who practices before the Board of Review in Australia. There is in my opinion no reason to think that the procedure before the Review Tribunal would differ. In 1975 the last Tribunal was Mr. C.F. Fairleigh Q.C., also a member of the Australian Board of Review.

43. *Mobil Oil Australia* v. *F.C.T.* (1963-65) 13 A.T.D.146-47.

It can be seen therefore, that an appearance before the Review Tribunal permits a taxpayer to receive a fair hearing. It is also true that in certain matters the Review Tribunal may appear to regard a particular class of taxpayers with some cynicism. As Castan puts it:

> The Boards of Review deal only with tax cases and hear hundreds of cases on a continuing basis. Inevitably they become rather cynical of witnesses. The best example of this is in the area of land transactions .... The Board has "heard it all before". Almost every story that a taxpayer tells in relation to his own affairs is a story which the Board had dealt with previously ....[44]

It is unlikely that a major mining company would meet this type of cynicism. Cases before the Tribunal or the Board on section 197 or its Australian equivalent are few. Major cases are likely to be presented for the taxpayer by senior counsel. Witnesses called in these disputes include businessmen and economists of world standing. The impact of such a case upon a Tribunal will be totally different to the image presented in Castan's example. Indeed the taxpayer is likely to have the Collector at a disadvantage, because a multinational company may well have access to market information that is denied to a tax official in a small Third World country.

B. The Jurisdiction of the National Court.

There are three avenues of appeal or reference to the National Court available to a taxpayer dissatisfied with a decision made under the *Income Tax Act*. They are:

(a) by virtue of section 247(b) of the *Income Tax Act* 1959, (I.T.A.A. s.187(b)).

(b) by virtue of section 255(1) of the Act, (I.T.A.A. s.196(1)),

(c) by virtue of section 255(2) of the Act, (I.T.A.A. s.196(2)).

Section 247(b) authorises a taxpayer to request the Chief Collector of Taxes to treat an objection to a decision of the Collector as an appeal, and forward it to the National Court. The words of this provision do not indicate that appeals are limited to matters of law. In this respect the section can be compared with section 196(1) and 196(2) which do contain words limiting appeals to matters of law. On its face then, section 247 indicates that appeals may be against decisions of either fact or law: 'When a right of appeal is given from a tribunal or administrative body direct to a court without limitation to a question of law, point of law, or error of law, then *prima facie* there is a right of hearing *de novo;* but it is a question of statutory interpretation in each case'.[45] In any particular case at least two statutory contexts would need to be considered.

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44. Castan *op.cit.*, 6/11.

45. Whitmore H. and Aronson, M., *Review of Administrative Action* (1978), 272.

First, the context in which the right of appeal arose needs to be construed. The right of appeal under section 247(b) is an alternative to the right to have an objection referred to a Review Tribunal under section 247(a). It has been noted already that the Act confers upon a Review Tribunal all the powers and functions of the Collector, when reviewing a matter before it. The legislation does not bestow similar powers upon the National Court.

Second, it is necessary to examine the provision which gives rise to the dispute. Where a particular dispute involves the exercise of a discretion, the court must decide whether the statute intends that the discretion be exercised by a particular person, or by the court.[46] If it is decided that the intention of the statute vests the discretion in an official, then the court is confined to exercising supervisory powers only.[47] By this is meant that a court will not examine the exercise of the discretion upon its merits, rather the court will be concerned with seeing that the exercise was made lawfully. In the particular case of section 197 of the *Income Tax Act* it has been observed that even if an appeal lies both in fact and in law 'the court will not substitute its own discretionary judgement for those of the Commissioner or Board'.[48]

In Australia the judicial attitude to the review on appeal of an exercise of a discretion was articulated by Dixon J. in *Avon Downs Pty. Ltd.* v. *F.C.T.*[49] That case involved an appeal under section 187(b) of the *Income Tax Assessment Act* 1936, against the exercise of the Commissioner's discretion, disallowing the taxpayer a deduction for a loss under section 80 of that Act. Dixon J. said:

> But it is for the commissioner, not for me, to be satisfied of the state of the voting power at the end of the year of income. His decision, it is true, is not unexaminable. If he does not address himself to the question which the sub-section formulates, if his conclusion is affected by some mistake of law, if he takes some extraneous reason into consideration or excludes from consideration some factor which should affect his determination, on any of these grounds his conclusion is liable to review.[50]

This statement was approved recently by the High Court of Australia in two appeal cases on the section 80 discretion. The cases are *F.C.T.* v. *Brian Hatch Timber Co. (Sales) Pty. Ltd.*,[51] and *Kolotex Hosiery (Australia) Pty. Ltd.* v. *F.C.T.*[52] The rules promulgated by Dixon J. paraphrase a

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46. Whitmore and Aronson *op.cit.*, citing *Commissioner of Stamp Duties (N.S.W.)* v. *Pearse* (1950-51) 84 C.L.R. 490, 516 as authority for this proposition.

47. *Ibid.*

48. *Mobil Oil Australia* v. *F.C.T.* (1963-65) 13 A.T.D. 135, 146.

49. (1948-49) 78 C.L.R. 353.

50. *Id.* 360.

51. (1972-73) 128 C.L.R. 28, 30, 45, 52, 57, 59.

52. (1974-75) 132 C.L.R. 535, 541, 567, 576.

multitude of other rules developed by the courts in the exercise of their supervisory jurisdiction. For example, the rule stating that if the Commissioner's conclusion is affected by a mistake of law it is liable to review, paraphrases a number of particular rules of administrative law. The same observation may be made of the rule which states that if the Commissioner does not address himself to the question the sub-section formulates, his conclusion is liable to review. Indeed, this rule also involves a mistake of law.

The rules which guide the exercise of a court's supervisory jurisdiction are legion, and the subject of much study by academic lawyers.[53] These rules describe the conditions which will induce a court to issue a prerogative writ, or make an order in the nature of a prerogative writ, such as a declaration or injunction. In Australia there has been an attempt to simplify this area of law, which has resulted in the codification of some of the common law. The basic rules, subject to some modification, are now contained in the Commonwealth *Administrative Decisions (Judicial Review) Act* 1977, section 5.[54] A comparison of the rules in section 5 with the rules in *Avon Downs* shows the extent to which the appellate and supervisory functions are merged. An example of the merging between the two jurisdictions can be seen in the words of Barwick J. in *Giris Pty. Ltd.* v. *F.C.T.* who said that interference by a court will be allowed if the Commissioner formed his opinion 'arbitrarily' or 'fancifully'.[55] The mixing of the two judicial functions has been openly acknowledged by Lord Denning in *Ashbridge Investment Ltd.* v. *Minister of Housing and Local Government.*[56] It has also been noted by commentators and writers.[57] Tracey in an article on the effect upon the supervisory functions of an absence or insufficiency of evidence, concluded:

> Not since early this century have courts held that to decide without supporting evidence is to commit a jurisdictional error and invoke the supervisory powers. On the other hand it is clear that courts which are accustomed to dealing with appeals in which it is claimed that there is "no evidence" are going to be reluctant to refuse to consider similar argument in cases within their supervisory jurisdiction in which gross errors are involved.[58]

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53. The leading English text is De Smith, *Judicial Review of Administrative Action*(1973). Whitmore and Aronson *op.cit.*is the leading Australian text.

54. See Appendix B.

55. (1969) 119 C.L.R. 365, 374.

56. [1965] 1 W.L.R. 1320, 1326.

57. R.R.S. Tracey, 'Absence or Insufficiency of Evidence and Jurisdictional Error' (1976) 50 *A.L.J.* 568, 569 and Whitmore and Aronson *op.cit.* 272.

58. Tracey *op.cit.* 572-73.

The importance of the 'no or insufficiency of evidence rule' to the review of a discretion is that it is a device which allows a court to consider the exercise of the discretion upon its merits. This is particularly relevant to appeals or references under section 255 of the *Income Tax Act* (I.T.A.A. s.196) which are confined by the words of the statute to matters of law. The courts have not maintained any consistency over the years in the distinction between matters of fact, and matters of law. Indeed, Whitmore and Aronson comment:

> Over the years when an appeal from the Taxation Board of Review was to the original jurisdiction of the High Court, that Court was inclined to insist that a large range of issues raised questions of fact; the number of appeals was thus severely limited. This, it might be suggested, was a clear policy decision designed to avoid overloading of the Court. Since jurisdiction has been transferred to the State Supreme Courts there has been a different approach. A large number of issues have been held to raise questions of law and the jurisdiction has become appellate rather than supervisory.[59]

The contention whether a matter is a question of fact or law has further repercussions in any consideration of a possible impeachment of an exercise of a discretion. If the amount of money at stake in a tax dispute is large, as it is well likely to be when the taxpayer is a multinational corporation, and the approach to solving the legal problem differs from judge to judge, 'the only useful advice that a practitioner can give, in the absence of a decided case precisely on all fours is "to give the matter a go".[60] The large corporate taxpayer, nowadays, is a formidable opponent in appeals against discretions. Not only will he have access to the best legal advice and counsel available, he will also have the financial stamina to see the case all the way to the highest court in the land. Also, no longer can the Collector exercise his discretion and rely on the legal onus being on the taxpayer to show that the assessment is excessive.[61] The taxpayer is now entitled to know the reasons why the discretion was exercised against him,[62] and if the Collector will not accede to a request for particulars of these reasons, a court will order particulars to be given, or it will order discovery.[63]

The posture of the Courts in Australia has been to stand between the taxpayer and the government, and to protect the individual's property rights. The judges of the High Court have made plain their distaste for legislation which removes from the objective scrutiny of the courts the process of assessment.[64] The extent to which the High Court has gone

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59. *op.cit.* 259-260.

60. Whitmore and Aronson *op.cit.* 247.

61. *Income Tax Act* 1959 section 250(b) (I.T.A.A. s.190(b)).

62. *Giris Pty. Ltd.* v. *F.C.T.* per Barwick C.J. (1968-69) 119 C.L.R. 365, 373.

63. *Bailey* v. *F.C.T.* (1977) 7 A.T.R. 251.

64. *Giris id.* per Barwick C.J. 372-73, Windeyer J. 382. *Kolotex Hosiery (Australia) Pty. Ltd.* v. *F.C.T.* per Barwick C.J. 540-41.

with its construction and application of section 260 of the *Income Tax Assessment Act* may be considered an extreme in judicial legislation.[65] Certainly the behaviour of the Court pays little regard to the needs of the revenue. The politics of income tax as a method of redistributing wealth has only recently become the subject of public debate in Australia, in the context of retrospective anti-avoidance legislation. In a Third World country such debates are unlikely to remain solely the subject of newspaper editorials, because the gap between rich and poor is much wider than in developed countries. There is always the fear that uncontrolled displays of wealth and privilege may bring violence and social disruption. It is in my opinion unwise to allow the courts to be seen to exhibit an extreme preference towards individual property rights. *A fortiori*, this preference should not be tolerated when individuals who benefit from the protection are rich, powerful, and foreigners. The spectacle of a court giving special protection to such a class of individuals jeopardises the reputation of the courts and the rule of law. It is my view that the courts should not be placed in a position of having to determine such issues.

