Transfer pricing in the Australian aluminium industry

By Gregory John Crough

Since the Second World War the expansion of capital has accelerated and profoundly transformed the world economy and international politics.

In this article G J Crough looks at transfer pricing, one of the most important methods used by the TNCs to safeguard and extend their global power.

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Introduction

Probably the single most important method of tax avoidance is by transfer pricing, which enables transnational corporations to maximize global profit, and minimize global tax; the prices of internal corporate transactions which straddle different countries are manipulated so that profits are 'shunted' to, or made to appear in, countries with low taxation rates, and vice versa.

This practice is described by the Organization for Economic Cooperation and Development (OECD), 'the rich countries club' whose members own and control most of the world's transnationals, in the following language:

> "In a multinational enterprise, many transactions normally take place between members of the group – sales of goods, the provision of services, the licensing of patents and know-how, the granting of loans and so on. The prices charged for such transfers do not necessarily represent a result of the free play of market forces, but may, for a number of reasons and because the multinational enterprise is in a position to adopt whatever principal is convenient to it as a group, diverge considerably from the prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market."[1]

It is clear that intra-corporate transactions now represent a very considerable proportion of world trade. Evidence compiled in a recent United Nations Conference on Trade and Development (UNCTAD) report showed that possibly 30–40 per cent of all international trade is on an intra-corporate or related-party basis, that another 30 per cent is likely to constitute State trading, that a further share of international trade is captive in nature as a result of sub-contracting or long-term and medium-term contractuel arrangements. The report observed that in the light of this data and the vast array of other formal and informal links between the major international trading organizations, "it is apparent that the concept of a freely competitive international trading market is illusory."[2]

The scale of these intra-corporate transactions, and the extent of the involvement of transnational corporations and large international trading organizations in world trade, clearly gives tremendous scope for the manipulation of prices, with the resultant effect on profits and hence on both taxable income and national income. Under-pricing of exports will reduce the profits of the exporting company and its taxable income, as well as reducing the foreign exchange income to the exporting country; conversely, the over-pricing of imports will increase the import bill of the country concerned, in terms of foreign exchange, reduce the profits of the importing company, and hence its taxable income.

Consequently manipulation by transfer pricing can affect not only profits and taxable capacity, but also the balance of payments, and hence the real income of entire countries, as is made abundantly clear in the work of Constantine Vaitsos, *Intercountry Income Distribution and Transnational Enterprises.*[3]

It is important, at the outset, to remember that the effects of transnational corporations on foreign trade, payments and debts should be examined in their totality, and not simply in terms of the cash flows of foreign capital, or the restrictions on trade and payments caused by international cartels and transfer pricing. Such a study was published by the United Nations Centre on Transnational Corporations in 1981. This study concluded, in typical UN fashion, that there is no enough hard information to be *absolutely* sure of the effects because so much of world trade is now trade between different branches of global corporations which tend not to inform anybody about it. It is pretty

The Weipa bauxite deposit in Queensland is one of the richest in the world. It is exploted by two leading transnational corporations Rio Tinto-Zinc based in Great Britain and Kaiser Aluminum based in the US.

clear, however, that transnational investment benefits the investing country more than the host country in terms of foreign exchange, primarily because it increases the exports of the former into the latter; global decisions are taken without much regard to the effects on particular host countries; large-scale transnational capital movements destabilize host-country economies; and traditional methods of control are futile – new and more industry-specific methods must be found.[4]

Transfer Pricing in Australia

The actual extent of transfer pricing in most countries is very difficult to estimate, since very few reliable statistics are collected. This is particularly so in Australia, where the conservative Liberal-National Country Party Government has closed down most sections of the Australian Bureau of Statistics which collected foreign ownership and control statistics. Given the very high levels of foreign control of Australian industries and resources and the extensive involvement of transnationals in Australia's international trade transactions, the potential for transfer pricing is very great indeed.

The possible consequences on taxable income, the balance of payments and national income can be illustrated by reference to two examples of the practice which received a considerable amount of publicity in 1981–82; both cases relate to the Australian bauxite/aluminium industry.