Mining activities in Papua New Guinea contribute a substantial proportion of the total annual revenue. Mining companies as taxpayers therefore are in a special class, and in other respects the *Income Tax Act* treats them accordingly. If section 197 of the Act is to continue to apply to miners in the future, it should be modified. In so far as the section applies to the mining industry two options appear to be available. First, greater details of the manner in which the Collector's discretion may be exercised could be provided. Secondly, the exercise of the discretion could be made the subject of either limited or no review. A removal of the right of review before a Review Tribunal would be a practical, and not unnecessarily harsh, step to take. A mining company would still, in these circumstances, have limited rights of appeal to the courts.

III. *The Qualification By Case Law of Section 197 of the Income Tax Act.*

Having considered the general rules that affect the exercise of a discretion it is now necessary to examine the particular case law rules that have accumulated around the administration of section 197 (s.136 I.T.A.A.). In the Australian courts section 136 of the *Income Tax Assessment Act*, and its predecessor have been the subject of a number of constitutional challenges. During the first challenge[66] to section 136 or section 28(1) of *Income Tax Assessment Act* 1922-23 as it then was, it was argued that the Board of Appeal was a judicial body, and that as the judicial power of the Commonwealth of Australia was vested in the Federal Court, and the Board was not 'a court', that the legislation which purported to give power to the Board was *ultra vires* section 71 of the Australian Constitution.

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65. See Editorial, 'The High Court Decision in Slutzkin's Case' (1977) 6 A.T.R. 65, 67-68.

66. *British Imperial Oil Company* v. *Federal Commissioner of Taxation*. (1924-25) 35 C.L.R. 442 (The first 'British Imperial Oil Case').

In Papua New Guinea 'the judicial authority of the people' is vested in the National Judicial System.[67] The National Judicial System in essence consists of the superior courts and lower courts including courts of summary jurisdiction.[68] However, judicial authority may be conferred upon a person or body outside the National Judicial System,[69] but such persons or bodies, except in the case of the disciplined forces, are limited in their powers of sanction, to sanctions other than death, imprisonment, and other unreasonable penalties.[70] There are two legal points that arise from the decision in the first *British Imperial Oil Case*, and the Papua New Guinea Constitution. The first is that the statute which created the old Board of Appeal was amended, and a new Board of Review constituted. The amendment was in substantially the same terms as the present section 253(1) of the *Income Tax Act* (s.193 I.T.A.A.). In the second *British Imperial Oil Case* it was held that the amendments were *intra vires* section 71 of the Australian *Constitution* and that the powers held by the Board were not judicial in nature.[71] It is now quite clear that the Board of Review is an administrative tribunal. The second point is somewhat finer, and concerns a difference in the wording of the Australian and Papua New Guinea Constitutions. Section 158 of the Papua New Guinea *Constitution* vests the judicial *authority* of the people in the National Judicial System, whereas in section 71 of the Australian Constitution the judicial *power* of the Commonwealth is vested in the federal courts. The difference between a 'power' and an 'authority' in the context of those provisions is of political consequence at the most, if it is not a drafting error.

A further constitutional issue arose in the second *British Imperial Oil Case*.[72] This issue involved the interpretation of section 55 of the Australian *Constitution*. Section 55 on a plain reading forbids the enactment of a law which deals with more than one subject of taxation. This issue has no relevance in Papua New Guinea because there is no equivalent provision in the Papua New Guinea *Constitution*. Under Schedule 1.2(1) 'taxation' is defined to include 'rates, charges and fees and imposts of any kind'. The imposition of taxation can only be achieved by an act of Parliament.[73]

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67. *The Constitution of the Independent State of Papua New Guinea*, s.158(1).

68. Papua New Guinea *Constitution*, s.155, 172(1).

69. Papua New Guinea *Constitution*, s.159(1) states that judicial bodies in the disciplined forces are empowered to have disciplinary powers of detention.

70. Papua New Guinea *Constitution*, s.159(3).

71. *British Imperial Oil Co. Ltd.* v. *Federal Commissioner of Taxation* (1926-27) 38 C.L.R. 153).

72. *Id.*

73. Papua New Guinea *Constitution*, s.209(1).

The next relevant issue raised by the *British Imperial Oil Case* is the question of the extra-territorial effect of section 197 (s.136 I.T.A.A.). Quite apart from the decision in that case that section 28 of the *Income Tax Assessment Act* 1922-23 did not have an extra-territorial effect the Papua New Guinea *Constitution* stipulates that:

> 'No law made by the Parliament is open to challenge in any court on the ground that ....
>
> (b) it purports to have extra-territorial effect.'[74]

The *Constitution* goes on to negative any presumption against the extra-territorial effect of any law made by the Parliament.[75]

Finally (as has already been indicated), section 197 (s.136 I.T.A.A.) has been drafted in such a way as to remove any suggestion that the section is mandatory. In the *Texas Co. (Australasia) Case*[76] it was argued that once the Commissioner had established a taxpayer company was being controlled from abroad and it had failed to earn any taxable income at all, then the Commissioner had no option but to assess the taxpayer under section 28, as it then was. The High Court rejected this submission and in his judgment Dixon J. said:

> But in any case I think that section 28 by the words "shall be assessable and chargeable" does not mean to impose upon the Commissioner an imperative duty to assess upon a percentage of the total receipts whenever the three preliminary conditions prescribed by the section are fulfilled. I construe these words as conferring a power and a discretion, not as imposing upon the Commissioner an inexorable duty to fix some percentage, however small, and to proceed to asses thereon.[77]

Section 197 of the *Income Tax Act* 1959 is in somewhat less than mandatory terms, as the tense of the section has been changed from the future tense to the present tense, by deleting the words 'shall be liable .... as the Commissioner determines' and inserting in their place 'is liable .... as the Chief Collector determines'.

The three preliminary conditions referred to by Dixon J. are that the business is (a) 'controlled' by (b) non-residents and that (c) it appears to the Chief Collector to have produced less income than it ought. The issue of the control of a company has been decided in a series of cases that do not relate to section 197 (s.136 I.T.A.A.)

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74. Papua New Guinea *Constitution*, s.109(3).

75. Papua New Guinea *Constitution*, s.109(4).

76. *Texas Co. (Australasia) Ltd.* v. *Federal Commissioner of Taxation* (1939-40) 63 C.L.R. 382.

77. *Id.* 481.

The rules are that the control of a company is with those who determine what the company can or cannot do, by resolutions in the general meeting of the company.[78]

Whether or not this control is exercised by non-residents depends upon the definition of 'resident' in section 4(1) of the *Income Tax Act* (s.6(1) I.T.A.A.), and the case law that has developed around that provision. A person is resident in Papua New Guinea if he is domiciled there, unless the Chief Collector is satisfied that the person is also a resident if he remains in Papua New Guinea for more than six months, unless the Collector is satisfied that his usual place of abode is elsewhere and the person has no intention of taking up residence in Papua New Guinea. A company is resident in Papua New Guinea if it is incorporated there. If it is not incorporated in the country then it is resident if it has either its central management and control in Papua New Guinea, or its voting power is controlled by shareholders who are Papua New Guinea residents.

The section has been construed so as not to allow the Chief Collector to determine the total receipts, as soon as it becomes apparent that a foreign controlled company had no taxable income in a given year. Dixon J. in the *Texas Company (Australasia)* case said:

> It would I think be opposed to the general conception of the provision to construe it as if the mere fact that no taxable income was earned by a foreign controlled company was enough, without any consideration of the question whether it might in the given year have been expected to earn taxable income, to justify the Commissioner in assessing upon a percentage of total receipts. It does not mean that every time a company makes a loss it is to be so assessed, but if it makes the smallest profit or taxable income then it must be considered whether it is less than the ordinary income than might be expected.[79]

The cases lay down that the purpose of section 197 (s.136 I.T.A.A.) is to attribute to a business an amount of income that might have been expected to arise if the business had been controlled by residents. It follows that where the smallness of the income of a non-resident controlled business is due to factors other than its control by non-residents the provision cannot be applied to the business. The Board of Review in *Case No. N69* was of this view. The Board said:

> Section 136 enables taxable income thus diminished by transfer pricing to be restored to what its true amount would be if there were no such control or ownership by non-residents. The purpose is to attribute to the business carried on in Australia 'the amount of taxable income which might be expected to arise from that business' if there were no foreign

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78. *Barclays Bank* v. *Internal Revenue Commissioner* [1959] 3 W.L.R. 240, *per* Lord Evershed M.R. at 247; *British American Tobacco* v. *Internal Revenue Commissioner* [1943] 1 All E.R. 13; *Mendes* v. *Commissioner for Probate Duties* (1967) 41 A.L.J.R. 108.

79. (1939-40) 63 C.L.R. 382, 481.

control or share ownership. The absence of taxable income or smallness thereof might be due to factors other than foreign control or share ownership, and in that event s.136 cannot be invoked ....[80]

The Board cited Dixon J. in *Texas Co. (Australasia) Ltd.* v. *Federal Commissioner of Taxation*[81] as authority for this proposition. Dixon J. had said:

> Now section 28 in stating the condition under discussion says: "when .... it appears to the commissioner that the business produces either no taxable income or less than the ordinary taxable income which might be expected to arise from that business". The Board of Review interpreted the provision as meaning whenever a business in Australia controlled from abroad makes a loss, then the Commissioner's discretion arises to fix a percentage of gross receipts as the taxable income of the business. This appears to me to be a too literal construction of the words. The alternative expression means, I think, to require a comparison between the ordinary taxable income which the business controlled from abroad might be expected to produce and what it does produce whether nothing or something ....
>
> It does not mean that every time such a company makes a loss it is to be assessed, but if it makes the smallest profit or taxable income then it must be considered whether it is less than the ordinary income that might be expected.[82]

The Board of Review in *Case No. N69* then cited the following passage of Isaacs J. in *British Imperial Oil Co. Ltd.* v. *Federal Commissioner of Taxation* in support of its observation:

> Examination of the relevant Acts will show that Parliament has taken as a single subject of taxation gross income as the basis less such exemptions and deductions as it considers just. That is its general scheme. But special cases have to be met. One of these special cases is provided for in s.28, namely the case of a business in Australia carried on by some person here, the business drawing its receipts from Australian sources but being so controlled by persons resident outside Australia that those receipts apparently show no such surplus *as would be taxable income or ordinarily taxable under the general scheme if the business were independent of the outside control.* [emphasis supplied by the Board].

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80. 13 T.B.R.D. 270, 278.

81. (1940) 63 C.L.R. 382.

82. *Id.* p.479-481.

> Internal manipulation may thus easily, by conforming outwardly to technicalities of law, conceal the realities of the Australian "business" regarded as a productive entity; and therefore the Commissioner is empowered to enquire into the facts and ascertain what percentage of the total receipts represent the true measure of the next income result of Australian trading. Parliament then for the special case accepts that percentage as the "taxable income" in respect of the business in place of the misleading result that would be arrived at under the general scheme.[83]

It is necessary to remember that the particular issue in *Case No. N69* is a threshold issue, and is concerned with establishing one of the preconditions necessary to bring the section into effect.

The discretion that the Chief Collector exercises when he decides that it appears to him 'that the business produces either no taxable income or less than the amount that might be excepted' is quite different from the discretion he exercises when he decides upon an apportionment of the total receipts and fixes an amount of income tax thereon. But the interesting point that arises from the threshold authorities cited, is that whereas they tend to prohibit the invocation of section 197 (s.136 I.T.A.A.) where there is solely the appearance of inadequate income (and a loss arising from influences not associated with the non-resident ownership or control, is cited as an example), the cases on whether a prior loss would be sufficient to upset the exercise of the discretion upon the determination of the apportionment of the business income are not so clear.

For example in *Case No. N69* the Board of Review said: 'The absence of taxable income or smallness thereof might be due to factors other than foreign control or share ownership and in that event cannot be invoked'. This decision can be contrasted with the *Texas Co. (Australasia) Case*. In that case the High Court refused to formulate a rule upon the effect of prior losses.

Why have the courts been prepared to lay down a rule in one case, but not in another? The decision to exclude a loss in a current year, for threshold purposes, was made after scrutinizing the statutory context of the discretion. The analysis was legal in nature, and the conclusion supported by strong authority, namely Isaacs J. in the first *British Imperial Oil Case* and Dixon J. in the *Texas Co. (Australasia) Case*. The courts adopted the traditional posture of standing between the parties, blind to their status.

This posture may be contrasted with that assumed when the courts refused to formulate a rule upon the effect of prior losses. There, the posture reflected the judicial ideology of limited interference with administrative process. But a decision not to adjudicate between a person in a position of strength, like the Chief Collector with authority to exercise a discretion, and a taxpayer in a position of weakness, is a choice for the powerful. It is an indirect acknowledgement of the status of the parties. The judges limit their interference in administrative

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83. (1925) 35 C.L.R. 442, 434; this is the first *British Imperial Oil Case*.

acts because they acknowledge the consequences of unrestrained interference - that is disruption of the administrative process. In the last section I pointed out how in the circumstances of a Third World country particular rules of administrative law worked against the revenue. Here they are tipped against the taxpayer.

Inconsistencies of this nature are fundamental to a legal system which solves disputes through linguistic analysis. By linguistic analysis I mean the scrutiny of words in a statute, and the application to those words of general rules of law. This type of analysis devolves from philosophies of fairness and fair play. The analysis is considered fair because it uses abstract tools to achieve its objective. There is a reluctance to weigh up the substantial issues that lie at the base of a particular dispute. Tax cases, for example, are not solved by taking into account the taxpayer's ability to pay, or the revenue's need, because it is argued this would be impracticable. Fairness is not part of the argument for excluding a consideration of the ability to pay, although fairness may be said to motivate expediency in tax collection. That is, in the interests of expediency and tax collection it is better to consider all as equal in their ability to pay, because taxes are a deprivation of property, and nobody either rich or poor likes to pay them. But this argument has been examined before. To ignore the status of the parties when one is stronger than the other gives an advantage to the rich and powerful. A concept of fairness which admits this type of inconsistency is limited. This limitation is clearer if the needs of the parties are considered.

The settlement of a taxation dispute is a matter of the re-allocation of resources from private ownership to public use. How can it be said to be fair, in a dispute involving the reallocation of resources, to ignore the needs of the parties? It cannot be fair to give more to one who already has plenty, or to deprive those who have little. A concept of fairness which fails to recognise these factors is one-eyed. This is a criticism of western jurisprudence popular amongst Third World writers.[84] A fairness that fails to take account of the reality in the world is defective. In Third World terms, the reality is its problems of poverty.

Countries like Papua New Guinea are burdened with a model of dispute settlement that has weaknesses. Whether or not the weaknesses warrant a break with the past is a matter that needs careful assessment. But one thing is certain, the present system is not beyond criticism. The formulation of section 197 of the *Income Tax Act* has been supplemented by judge-made case law that provides protection to a foreign business operating in Papua New Guinea from a decision made by the Chief Collector of Taxes. In the light of the needs of other people in the country it is questionable whether this protection should be maintained.

Because of its characteristic operational limitations, mining is an industry that demands fiscal stability. Nothing could be worse for the long term development of the industry than to introduce a taxation code for miners that had to be amended over the years in a patchwork manner. Therefore it is essential that new legislation in this field embrace all aspects of tax administration. Most, but not all, miners sell their products at quoted market prices. In order to protect the

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84. C.G. Weeramantry, *Equality and Freedom. Some Third World Perspectives* (1976) 7-13.

tax base from potential exploitation by the minority, pricing needs to be carefully controlled. If the Collector's discretion in section 197 of the *Income Tax Act* is to apply to miners, in future, then his decision under the provision should not be reviewable before a Review Tribunal. Miners' interests can be adequately protected by continuing the present access to the courts allowed by administrative law. The courts provide a limited review of administrative acts, but protect taxpayers from excesses in the arbitrary exercise of power. Access to the Review Tribunal in these circumstances is, in my view, an unnecessary surrender of control on the part of a weaker party to a stronger adversary.

The legal rules discussed in this section are now summarised:

(a) When the Review Tribunal considers an objection to a prior determination of income under section 197 (s.136 I.T.A.A.) it is acting as an administrative tribunal, and there is no violation of the judicial authority of the National Judicial System under the Papua New Guinea *Constitution*.

(b) The income tax levied upon an apportionment of income under section 197 (s.136 I.T.A.A.) is a valid tax and *intra vires* section 209(1) of the Papua New Guinea *Constitution*, and cannot be challenged upon the basis of any apparent extra-territorial effect.

(c) The precondition of 'control' depends upon determination of the voting power prescribed for a general meeting of the company, by its memorandum and articles.

(d) The precondition of the residential status of either the individuals or companies having control of the business is determined by the definition of 'resident' in section 4(1) of the *Income Tax Act* (s.6(1) I.T.A.A.), and the case-law on that definition.

(e) The precondition whereby it must be subjectively apparent to the Chief Collector that insufficient taxable income is revealed by the business cannot be satisfied solely on the grounds that the business makes no taxable income. Further inquiry is required.

(f) It is clear from the construction of section 197 of the *Income Tax Act* that the section does not impose an imperative duty upon the Chief Collector to assess income tax upon a percentage of the total receipts, whenever the three preliminary conditions prescribed by the section are fulfilled. The authorities confirm that the duty is discretionary.

At the close of this section it is appropriate to draw attention to the drafting weaknesses of section 197. The *Asprey Report*[85] describes

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85. Taxation Review Committee, 'Full Report 31 January 1975', Canberra, 1975. This document is generally known as 'the Asprey Report'.

two schemes by which a taxpayer may organise his affairs to avoid any determination of his income under section 197 (s.136 I.T.A.A.).

The control contemplated by paragraph (a) of the section, according to the *Asprey Report*, 'probably refers to control by directors'.[86] This view differs from that contained in the authorities cited in this chapter.[87] However, if the pre-condition of control means control by directors it can be satisfied by having a majority of the directors resident in Papua New Guinea. On the other hand if the pre-condition means control by shareholders in a general meeting, the condition may be satisfied by interposing a Papua New Guinea holding company between the taxpayer and his ultimate non-resident controllers. Such an arrangement would also satisfy the terms of paragraphs (b) and (c) of the section. The *Asprey Report* recommends the redrafting of the Australian provision in terms of articles 5 and 7 of the Australian/United Kingdom tax agreement.[88] In so far as these changes to the legislation prevent schemes based upon the present paragraphs (a) to (c) of the section, they should be implemented in Papua New Guinea.

IV. *Ascertaining the Value of Products for the Purposes of Section 136 of the Income Tax Assessment Act.*

This section will examine how products are valued for the purposes of section 136 of the *Income Tax Assessment Act* 1936. Section 136 concerns a determination of the 'total receipts' of a business. In the main, the total receipts of a mining company derive from sales of mining products. The section will therefore set out the rules which prescribe how products are to be valued for the purposes of the section.

In 1934 an Australian Royal Commission on Taxation considered incorporating section 28[89] of the *Income Tax Assessment Act* 1922 into new draft income tax legislation. The Commission reported upon public reaction to section 28 in the following terms:

> Witnesses generally, approved of the section, but objected to the power of the Commissioner to make arbitrary assessment. It must be recognised, however, that a section of this nature is necessary to deal with cases where Australian profits are reduced by unfair means, as, for example, by invoicing goods at prices in excess of the fair market value in the country of shipment.[90]

The concern with market value in this paragraph is apparent.

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86. Asprey Report *op.cit.*, para. 17.87.

87. See footnote 78, above.

88. Asprey Report *op.cit.*, para. 17.88. *Income Tax (International Agreements) Act* 1953. Schedule 1.

89. Section 28 of the *Income Tax Assessment Act* 1922 was a provision that had a similar effect to section 136 of the *Income Tax Assessment Act* 1936.

90. Commonwealth of Australia, House of Representatives, Royal Commission on Taxation, 'Second Report'. Parliamentary Papers, General Session 1934, 1935, 1936, page 1917, para. 890.

Twenty-eight years later, in 1962, the Board of Review in *Case No. N69*[91] was to take up this concern. The Board of Review saw section 136 as having two functions. The first was to prevent fiscal evasion, and the second was to divide, or attribute profits territorially, between the Australian business and the foreign head office or other associated foreign business. The Board of Review noted that sections 38 and 39 of the *Income Tax Assessment Act* also dealt with the problem of territorial attribution of profit, and drew on those provisions as models to assist in defining what should be the rule of attribution of profit under section 136. The Board of Review said:

> .... we use s.38 and 39 as showing no more than that the legislature has in those provisions chosen as a yardstick for territorial attribution of profit the market value of goods in their country of origin - a standard of valuation at territorial limits by reference to market value at the place and time of export to Australia. It being our opinion that s.136 cannot be divorced from the problem of such attribution, we think that the same kind of yardstick is likely to prove to be the best starting point for a determination of taxable income in a s.136 situation. What we are saying is no more than that where the commodity in question has a world market and quoted market prices are available at different stages in the process of production and production and distribution, these market prices offer the best possible basis for pricing goods passing between inter-connected companies. It is difficult to imagine such prices being controlled by any single concern in its own interests. Their use gives as good a picture as can be got of the real economic value of any individual member of the group, at all events where the qualities of the commodity supplied to that member are comparable with a commodity quoted in open markets and where the generally prevailing prices in actual trade transactions can be measured against the quoted prices.[92]

This case involved a dispute over prices paid by the taxpayer for petroleum products imported into Australia. The taxpayer said that the prices were quoted market prices. The Federal Commissioner of Taxation argued that although the prices were quoted prices, they were fixed by a cartel, and did not reflect market value. On the facts, the Board of Review was satisfied that the prices did reflect a fair market value. It came to this conclusion after deciding that in the circumstances of the case there was little difference between arm's length prices and the market value. The Board of Review was prepared to enunciate the following rules as being applicable in circumstances where there are no market prices available for a commodity:

> Where there is insufficient evidence of fair market value or where there is no open market in the particular commodity the type of situation envisaged in s.40 of the Assessment Acts[93] - the task under s.136 is still to

91. (1962) 13 T.B.R.D. 270.