The first involves Australia's largest aluminium corporation, Comalco Ltd and its subsidiary Commonwealth Aluminium Corporation Ltd. Comalco is owned by two of the largest mineral corporations in the world, Rio Tinto-Zinc Corporation Ltd (UK) and Kaiser Aluminium and Chemical Corporation (US), each of which holds 45 per cent of the shares. It is one of the largest corporate groupings in Australia, with assets of 1,263 M AUD and revenues of 720 M AUD.

Transfer pricing, because it is internal to the corporation concerned, is normally difficult to discover. But as a legal case regarding Comalco was fought in the High Court of Australia a great deal of information on the corporation's practices was produced.

The Commissioner of Taxation argued that the pricing practices of the Commonwealth Aluminium Corporation in selling bauxite mined at Weipa in Queensland to Japan resulted in a lower profit for the company in Australia, and hence a lower taxable income. As a result, the Commissioner used Section 136 of the Income Tax Assessment Act to reassess the company's taxable income and to require it to pay more tax in Australia. The technique used by the company has been summarised by one of the High Court judges:

> "During the tax years in question (1967–71) a substantial part of the taxpayer's product, bauxite, was shipped directly to Japan to two Japanese companies (Showa Denko and Sumitomo Chemical) although it had been sold to a Hong Kong company, Comalco Bauxite Ltd (HK), 52 per cent of which is owned by Comalco and 48 per cent by the two Japanese companies. The Hong Kong company was intended to and did relatively little except for book entries. There was no physical delivery to it. It simply purchased the bauxite from the taxpayer, for example, at 33 shillings per ton, and sold it to the Japanese companies at 40 shillings per ton."[5]

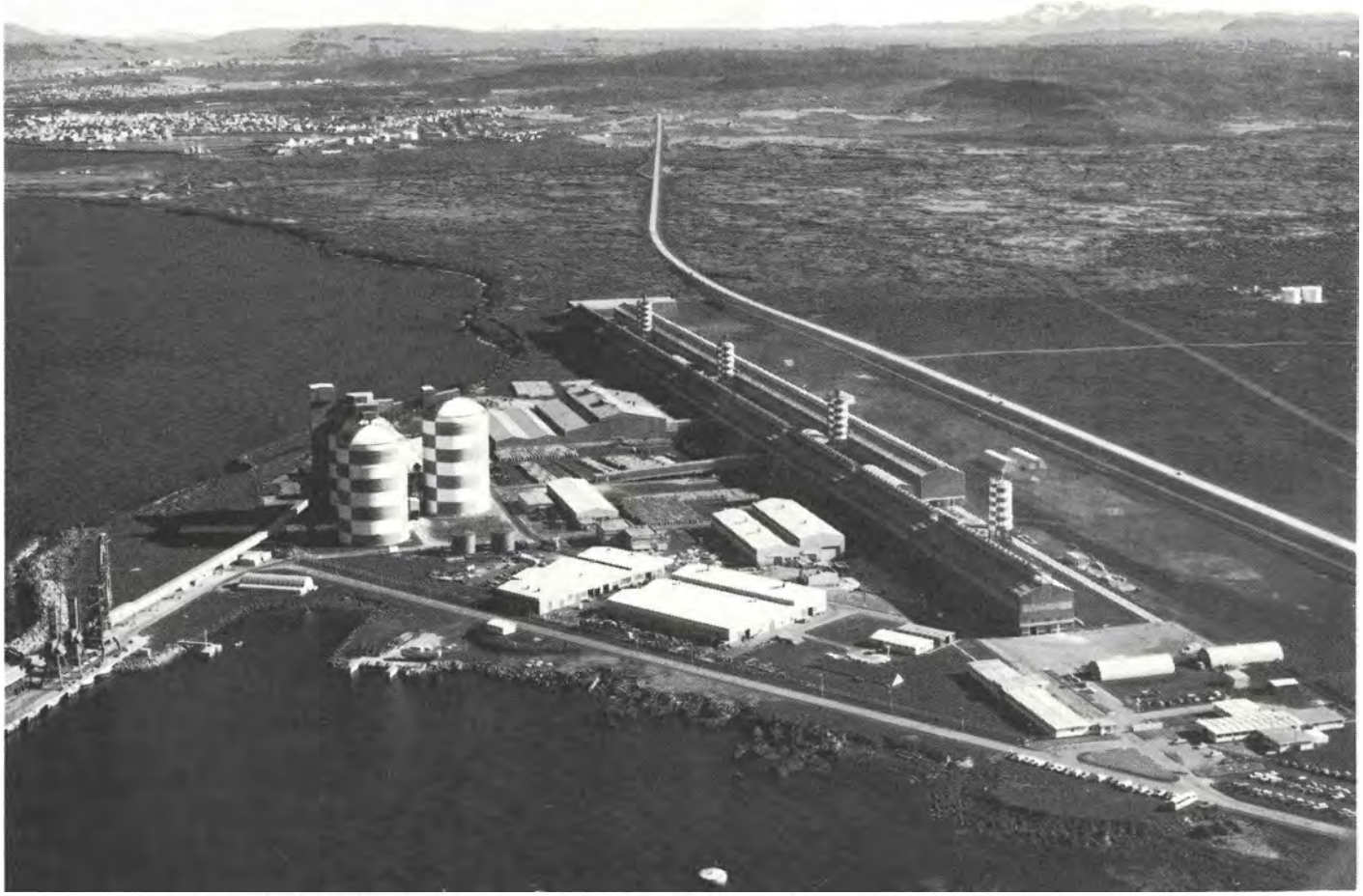
At the time the taxation rate in Hong Kong was 12,5 per cent, while in Australia it was 46 per cent, so that any profits made in Hong Kong would be taxed at a much lower rate. The additional taxable income in dispute in this case was well over 2 M AUD.