92. *Id.* 286.

93. Section 40 of the *Income Tax Assessment Act* 1936-78 envisages a situation where a profit split cannot be made by using either section 38 or 39 of the Act. These provisions regulate net gains derived from distinct sales of imported goods. 'Section 136 is directed at the ascertainment of what taxable income the business produces.' See *Case No. N69* (1962) 13 T.B.R.D. 270, 285-86.

> determine what taxable income "might be expected to arise from that business" if there were no overseas control or share-holding. If there are no quoted world market prices which can be applied with any appropriate adjustments for quality differences or to allow for actual trading conditions as reflected in prevailing prices, then the Commissioner must work from the best information that is available. He might try to construct a hypothetical market value by adding to cost of production an allowance for production or manufacturing profit, such allowance being made by fixing a reasonable rate of return on the investment in production facilities or by fixing some percentage on cost of production.
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> But in such a situation the Commissioner would, in our opinion, be resorting to figures of cost of production not for the purpose of notionally limiting (in the process of territorial attribution) the profits which might be said to attach to the production process but for the purpose of ascertaining them.
>
> If a s.136 determination cannot be made either by reference to quoted prices in an actual market or by reference to a constructed hypothetical market, then no doubt one must fall back on some empirical basis, be it fractional apportionment or percentage of turnover. But one thing we are quite clear about, s.136 does not, when construed in the context of the Assessment Act, enable the Commissioner to allocate to Australia such parts, for example of the world profits of an inter-connected group of businesses as the Commissioner might determine in accordance with a view that prices charged in world markets for goods are "too high" in reference to some subjective standard of his own.[94]

This dictum was written sixteen years ago. It has not been considered by the High Court of Australia, and it remains free of criticism in any reported case.

In this section it has been assumed that the Collector has the power to determine the taxpayer's income by applying to the sales of products that constitute the revenue of the taxpayer the various methods of valuation discussed in the decision in *Case No. N69*. However, the assumption in the particular case of mine products exported by a Papua New Guinea resident company may be attacked upon two grounds.

First, in the *Asprey Report* it was thought probable that the words in section 197, 'amount of the total receipts .... of the business' limit the Collector to imposing tax only upon the actual receipts of the taxpayer. In the words of the Report: 'in the deflated receipts situation described in paragraph 17.86 the Commissioner's power to substitute notional receipts in a non-arms length transaction is doubtful'.[95] These remarks were also applied to goods imported at an

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94. *Case No. N69* (1962) 13 T.B.R.D. 270, 286.

95. Asprey Report *op.cit.*, para. 17.87.

inflated price[96] which, if the opinion in the Report is correct, would place in question the very basis of the decision in *Case No. N69*.

Secondly, it may be said that the *dictum* in *Case No. N69* cannot be applied to the export situation. It may be argued that *Case No. N69* is confined to its facts; that it concerns importing a mineral into Australia, for refining inside the country. This is a different situation from that of a miner in Australia selling overseas to a buyer, the buyer being controlled by the same interests that control the miner. The criticism would rely on the Board's remarks which preface its application of section 136. The Board said:

> .... we think that the *Assessment Act of 1936* contains provisions which show at least by implication that there is one path which ought ordinarily to be preferred though not necessarily exclusively to other paths which might be followed in applying s.136 in a case where goods are supplied to an Australian business by its related foreign enterprise.[97]

This statement indicates that the Board's remarks are restricted to the import situation. It does not confine pricing solutions solely to the approach discussed by the Board in its reasons.

The criticism is answered by examining the general approach of the Board of Review in *Case No. N69*. The Board saw section 136 as being a provision concerned with preventing fiscal evasion, and dividing profits between two entities.[98] It noted that in sections 38 and 39 of the Act, the legislature had chosen 'as a yardstick for the territorial attribution of profit the market value of goods in their country of origin'.[99] These provisions dealt with the same broad problem that was dealt with in section 136. Further, market value in the mind of the 1934 Royal Commission on Taxation was instrumental in the drafting of section 136, and the Board quoted the passage cited in this section, from the 'Second Report' of the Royal Commission.[1] The Board was concerned with the problem of the attribution of profits derived from the sale of products that appeared to have quoted market prices. It saw sufficient indication in the statute to warrant a choice of market prices as 'the best possible basis for pricing goods passing between inter-connected companies'.[2] This statement of the Board is wide enough to include market prices applying to both exported products and those applying to imported products. In the circumstances of foreign control envisaged by section 136, export earnings and import earnings both produce taxable income, and are sufficiently analogous for the one set of rules to apply to both. Further, the rules laid down by the Board of Review in *Case No. N69* are consistent with the approach required by the courts when reviewing the exercise of a discretion. A discretion must

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96. *Ibid.*

97. *Id.* 284-85.

98. *Id.* 285.

99. *Id.* 286.

1. *Id.* See above, footnote 90.

2. *Id.* 286.

be exercised lawfully with a proper regard for what is relevant or irrelevant.[3] It would be irrational to apply the standard of a market value to income derived from the sale of imported products, but to apply some other standard to the sale of exported products.

Case No. N69 discussed the application of section 136, and in so doing described rules which ascertain the value of products for the purposes of the section. In summary these rules are:

(a) In circumstances which attract section 136, the liability of a taxpayer to pay income tax upon taxable income depends upon the determination by the Federal Commissioner of Taxation of an appropriate amount of receipts.

(b) In a business like mining, the amount of receipts is largely derived from the value of the sales of the product of the business or mine.

(c) The value of these sales is to be ascertained ordinarily, but not exclusively, by following one path (to use the Board's metaphor).

(d) The path favoured, where there is a world market for the product, is to ascertain its fair market value.

(e) The best indication of a fair market value, where quoted market prices exist, is the appropriate quoted market price at the time of sale, subject to variations of quality between the product sold and the product quoted on the market.

(f) If there is no evidence of world market prices the Commissioner is required by section 136 to determine prices that 'might be expected to arise from that business', were it controlled from within Australia.

(g) Accordingly, if no world market in the products exists, the Commissioner should construct a hypothetical market. He may do this by using one of two on-cost methods. The first method involves adding to the cost of production an allowance for production or manufacturing profit based upon a reasonable rate of return on capital investment in production facilities. The second method involves adding a similar allowance for profit, based upon a percentage on cost of production.

(h) If world market prices or a hypothetical market cannot be used, the Commissioner can value the sales using an empirical method. In *Case No. N69*, the Board indicated that fractional apportionment or percentage of turnover could be used, although it did not explain its own view of these terms.

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3. See Appendix B, section 5(2)(a) and (6).

V. *The Papua New Guinea Proposal: Price Control.*

The Government of Papua New Gcinea, in a *Statement of Intent*[4] has indicated that it intends to enact special legislation that will regulate ore sales. The *Statement of Intent* says:

> Major features of the *Income Tax (Mining) Act* which differ from standard procedures in the current *Income Tax Act* are as follows:
>
> (ix) Sales revenues must reflect the full proceeds that would have flowed from arm's length commercial transactions.

It is not clear from the context of the *Statement of Intent* whether or not it is intended to introduce the arm's length concept into the *Income Tax Act* 1959. While the Government has said that it will replace the current 'Division 10 General Mining' in the *Income Tax Act*, there is no precedent for including an income controlling device in that Division. There is precedent for using a price control device which incorporates an arm's length standard. This precedent is found in an agreement between Dampier Mining (a subsidiary of the Broken Hill Proprietary Company) and the Government of Papua New Guinea. The agreement, known as the *Ok Tedi Agreement*, is given the force of law by an Act of the Papua New Guinea Parliament called the *Mining (Ok Tedi Agreement) Act* 1976.

The *Ok Tedi Agreement* contains a taxation clause, 'Clause 23 Taxation'. Some of the concepts in the clause differ from concepts presently enacted in Division 10 of the *Income Tax Act*. The government intends, in its proposed legislation, to introduce the concepts from the *Ok Tedi Agreement*, into the *Income Tax Act*. However, it is under a separate clause, 'Clause 27 Marketing and Contracts', that provision is made for the prior approval by the government of ore sales. A paraphrase of this clause reads:

> 27.1 The Company shall be responsible for marketing of all Mine Products .... provided that -
>
> (a) the Company shall sell its products at prices which are reasonable judged on an arm's length basis in a transaction confined to the products of the Company or otherwise with the approval of the State ....; and
>
> (b) all sales contracts in excess of 25,000 tonnes of mine products will be submitted to the State for prior approval, and all other sales contracts .... will be submitted to the State within 30 days of execution.
> Approval where required will be given within 14 days and will not be unreasonably withheld in the case of a contract, at prices which are reasonable judged on an arm's length basis ....[5]

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4. Papua New Guinea Government, Department of Finance, 'Financial Policies Relating to Mining and Mining Tax Legislation. Statement of Intent', (Port Moresby, June 1977) (mimeo).

5. *Mining (Ok Tedi Agreement) Act* 1976. The Agreement is contained in a schedule to the Act called 'The Schedule'.

There is a contrast between this approach to transfer pricing, and the approach that may be seen in the exercise of a discretion under section 197 of the *Income Tax Act* (s.136 I.T.A.A.). Where the State approves ore sales before or shortly after they are made, it appears to be in a position of strength.

The situation is analogous to that of the collection of custom duties: the goods are not released from bond until the duty is paid. But this position of strength is only real when the State is adequately informed as to the structure of the market in the commodity in question.

The relationship between the international oil companies operating in Australia, and the State and Commonwealth governments, illustrates this weakness. The governments, in the past, failed to scrutinize adequately the transfer prices of the oil companies. South Australia led the fixing of petroleum prices in Australia, because that state retained its wartime price control legislation. The prices determined by the South Australian Prices Commissioner were followed in other States. This practice was maintained until 1974, when the Commonwealth established its own pricing authority, the Prices Justification Tribunal, after which the Prices Commissioner accepted the implementation of prices approved by the Tribunal.[6]

The pricing practices in respect of petroleum established in South Australia by the Pricing Commissioner had their weakness. The cost of petroleum was based upon its f.o.b. price 'The f.o.b. price of a finished product was normally taken as the posted prices at the Persian Gulf refining ports of Bandur Mah Shar in Iran or Ras Tanura in Saudi Arabia'.[7] There was evidence that the posted prices did not reflect a market value. In 1976 a Royal Commission on Petroleum commented:

> Both the South Australian Prices Commissioner and the Prices Justification Tribunal have been faced with the problem of how effectively to monitor landed costs of crude oil and products. During the 1960's the South Australian Prices Commissioner made some attempt to go behind the landed costs reported by the companies but without success. In the Shell application, the Prices Justification Tribunal stated in its decision that the genuineness or otherwise of the 'transfer' prices charged to the Australian Companies was the subject of several submissions and went on to say that they did not accept that they necessarily were the prices which the company should have paid.... These doubts were not mathematically resolved but were taken into account ....[8]

This passage admits that the Prices Commissioner did not identify the true market value of imported petroleum products. It also admits that the Prices Justification Tribunal was unable to ascertain from the evidence before it the market value of petroleum, but took the evidentiary discrepancies into account when it fixed a price. It would appear that

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6. Commonwealth of Australia, the Parliament, Royal Commission on Petroleum, the Fourth Report, 'The Marketing and Pricing of Petroleum Products in Australia'. Parliamentary Papers No. 99/1976, 335.

7. *Id.* 332.

8. *Id.* 52-53.

the necessary information to enable the Tribunal to get at the market value was not available.

The inadequacy of posted prices for petroleum was commented on by the Royal Commission on Petroleum:

> 32.3 Commission's Observations
>
> The Commission has several observations on price control as practised in Australia. The most important observation is that the fundamental basis for calculating ceiling prices, that is the import parity cost of products from the Persian Gulf at posted prices plus G.P.A.F.R.A. freight has never been critically examined. Very fundamental changes have taken place in the international oil industry since World War II. In the 1950s and accelerating throughout the 1960s, the posted prices of product in the Persian Gulf were not representative of the prices at which products were actually sold. This was also true of crude oil posted prices.[9]

There are two statements in this passage that are relevant. The first is that posted prices of petroleum products had never been critically examined. How can a pricing authority determine a fair market value if there has been no adequate examination of the price structure of the commodity? In Papua New Guinea the pricing authority will be bound by an arm's length standard. If this standard for present purposes is equated with fair market value the pricing authority must have the power to look behind the posted prices. But mere legal power to look behind the prices may be not enough. The pricing authority must have the resources to get at the necessary information that describes the market structure.[10] The absence of such information is illustrated by the above statement of the Royal Commission that the posted prices 'were not representative of the prices at which products were actually sold'. In other words, the transactions in petroleum products between buyers and sellers did not reflect posted prices, and the prices actually used were more likely to reflect the market.

This statement of the Royal Commission can be contrasted with a remark of the Taxation Board of Review in *Case No. N69*. The Board said:

> .... we are satisfied that there are quoted prices in open world markets for both crude oil and products by reference to which one can apply .... s.136 .... Accordingly we do not find it necessary to consider the evidence relating to the cost of production of the commodities with which we are concerned in this case.[11]

In this statement the Board of Review refused to look behind the posted prices, and accept that they accord with a fair market value. But fourteen years later the Royal Commission was able to say that the

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9. *Id.* 337.

10. See Asprey Report, *op.cit.*, para. 17.89.

11. (1962) 13 T.B.R.D. 270, 287.

posted prices were not representative of prices at which petroleum products were actually sold.

The discrepancy can only be explained in terms of the information before the respective bodies. The taxpayer's success before the Board of Review was due to the taxpayer adducing evidence that supported posted prices as being representative of the market. But the Royal Commission was able to gather evidence from wider sources. Its hearing took place over two years and involved visiting eight countries.[12]

A pricing authority, such as is being proposed in Papua New Guinea, must not only have the power to look behind quoted prices, it must also have the resources to carry out the task. This article will be concerned with the power that is vested in the government by a phrase containing the words 'arm's length'. But the power alone will be ineffective unless it is complemented by an ability upon the part of the government to examine the structure of markets in particular commodities.

Before considering in the next section the term 'arm's length', a further issue needs to be mentioned. The issue is that raised by producer cartels. Producer cartels have been formed amongst Third World countries to control over-supply and the low prices that affect various commodity markets in foodstuffs and raw materials. The Organisation of Petroleum Exporting Countries (O.P.E.C.) is such a cartel. So is the International Bauxite Association.[13] If a country joins a producer cartel, and involves itself in price fixing activities, the considerations in this section relating to the power and ability of a government to examine commodity prices may need modification.

VI. *The Meaning of the Phrase 'Arm's Length' in Case Law.*

Section V discussed the use that is made of the term 'arm's length' in the *Statement of Intent* and in the *Ok Tedi Agreement*. That term is currently used colloquially to designate a sale or transaction that is in accordance with market value.[14] The term is also used in the Australian *Income Tax Assessment Act* 1936.[15]

This section examines the origin of the term 'arm's length', and describes its meaning in law.

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12. Royal Commission on Petroleum, the Fourth Report *op.cit*,

13. *D.A. Beloff et al.*, 'Non-Fuel Mineral Cartels-United States Economic Policy' (1975) 7 *Law and Pol Int'L Bus* 863, describe the emergence of the International Bauxite Association.

14. *Supplement to the Oxford English Dictionary*, A-G (Oxford: O.U.P. 1973), 123, col.1.

15. Ss. 23F (18), 31C and 121BA(4).

In 1814, the law reporter Dow attributed the term 'arm's length', to Lord Eldon, in the reported case of *Cane* v. *Lord Allen*.[16] However Dow uses indirect speech and it is difficult to be sure whether or not the words he attributes to Lord Eldon fell from the lips of the Lord Chancellor or whether they were those of Dow himself. By 1853 the phrase was obviously in vogue, as it was used by Lord Cranworth L.C. and Turner L.J. in *Holman* v. *Loynes*;[17] and in 1858 it was discussed in Lord St. Leonard's 'Handy Book of Property Law'.[18]

The term was used to describe the behaviour which equity required of certain fiduciaries when they dealt with the property of those to whom they owed a duty. The general rule of equity was that fiduciaries were disqualified from dealing on their own behalf, in such property.[19] Thus equity inhibited attorneys purchasing from their clients, trustees from their beneficiaries and guardians from their infants. It was, for example, difficult for an attorney who had bought property from a former client to show to a court reason why the sale should not be declared void. The onus of proof was on the attorney, and was described by Sir James Wigram thus:

> The nature of the proof therefore, which the Court requires must depend upon the circumstances of each case, according as they may have placed the attorney in a position in which his duties and his pecuniary interests were conflicting, or may have given him knowledge which his client did not possess, or some influence or ascendancy or other advantage over his client; or, notwithstanding the existence of the relation of attorney and client may have left the parties substantially at arm's length and on an equal footing ....[20]

Lord Eldon, twenty eight years earlier, described the attorneys' options in this manner:

> .... unless he withdrew from that connection, or put himself completely at arm's length he must show, in case the contract were questioned, that he had given the same disinterested advice that he naturally would have given if the contract had been made with another party.[21]

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16. II Dow. 289; 3 E.R. 869, 872.

17. 4. De.G.M. and G. 270; 43 E.R. 510, 513, 516.

18. *Oxford English Dictionary*. I. 48, sub.tit. 'arm'.

19. *York Building Co.* v. *Mackenzie* VII Brown 42; 3 E.R. 433, 446.

20. *Edwards* v. *Mayrick* 2 Hare 60; 67 E.R. 25, 29. (1842) cited in *In re Haslam and Hier - Evans* [1902] I Ch. 765, 770.

21. *Cane* v. *Lord Allen* II Dow. 289; 3 E.R. 869, 871.

An attorney who bought from his client had three options. First, he could divest himself of the fiduciary relationship. Secondly, if the fiduciary relationship was to subsist, then the attorney could divest himself of any superior knowledge, influence, or other advantage. He had to give to the client the same disinterested advice that he naturally would have given if the contract had been made with another party. Thirdly, he could put himself completely at arm's length and on an equal footing with his client. There is a deal of affinity between these options. For example, between the first and the third options. If an attorney terminated his relationship with a former client, and the client went to another for advice, it would seem that a future sale would proceed upon an equal footing. But would it have been an 'arm's length' sale? What do these words mean?

Wharton's Law Lexicon indicates in its definition of the term 'at arm's length', that in order for the attorney to have dealt with his client at 'arm's length', he would have to make a full disclosure of any knowledge obtained while the attorney/client relationship existed. *Wharton's* says:

> One who stands towards another in such a position as to have an advantage of him, is bound on a proposal for a contract between them to divest himself entirely of that authority or influence which he possesses so as to place himself on an equality, and to let the negotiation proceed as between two independent persons. This is called putting *at arm's length*. It is most frequently applicable to transactions between attorney and client.[22]

The duty to disclose has been explicitly described in the case of trustees dealing on their own behalf in the trust property. '....There must be no fraud, no concealment, no advantage taken by the trustee of information acquired by him in the character of trustee.'[23] This duty arises by virtue of the nature of the fiduciary relationship, which is one of confidence.[24] The duty does not arise by virtue of the fiduciary's ability to influence his client, otherwise in the absence of influence, there would be no duty to disclose. This is not the law.[25] The law is that confidence compels disclosure by a fiduciary.

Wharton's description of the term 'arm's length' occurs in the context of such rules of equity discussed above. The law demands divestiture of authority and influence in these dealings. Once the rules of equity in *Wharton's* description are accounted for, it can be seen that the term describes negotiations between parties that are equal to, and independent of, one another.

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22. *Wharton's Law Lexicon* (5th ed. 1872) 93.

23. *Snell's Principles of Equity* (27th ed. 1973, by R.E. Megarry and P.V. Baker), 240-241.

24. *McKenzie* v. *McDonald* [1926] V.L.R. 134, 144-45. per Dixon J.

25. *Moody* v. *Cox and Hatt* [1917] Ch. 71, 80 per Lord Cozen-Hardy M.R,

The term 'arm's length' is used in legislation in the United States of America. It has occurred in taxation statutes,[26] rent control legislation,[27] and the Security Exchange Commission regulations.[28] It has also been the subject of litigation.[29]

The case of *Morgan Stanley and Co.* v. *Securities Exchange Commission*[30] contains a comprehensive examination of the term. In that case the rules made under the *Public Utility Holding Company Act* denied underwriting fees to a finance organisation which was an 'affiliate', under the Act, of any public utility involved in raising public loans. An 'affiliate' was defined as:

> any person or class of persons that the Commission determines, after appropriate notice and opportunity for hearing, to stand in such relation to such specified company that there is liable to be such absence of arm's length bargaining in transactions between them as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such persons be subject to the obligations, duties, and liabilities imposed by this chapter upon affiliate companies.[31]

The facts of this case were that Morgan Stanley and Company raised a loan on behalf of a utility called Dayton Power, and sought to recover underwriting fees. The securities Exchange Commission opposed the payment of underwriting fees on the basis that Morgan Stanley and Dayton Power were 'affiliates'. The Commission contended that there was an absence of arm's length bargaining between the parties that made it appropriate in the public interest for Morgan Stanley to be considered an 'affiliate', and denied underwriting fees.

The case turns largely upon the view that the court took of the facts, but certain comments made by the judges are pertinent to a legal definition of 'arm's length'. In his majority judgment Justice Clarke said:

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26. *Revenue Act* 1963, 26 U.S.C.A. para. 1481 note s.619(b)(3).

27. *State Rent Law N.Y.* L. 1964, ch. 274 as amended L.1957 15 U.S.C.A. para. 796(a).

28. Rule U-12F-2 under *Public Utility Holding Co. Act* 15 U.S.C.A. para. 796(a).

29. See case law under heading 'Arm's Length' in *Words and Phrases* vol. 4.421 (1962).

30. 126 F. 2nd 325 (2nd cir. 1942).