As the Chairman of the Taxation Board of Review noted:

> "I am unable to detect any business exigency which so far as the taxpayer itself was concerned required the interposition of a company between it and the Japanese customers. Moreover, the decision to supply the Hong Kong company with bauxite at 33 shillings per ton was one which was voluntarily undertaken and which in my view operated to the detriment of the taxpayer and to the advantage of its parent. I am of the opinion that the taxpayer got less for its bauxite that went to Japan than might be expected, and that in consequence the amount of taxable income which arose from the taxpayer's business was also less than might be expected."[6]

Apart from this being a clear example of the use of transfer pricing by a transnational corporation, it also illustrates the use of tax havens scattered around the world where taxation rates are either very low or non-existent. As one of the chief executives of Comalco wrote in a letter to the Sumitomo Chemical Company:

> "Comalco has selected Hong Kong as the location of the sales company as the Hong Kong corporation tax, at 12,5 per cent, is very much lower than the corporation taxes in either Australia or Japan and taxes



> on the profits to be shared can thus be minimized to the mutual benefit of both Comalco and the Japanese participating companies."[7]

These tax havens are now used extensively by thousands of corporations, as places where profits can be shunted by transfer pricing to reduce world-wide taxation payments. Australian companies are increasingly using these havens, particularly those in the Asian-Pacific region, Hong Kong, Singapore, and Vanuatu. In this particular case, the sales by Commonwealth Aluminium Corporation of bauxite to the Hong Kong company represented about 25 per cent of CAC's total sales in the period 1966–74, or over 10 million tons.

Tax havens, however, are not essential to transfer pricing, as a second example shows. This relates to exports of alumina from Gove in the Northern Territory to Iceland, by the subsidiary of the Alusuisse company. There is now clear evidence that the price at which the alumina was imported into Iceland was considerably higher than the recorded export price from Australia. This meant that the Alusuisse subsidiary in Australia reported lower profits (since its sale price was lower) and the Alusuisse-owned smelter in Iceland also reported lower profits (because it was paying higher prices for the imported alumina).

Such a matter is particularly critical for a country such as Iceland, which has a population of only 230,000; the smelter is the largest foreign entity there, using 45 per cent of all electricity generated in the country, although it pays less than 10 per cent of the country's total electricity bill.

As the table below indicates, the Government of Iceland found an unexplained discrepancy of 47.5 M USD which the Government referred to as an 'increase at sea'. For the period 1971–79 the smelter company in Iceland reported a total loss of over 8 M USD while the alumina exporting company in Australia, Swiss Aluminium Ltd recorded a trading surplus of 122 M AUD during 1972–79, but appears to have paid negligible tax.