31. *Id.* per Justice Chase, 333.

> Arm's length can hardly be meant in the traditional sense of fiduciary relationships for the very provisions of the Act require complete disassociation of banker and utility. The type of influence envisaged is not overall control, but influence in choosing underwriters. In sum, the Rule aims at breaking up underwriting ties which owe their existence to factors other than competitive advantage, in the broadest sense of the word. In this light we think the Commission acted within its power ....[32]

This comment upon the term 'arm's length' recognises the need to construe the term outside its fiduciary origins. It requires that the term be applied within the context of the particular statute in which it occurs. The dissenting judgment of Justice Chase in this case completes the divorce of the term from its traditional association with the law of equity. Justice Chase said:

> That term arm's length as used in this rule or in this statute has received no judicial interpretation so far as I am aware, and most of the cases dealing with it have been those where some fiduciary or subsidiary relationship was involved .... [he then cited a list of U.S. cases] .... In Black's Law Dictionary it is stated that "parties are said to deal at arm's length when each stands upon the strict letter of his rights, and conducts the business in a formal manner, without trusting to the other's fairness or integrity, and without being subject to the other's control or overmastering influence". As used in this rule "arm's length bargaining" should mean bargaining in which the issuer of the security is competent to, and does freely seek to promote its own best interest with due regard for the public and in accord with fair and honest business methods.[33]

The definition in *Black's Law Dictionary* avoids phrasing that connotes any association with equity. It accords with those parts of the definition in *Wharton's Law Lexicon* that describe the parties as being equal to one another, and independent, but it goes further because it is more precise. 'Arm's length' as defined in *Black's Law Dictionary* is consistent with the colloquial understanding of the term designating a sale at market value.[34] If parties conduct business in a formal manner, without trusting in the other's integrity, and without one being subject to the influence of the other, any bargain reached could well reflect market value. This argument is not wholly consistent because independent business entities can fix prices that do not reflect market value, but the colloquial use of a phrase does not have to be strictly logical. However, both Justice Chase and Justice Clarke agreed that the term has to be applied subject to its statutory context. Justice Chase in applying Black's definition to the utility saw the utility as freely seeking 'to promote its own best interest with due regard for the public and in accord with fair and honest business methods'. In the circumstances it would be likely that such a bargain would be struck at a value that reflected the market price for the particular service transacted.

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32. *Id.* 330.

33. *Id.* 335.

34. See footnote 14, above.

The term 'arm's length' as it is used in modern statutes describes the behaviour of the parties to a business transaction. The parties are independent of one another in their bargaining and each relies upon his or her own business acumen to achieve the best from the transaction for himself or herself. The precise legal meaning of the term will depend upon the context in which it occurs in the statute.

VII. *Prices Which are Reasonable Judged on an 'Arm's Length' Basis.*

In the last section the term 'arm's length' was discussed without placing it in the context of a particular statute. This section will discuss the meaning in law of that term in its context in cl.27 of the *Ok Tedi Agreement.*[35] The discussion will describe how sales contracts for mine products are valued for the purpose of cl.27. This section also compares the conclusion reached in respect of values under cl.27 with the rules on pricing laid down by the Board of Review in *Case No. N69.*[36] In that case the Board discussed how the Federal Commissioner of Taxation should exercise his discretion under section 136 of the *Income Tax Assessment Act* 1936. It set guidelines to assist the Commissioner's determination of prices under the section. Are there conceptual differences between the two approaches? If there are, what are the legal consequences of each approach?

The first task is to examine the term 'arm's length' as it occurs in cl.27 of the *Ok Tedi Agreement*. The phrase as it appears is '.... that the Company shall sell its products at prices which are reasonable judged on an arm's length basis ....' This phrase contains three legal concepts: 'price', 'reasonableness' and 'arm's length'. It is intended to examine each of these and relate it to the other concepts in the phrase.

Starke J. in *Offset Printing Co. Pty. Ltd.* v. *The Commonwealth*[37] said that 'price' is the sum of money or its equivalent at which a thing is valued. It follows then that the phrase in cl.27 is concerned with a value that is 'reasonable'. The clause in particular is concerned with the determination of the value of mine products. Value may be defined in terms of real value, or market value. For example, the Victorian *Probate Duty Act* 1962, s.17(1) states:

> .... the Commissioner shall fix the value of any property for the purposes of this Act at the price which such property would fetch if sold in the open market.

This provision is in terms of market value. On the other hand the *Commonwealth Estate Duty Assessment Act* 1914 directs that duty be levied upon 'the value' of the deceased's estate. This is taken by the courts to mean 'real' or 'true' value.[38]

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35. The text of cl.27 is set out above, see footnote 5, and in full at Appendix C.

36. (1962) 13 T.B.R.D. 270, 286. The rules were discussed in section IV, above.

37. (1943) 67 C.L.R. 314, 372.

38. H.A.J. Ford. *Principles of the Law of Death Duty* (1971) 338. And also *Abrahams* v. *Federal Commissioner of Taxation* (1945) 70 C.L.R. 23, 29.

The words of cl.27 carefully avoid the use of any phrase that would restrict the method of valuation to market value. It is not worded in terms of 'arm's length prices', a phrase which may indicate an intention to restrict the method of valuation to market value. Instead, the value required by the provision is expressed as a 'price' that is 'reasonable judged on an arm's length basis'. The words 'reasonable judged on an arm's length basis' describe the price in terms of hypothetical standard against which the value can be measured.

A hypothetical or supposed standard contrasts with a known standard. Market value described in terms of quoted prices is a known standard. But as Ford says real value is described in terms of a hypothetical standard, namely the willing vendor and willing buyer:

> Whether or not there is an actual market the approach in applying the real value standard is broadly the same as that used in determining compensation to be paid for the compulsory acquisition of property.[39] The court seeks the price which a hypothetical willing but not anxious vendor could reasonably expect to obtain and a hypothetical willing but not anxious purchaser could reasonably expect to have to pay for the property if the vendor and purchaser had got together and agreed on a price in friendly negotiation.[40]

Where property is being bought and sold in a market there is usually no difficulty in determining its real value because it is almost invariably the market value.[41] Market value is a matter of evidence, which persons conversant with the market may prove in testimony.[42] This is true also when the market is a foreign market, for:

> there is only one way of ascertaining what is the fair market value of goods in a foreign country in the usual and ordinary acceptation of the term, and that is by the evidence of experts. They know, and they only.[43]

In the context of cl.27, prices quoted on the world's metal markets would *prima facie* reflect market value, and notwithstanding anything to the contrary, would apply to an approval given under the clause. But cl.27 may well apply to mining products with quoted posted prices which do not reflect real value. If a market is the subject of price fixing

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39. Ford *op.cit.* 347 cites *Commissioner of Succession Duties* (S.A.) v. *Executor Trustee and Agency Co. of South Australia Ltd.* (1947) 74 C.L.R. 358,361.

40. *Abrahams* v. *Federal Commissioner of Taxation* (1944) 70 C.L.R. 23, 29: cited in Ford *op.cit.* 347.

41. *Commissioner of Succession Duties* v. *Executor Trustee and Agency Co. of S.A.* (1947) 74 C.L.R. 358, 361 per Latham C.J. Rich and Williams J.J.

42. *Phipson on Evidence* (11th ed.; 1970, by J.H. Buzzard, R.D. Amlot, S. Mitchell) para. 1288.

43. *Goldring* v. *Lockyer* (1904) 4 S.R. (N.S.W.) 276, 278. per Darley C.J., Owen and G.B. Simpson JJ.

by a cartel or oligopoly, the market prices cannot be evidence of the real value of the commodity quoted, because price fixing negates the free interaction of market forces and the fixed prices merely reflect some artificial value that the parties to the arrangement seek to put on the commodity.[44] The situation is analogous to the value for the purposes of damages, put on shares purchased as a result of a fraudulent prospectus. The English High Court in these circumstances had made clear the differentiation between real and market value. It said:

> No doubt, if the shares were really worth anything when bought, the defendants ought to have credit for what they are really worth. But the fact that they were quoted at a premium on the Stock Exchange is only evidence of value, not proof of it; and, if the jury thought (as well they might, and probably did) that the quotation on the Stock Exchange did not show a real, but only a delusive value caused by the fraudulent nature of the prospectus and the mode in which the shares were manipulated by the defendants and others in concert with them, the jury were not only justified in disregarding, but were bound to disregard, such delusive and fictitious value....[45]

Dixon J. approved this statement in *Potts* v. *Miller*,[46] and Williams J. of the Australian High Court followed Sir Owen Dixon, in *McCarthie* v. *Federal Commissioner of Taxation*[47] and created the rule in valuation for estate duty purposes that 'the market value is not always the same as the real value'.[48] To summarise the argument: the phrase 'prices which are reasonable judged on an arm's length basis' does not specifically exclude prices which reflect real value. Nor is it drafted in such a way as to refer only to market value. But it is drafted using a hypothetical standard which is a device for indicating real value.

A further observation can be made to support real value as the criterion in the clause. The royalty clause, cl.24, provides for mine products to be valued in terms of real value.[49] The royalty is to be paid on the whole of the consideration receivable by the Company. But if the consideration 'is not a consideration which would be receivable

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44. 'Where the commodity in question has a world market and quoted market prices are available at different stages in the process of production and distribution, these prices offer the best possible basis for pricing goods passing between inter-connected companies' *Case No. N69* 13 T.B.R.D. 276, 286.

45. *Twycross* v. *Grant* [1877] 2 C.P.D. 469, 489 *per* Lord Coleridge C.J. Grove and Lindley, JJ. affirmed on appeal (Cockburn C.J., Bramwell and Brett JJ., Kelly C.J. dissenting).

46. (1940) 64 C.L.R. 282, 299.

47. (1944) 69 C.L.R. 1,6.

48. Ford, *op.cit.* 349.

49. The text of cl.24, so far as it is relevant, is set out in Appendix A.

by a willing seller from a willing buyer' then the royalty is to be paid upon the weighted average of consideration received over a sixty day period prior to the relevant delivery. This clause is potentially inconsistent with cl.27. The royalty clause is clearly in terms of real value. Clause 27 is only arguably in terms of real value. If, however cl.27 determined market value, and the market value was not the same as the real value, the clause would be inconsistent. On this basis the government could approve a price under cl.27 at market value, but impose a royalty at real value. This potential inconsistency leads to the conclusion that both clauses are in terms of real value.

The word 'price' in the clause is qualified by the word 'reasonable'. Latham C.J. in *Opera House Investment Pty. Ltd.* v. *Devon Buildings Pty. Ltd.* said:

> The word 'reasonable' has often been declared to mean 'reasonable in all the circumstances of the case'. The real question, in my opinion is to determine what circumstances are relevant. In determining this question regard must be paid to the nature of the transaction.[50]

Although that was a case turning on the words 'such .... interest as the lessor may reasonably contract to pay the said monies', the approach is the same as a consideration of the items to be taken into account when estimating the value of shares not listed on the stock market - some items will be relevant and others irrelevant. For example, the earning power of shares, rather than the value of the capital assets in which the shareholder's money is invested, is a better guide to the real value of the shares, because generally a purchaser does not buy shares in a going company to wind it up.[51]

Clause 27 would require relevancy to be determined in terms of the mining, the sale, and refining of mine products. The remaining qualification in the term, 'prices which are reasonable', would also influence the issue of reasonableness.

The qualification on 'reasonable' by the words 'judged on an arm's length basis' limits the reasonableness of a price. It is therefore necessary to discuss the concepts of 'reasonableness' and 'arm's length' together.

In section VI it was stated that in a modern statute the term 'arm's length' described parties 'when each stands upon the strict letter of his rights, and conducts the business in a formal manner, without trusting the other's fairness or integrity and without being subject to the other's control or overmastering influence'.[52] The use of this definition in cl.27 means that approval would not be unreasonably withheld if the sale's contract contained prices which were reasonable, judged on the basis that the parties were both competent and free to promote their own interests, and that they acted without the effect of

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50. (1936) 55 C.L.R. 110, 116.

51. *Commissioner of Succession Duties (S.A.)* v. *Executor Trustee and Agency Co. of South Australia* (1947) 74 C.L.R. 358, 362.

52. *Morgan Stanley and Co.* v. *The Securities Exchange Commission* 126 F. 2nd 325, 335, (2nd Cir. 1942), see above, footnote 33.

either control or overmastering influence between them. The inference in this statement is that reasonable prices may be different from arm's length prices. The United States Court of Appeal has held this to be so in *United States Gypsum Company* v. *United States*.[53] In that case a District Court, administering an arm's length standard in a tax statute, came to the conclusion that the parties to one of the taxpayer's transactions were not independent of one another. Nevertheless, the District Court held that the prices charged by the taxpayer were arm's length prices, because in the circumstances they were reasonable. On appeal, the United States Court of Appeal said:

> It appears from the opinion of the district court .... that consideration of the evidence virtually persuaded the district court that U.S.G's prices to Export were substantially lower than the prices which would have been arrived at by unrelated parties dealing at arm's length. Certain decisions, listed in the opinion, however led the district court to find that "the distribution of income between U.S.G. and Export was not unreasonable and clearly reflects the income of both taxpayers". We do not consider the cited cases helpful in deciding whether, as a matter of fact, U.S.G's prices to Export were the same as would have been reached in arm's length dealing. In so far as these cases support a proposition that there may be "reasonable" prices, different from those which would have been reached in arm's length dealing, which will result in clearly reflecting the income of controlled taxpayers, we respectfully decline to follow them. We approve the District Court's statements indicating that the U.S.G. prices were not arm's length prices, and conclude that the ultimate finding was clearly erroneous.[54]

The discussion above, has identified rules that arise from the words of cl.27. These rules can now be summarised. The words 'prices which are reasonable judged on an arm's length basis' indicated that the price in a sales contract should be valued according to the real value of the mine product. Where *bona fide* quoted market prices exist these will indicate the real value. Where such prices are absent, there is no specific direction in the clause describing the method of valuation to be adopted. The words used refer only to a general hypothetical standard for ascertaining real value. In this respect the clause is deficient as there are various methods of valuation available.

These conclusions will now be compared with rules described in *Case No. N69*.[55] The law in that case indicates that market prices, where they exist, should be used. But where no quoted market prices exist, the Commissioner should try to construct a hypothetical market value 'by adding to the cost of production an allowance for production or manufacturing profit, such allowance being made by fixing a reasonable rate of return on investment in production facilities or by fixing some percentage on cost of production'.[56] Prices fixed in these calculations

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53. 454 F. 2nd 445. (7th Cir. 1971).

54. *Id.* 449.

55. (1962) 13 T.B.R.D. 270, 286.

56. *Ibid.*

have to reflect some standard of reasonableness, but they are not bound by the statute to be judged reasonable upon an arm's length basis. If the industry is prone to collusiveness and collective action it may well be that what is a reasonable rate of return, or a reasonable percentage on cost of production has no connection with prices that would occur if the market were allowed to operate freely. These remarks apply equally to calculations based upon empirical methods, fractional apportionment, or percentage turnover.[57]

What is the difference in concept between the method of valuation under cl.27, and that under s.136 of the *Income Tax Assessment Act?* Providing *bona fide* quoted market prices are available there is no difference. But if *bona fide* market prices do not exist, cl.27 requires a valuation based upon a hypothetical standard. The case law on s.136 suggests several known methods of valuation to guide the Commissioner. The consequence of the difference is that the approach under s.136 has some certainty about it, while cl.27 is uncertain if the real value has to be determined in the absence of market prices.

The pricing policy of the government was accounced in the *Statement of Intent*. The government said in its statement that 'sales revenues must reflect the full proceeds that would have flowed from arm's length commercial transactions'.[58] The *Ok Tedi Agreement*, at cl.23, embodies this policy. The policy is vague insofar as it applies to prices that cannot be compared with a market standard. Clause 27 reflects the same type of vagueness. As they presently stand, both the policy and the legislation need to be remedied.

VIII. *Conclusion.*

The remaining issue in this article concerns the question of how a government should protect its mining revenue from the consequences of transfer pricing. Should the protection be provided through a taxation provision like section 197 of the *Income Tax Act*, or by price control as in cl.27 of the *Ok Tedi Agreement*, or is some amalgamation needed?

The experience with the taxation provision is that it operates indirectly. It is a provision demanding self-regulation by the taxpayer rather than active intervention by the Chief Collector of Taxes. The Collector's power is activated after certain threshold conditions have been met, occurring as an exception, rather than as the rule. In Australia this has resulted in few cases under section 136 of the *Income Tax Assessment Act* reaching the law reports. In the United States empirical studies have shown that section 482 of the *Internal Revenue Code*, which is similar to section 136 in nature, regulates international business by its implicit threat of double taxation should the rules be disobeyed.[59]

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57. *Ibid.*

58. Government of Papua New Guinea, Statement of Intent, 'Financial Policies Relating to Mining and Mining Tax Legislation' (June 1977) 13.

59. G.L. Madere. 'International Pricing : Allocation Guidelines and Relief from Double Taxation' (1975) 10 *Texas Int. L.J.* 108, 109-111.

Under the price control model of cl.27 of the *Ok Tedi Agreement*, in the absence of *bona fide* world market prices, the arm's length standard describes the demeanour of parties in a theoretical market. This device is conceptually difficult and known to be inadequate. La Mont described this difficulty in a discussion of section 482 of the United States *Internal Revenue Code*. The regulations made under section 482 use the arm's length criterion. La Mont said:

> Another variable which can cause vexing problems is the degree of integration of a M.N.F. [Multinational Firm]. If vertical integration is pronounced, transfers among members of the affiliated group often may involve unfinished goods or component parts for which data on comparable sales may be unavailable. As a result, it may be impossible to establish one price as that rationally compelled by an optimal pricing system. One commentator has noted:
>
> > "Some products and services can be priced objectively because they have an open market. But many of the products and services passing between parent and subsidiary do not. In this case wherever there is a fixed cost from which several different entities benefit the ancient and insoluble struggle over cost and allocation rears its head generating unavoidable arbitrary response".[60]
>
> The arm's length standard of section 482, however appears to ignore this problem.[61]

Madere also referred to the problem. He said:

> Precise application of the arm's length standard is possible only where there are sales of identical or nearly identical property between unrelated parties under circumstances identical or nearly identical to those surrounding the controlled sales in question. Unfortunately such reference sales are frequently lacking. Not only do such variables as time, location, quality of product, level of the market, and intangible property associated with the sales affect price, but relationships between associated. enterprises may be so deeply intertwined that unrelated parties simply would not have entered into similar arrangements.[62]

In the light of these criticisms what motivated Papua New Guinea to incorporate the arm's length criterion into the *Ok Tedi Agreement*, and appears to be motivating its use in proposed general mining legislation? The answer seems to be because 'arm's length' is used

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60. Quoted from R. Vernon *Sovereignty at Bay* (Pelican ed. 1971).

61. H. La Mont, 'Multinational Enterprise, Transfer Pricing and the 482 Mess' (1975) 14 *Columbia J. Trans. Law* 383, 392.

62. Madere *op.cit.* 114.

internationally, in the taxation agreements between nations, there are known as the Tax Treaties.[63] Papua New Guinea's choice is a matter of international comity.

It is not an easy choice to make. Should Papua New Guinea abide by the comity of nations putting her faith in something which is defective, or should she forsake current international practice, and adopt a criterion which is workable?

It is not enough to condemn a method of controlling business behaviour without providing an alternative. But a consideration of alternatives is a consideration of what the law ought to be, and not only a matter of legal analysis. The nature of the particular problem raised is economic; a matter of business accounting practice. It is a matter which should be approached by a lawyer, cautiously.

My view is that alternatives to the present arm's length criterion should not involve a substantial departure from its component: market value. There are two reasons why I do not think market value should be abandoned. The first is that despite efforts to control or contain them, market forces dominate decision-making in business. Secondly, this domination is recognised internationally by the adherence to the arm's length concept in the tax treaties.

Australian and United States legal authorities and statutes indicate a preference for a particular approach to this problem.

In Australia section 136 of the *Income Tax Assessment Act* has been construed in terms of market value. In *Case No. N69* the Board of Review suggested that in circumstances where there were no quoted market prices the Commissioner should construct a hypothetical market value of the commodity. This value should be ascertained by 'adding to the cost of production an allowance for production or manufacturing profit, such allowance being made by fixing a reasonable rate of return on the investment in production facilities or by fixing some percentage on cost of production'.[64]

In the United States the Regulations made under section 482 of the Internal Revenue Code[65] use the arm's length criterion to reflect market values. Under the Regulations[66] there are four alternatives that may be used in determining an arm's length price. The alternatives have been discussed in detailed by La Mont[67] and I intend only to summarise what he has said.

The first option provided in the Regulations is called the Comparable Uncontrolled Price Method.[68] This option has no relevance

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63. For example, see the Agreement between Australia and the United Kingdom to be found in the Australian *Income Tax (International Agreement) Act* 1953-76. The First Schedule to the Act, Article 7.

64. (1962) 13 T.B.R.D. 270, 286.

65. *Internal Revenue Code of 1954*. (U.S.) 482, 26 U.S.C. 482 (1970).

66. *Treasury Regulations* (U.S.) 1. 482-2 (1969).

67. La Mont *op.cit.* 393-405.

68. *Treasury Regulations* (U.S.) 1. 482-2(c)(1)(ii)(1969).

to the problem under discussion, because it fixes an arm's length price by comparing the sales of the taxpayer with comparable sales of third parties. It is a provision that contemplates the existence of comparable sales and therefore is of limited applicability where market prices are absent. La Mont also suggested that the Comparable Uncontrolled Price Method is applied most easily to sales involving finished products.[69] He reasons that unfinished products have only limited comparability, depending upon the degree to which they have been processed or manufactured.

The second option described in the Regulations is called the Resale Price Method.[70] Under this option the arm's length price of a sale is calculated by subtracting from the actual resale price of a commodity an appropriate mark up. La Mont comments that this method is of particular relevance to the sales of distributorships, sales subsidiaries and trading corporations. In a situation like mining, where significant value is added to the unprocessed mineral by a subsidiary, this option is inappropriate as a method of valuing the sale to the subsidiary.[71]

The third option provided under the Regulations is called the Cost Plus Method. The calculation of an arm's length price here is computed 'by adding to the cost of producing such property .... an amount which is equal to such cost multiplied by the appropriate gross profit percentage'.[72] The two components of this calculation give rise to separate problems. First, as La Mont points out, there is a wide range of approaches and definitions used by companies in determining costs.[73] A uniform costing method is difficult to ascertain. But the section 482 Regulations apply to the full spectrum of business activity. They were not designed to meet the needs of a particular industry like mining. Similarly, appropriate gross profit percentages calculated for an industry may be inapplicable to a particular production process.[74] But large mining projects may have such an impact upon a country's economy as to warrant the fixing of individual gross profit margins.

The fourth option available under the Regulations allows for the use of 'some appropriate method of pricing other than those described ....'[75] The amorphous nature of this option encourages pricing based on profit splits and other empirical methods. Whether a method is appropriate depends upon expert testimony. This is then an option which reduces the predictability of litigation because it lacks a rule by which issues may be determined. It is an option that is weighed in favour of international companies, with access to information and experts. It is not an option favourable to a small Third World country.

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69. La Mont *op.cit.*395.

70. *Treasury Regulations* (U.S.) 1.482-2(e)(3)(i)(1972).

71. La Mont *op.cit.* 397.

72. *Treasury Regulations* (U.S.) 482-2(e)(4)(i)(1972).

73. La Mont *op.cit.* 399.

74. La Mont *op.cit.* 401.

75. *Treasury Regulations* (U.S.) 1.482-2(e)(1)(iii)(1972).

The cost plus method of determining a fair market value where market prices are unavailable is a viable option to the present arm's length pricing formulation.

Cost information of a mine would be available from the accounting records of the company, and would be accessible to the tax authorities. There may be need to define what are appropriate costs. The mark up based upon a reasonable rate of return is a concept familiar to Papua New Guinea mining policy.[76] A reasonable rate of return has already been fixed for the petroleum industry.[77] The concept of minimum expected rates of return is well known within the mining industry and is used in making investment decisions.[78]

In comparison, price control operates directly, enabling the revenue from mining to be better protected, because approval is considered before any large sale of ore takes place. Administratively this is possible as the number of taxpayers involved in mining and petroleum projects is small, and the amount of revenue large.

Because section 197 of the *Income Tax Act* includes an administrative discretion, it has unnecessary legal ramifications. Such discretions are supervised by the courts and subject to a copious body of case law. Additionally, discretions under the *Income Tax Act* are reviewable *de novo* by a Review Tribunal. There is in the provision sufficient elasticity permitting a determined tax evader room to manoeuvre. It is my view that in the case of large mining activities the economic circumstances of Papua New Guinea make such permissiveness unwise.

While I would appear to support the direct control of pricing rather than indirect regulation by taxation measures, both formulations as they presently stand are substantially defective in crucial matters of their application. Pricing regulation is important in circumstances where there are no *bona fide* world market prices. These are the very circumstances that provide the greatest opportunity for pricing disputes to arise, and it is here that both models are weak.

The substantial defect of section 197 of the *Income Tax Act* is that it provides no statutory guidance at all to the Chief Collector in his determination of a price. This is inappropriate because the courts demand that the Collector act lawfully in the exercise of his discretion. The law tells the Collector what he cannot do, but omits to instruct him in any positive manner on the exercise of his discretion.

At the beginning of this section I questioned whether a government should protect its mining revenue from transfer pricing, by a provision like section 197 of the *Income Tax Act* or a price control device as in cl.27 of the *Ok Tedi Agreement*, or whether some amalgamation was needed. The discussion has shown the inadequacies of section 197. It has also indicated a need to clarify the arm's length

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76. Papua New Guinea Government, 'Financial Policies Relating to Mining and Mining Tax Legislation'. (June 1977) 14.

77. Papua New Guinea, 'Government Statement on Petroleum Policy and Legislation' (March 1977) 15.

78. R.F. Mikesell, *Foreign Investment in Copper Mining* (1976) 5-6, 17.

standard in cl.27. My view is that both provisions need rephrasing, so that they may complement one another.

The prime protection to revenue from mining must come from the price control device, because it operates first in time. Under normal circumstances prices so fixed should bind the Chief Collector of Taxes. But where there are no *bona fide* quoted market prices, the Collector should retain his section 197 discretion, albeit in a modified form. In so far as it relates to mining, a modified section 197 should contain clear directions to the Collector. These directions should indicate a pricing standard based upon quoted market prices that have been approved by the government. In the absence of quoted market prices, any government approval should not be binding on the Collector for the purposes of taxation. A new section should contain a cost plus formulation to guide the Collector in these circumstances. The cost plus formulation should be similar to that discussed in this section, and apply when government approval had been granted, as a result of a mistake or fraud, or upon prices which had been fixed by collusion.

Price control criteria should be in similar terms to those applicable to the Chief Collector of Taxes. In the present price control provision the words 'arm's length' are old fashioned and metaphorical. At least these words should be replaced with words that are descriptive, for example 'trading between independent parties'.[79] But preferably a new provision should be phrased in terms of actual market prices, where they exist. For instance, where they do not exist, a cost plus formulation should be used.

It may be objected that proposals such as these will frighten away mining investment. This is most unlikely. A cost plus formulation guards the lower limits of pricing arrangements. It prevents a company selling short its products. Most mining companies sell their ore on the world market at market prices. It is an exception to the rule to sell at prices which are not quoted on say the London Metal Exchange. Mining operations that do involve sales at prices not subject to open quotation need special attention because of the potential impact upon the Papua New Guinea economy of profits earned in that country being taxed elsewhere. Such projects must be assessed in terms of Papua New Guinea's policy on the place of mining in economic development. That policy promotes mining solely because of its revenue earning capacity.[80] If the income base of the industry is not guarded, the revenue may be diminished, and the policy subverted.

Because of the large capital sums involved it is unlikely that a mining company would enter into a project in Papua New Guinea, with anything less than a proper pricing policy. The political risks of being caught perpetrating a pricing indiscretion are considerable in Third World countries. But the circumstances of a well planned project could alter to such an extent that a company may be tempted to make the best of its pricing practices. Anomalies of this nature can be foreseen and should be regulated.

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79. A similar phrase is used in the 1963 O.E.C.D. Draft Tax Treaty. See O.E.C.D., Report of the O.E.C.D. Fiscal Committee 'Draft Double Taxation Convention on Income and Capital' (1963) 47: quoted in full by La Mont *op.cit.* 442.

80. Papua New Guinea, National Planning Committee of the Central Planning Office, 'The Post Independence Development Strategy' (27 October 1976), 16.

APPENDIX A.

EXTRACTS FROM CLAUSE 24 ROYALTY. *MINING (OK TEDI AGREEMENT) ACT* 1976. (P.N.G.)

24.2 The Company shall pay royalty at the rate of one and one quarter per cent (1¼%) of the sum of -

(a) the F.O.B. Revenue applicable to deliveries by the Company pursuant to sales or other dispositions made by the Company of Mine Products where such deliveries are directly or indirectly for export; and

(b) the Net Smelter Returns ...

24.1 In this Clause:

'F.O.B. Revenue' means -

(a) in the case of a delivery of .... Mine Products which is made pursuant to a sale by the Company other than sale to which paragraph (b) of this definition applies the whole of the consideration receivable by the Company there fore less all or any costs ...

(b) in the case of any delivery of any Mine Products which is made pursuant to a sale by the Company for a consideration which is not a consideration which would be receivable by a willing seller from a willing buyer or which is made pursuant to a disposition by the Company otherwise than by a way of sale, an amount equal to the weighted average of the whole of the considerations receivable ... during the period of sixty days immediately preceding the relevant delivery ... etc. ...

APPENDIX B

Commonwealth of Australia

ADMINISTRATIVE DECISIONS (JUDICIAL REVIEW) ACT 1977.

(extract from section 5).

5. (1) A person who is aggrieved by a decision to which this Act applies that is made after the commencement of this Act may apply to the Court for an order or review in respect of the decision on any one or more of the following grounds:

(a) that a breach of the rules of natural justice occurred in connection with the making of the decisions;

(b) that procedures that were required by law to be observed in connection with the making of the decision were not observed;

(c) that persons who purported to make the decision did not have jurisdiction to make the decision;

(d) that the decision was not authorised by the enactment in pursuance of which it was purported to be made;

(e) that the making of the decision was an improper exercise of the power conferred by the enactment in pursuance of which it was purported to be made;

(f) that the decision involved an error of law, whether or not the error appears on the record of the decision;

(g) that the decision was induced or affected by fraud;

(h) that there was no evidence or other material to justify the making of the decision;

(j) that the decision was otherwise contrary to law.

(2) The reference in paragraph (1)(e) to an improper exercise of a power shall be construed as including a reference to:

(a) taking an irrelevant consideration into account in the exercise of a power;

(b) failing to take a relevant consideration into account in the exercise of a power;

(c) an exercise of a power for a purpose other than a purpose for which the power is conferred;

(d) an exercise of a discretionary power in bad faith;

(e) an exercise of a personal discretionary power at the direction or behest of another person;

(f) an exercise of a discretionary power in accordance with a rule or policy without regard to the merits of the particular case;

(g) an exercise of a power that is so unreasonable that no reasonable person could have so exercised the power;

(h) an exercise of a power in such a way that the result of the exercise of the power is uncertain; and

(i) any other exercise of power in a way that constitutes abuse of the power.

APPENDIX C

CLAUSE 27 MARKETING AND CONTRACTS *MINING (OK TEDI AGREEMENT) ACT* 1976 (P.N.G.)

Clause 27 Marketing and Contracts.

27.1 The Company shall be responsible for marketing of all Mine Products and all smelter and refinery products derived by the Company from such Mine Products, shall have sole control and management of sales of such Mine Products and products and shall assume all risks therefor, provided that:

(a) *the Company shall sell its products at prices which are reasonable judged on an arm's length basis in a transaction confined to the products of the Company* or otherwise with the approval of the State subject only to normal deductions for shipping, smelting and refining, and other realisation costs; and

(b) all sales contracts in excess of 25,000 tonnes of Mine Products will be submitted to the State for prior approval, and all other sales contracts (whether they relate to ores, concentrates or smelter or refinery products) other than sales of gold on normal market terms will be submitted to the State within thirty days of execution. Approval where required will be given within 14 days and will not be unreasonably withheld in the case of a contract at prices which are reasonable judged on an arm's length basis in a transaction confined to the products of the Company nor be revoked or varied unless the National Executive Council shall determine that the export of any goods could:

(i) breach any obligation of the State arising under international law; or

(ii) prejudice national security; or

(iii) prejudice the international relations of the State by the export of goods to another State with which it may be contrary to the interests of the State to engage in international trading.

(emphasis added by writer).