This experience introduces an intriguing new category into the economist's lexicon, the concept of 'value added at sea'; presumably like wine, alumina matures during the long sea voyage and is worth much more when it reaches its destination (!). The Government of Iceland was so determined to investigate this 'space-age alchemy' that it sent an official to Australia to ascertain the value of the cargo when it left Australia, and engaged the services of the auditing firm Coopers and Lybrand to explain the discrepancy. They found that about half the mysterious 'floating value' could be explained by costs paid in arrears and 'faulty documentation', but there was still a discrepancy of around 25 M USD. Thus the peculiar behaviour of alumina while at sea deprived both governments of taxation revenue, Australia experienced a loss of foreign exchange revenue due to undervalued exports, and Iceland had to pay more foreign exchange because of overvalued imports. The Government of Iceland has taken steps to recover its lost revenue, but to date the Government of Australia has done nothing.

Other Tax Avoidance Techniques

Apart from transfer pricing, there is a wide variety of other techniques that corporations can use to reduce their taxation payments, and there is no doubt that tax avoidance and evasion has become a major business in Australia. A report published by the Australian Senate Standing Committee on National Resources, the *Development of the Bauxite, Alumina and Aluminium Industries,* in 1981, documents the ability of the companies in the industry to engage in transfer pricing to avoid taxation payments. It also calls for a review of the provisions applying to the tax deducibility of capital expenditure in order to remove the possibility of their being used primarily to avoid taxation liability in the mining industry. The Australian Treasury, in its submission to the Committee, notes that through the

The Alusuisse smelter in Iceland, where alumina from the company's bauxite mines in Gove, Australia is refined.

use of 'thin' capitalization (since interest payments are tax deductible there is an incentive for companies to reduce the amount of equity funding and increase their borrowings), cost-toll companies (an example of this is the Queensland Alumina Ltd alumina refinery at Gladstone in Queensland) and capital write-off provisions, the taxation receipts may be significantly lower than expected, given the profitability of the company concerned.[8]

Conclusion

As corporations become more complex and more sophisticated in their international taxation planning, it becomes increasingly difficult for national taxation authorities to tax their operations effectively. When in addition a government is undermining the Taxation Department's attempts to enforce the existing legislation and is also introducing taxation measures which discriminate against certain groups in the community, as it is in Australia, we inevitably find that the burden of taxation shifts more and more onto those who cannot avoid their taxation responsibilities, primarily individuals and small businesses.

Australia is particularly vulnerable to such practices, because of the very high levels of foreign ownership and control of its industries and resources and the compliant Governments in power both at the Federal and State level. The two examples cited in this paper must only be regarded as the tip of the iceberg, and until more a systematic investigation is conducted and a more thorough review of corporations' pricing policies is instituted Australia will continue to experience an erosion of its national tax base and serious distortions to its balance of payments situation.

Table 1

Comparison of Reported Export Values of Single Aluminium Shipments from Australia to Iceland, between Australian Export Statistics and Import Documents from ISAL; January 1974 to June 1980

Shipment No	B/L date (1)	Recording month at ABS (2)	Export value according to FOB (3)	Export value acc. to ISAL FOB (4)	Difference (4) – (3) in 000 USD (5)	Increase at sea % (6)
8	05.01.74	02.74	1.596	2.059	.463	29.0
9	16.04.74	05.74	2.218	3.350	1.132	51.0
10	23.07.74	08.74	3.023	5.070	2.047	67.7
11	15.09.74	10.74	2.853	5.543	2.690	94.3
12a		12.74	1.792			
b	05.12.74	01.75	.901	5.018	2.325	86.3
13	18.02.75	03.75	4.009	6.312	2.303	57.4
14	09.04.75	05.75	3.338	5.411	2.073	62.1
15	20.09.75	10.75	3.449	4.736	1.287	36.7
16	28.10.75	11.75	3.221	4.584	1.363	42.3
17	21.12.75	01.76	2.190	3.140	.950	42.4
18	03.04.76	04.76	2.562	4.875	2.313	89.2
19	14.07.76	08.76	4.322	5.287	.965	22.2
20	07.11.76	12.76	3.655	5.727	2.072	56.7
21	28.02.77	04.77	3.755	5.334	1.579	42.1
22	06.06.77	07.77	4.216	5.975	1.759	41.7
23a		09.77	2.485			
b	05.09.77	10.77	1.261	5.661	1.915	51.1
24	13.01.78	02.78	3.772	5.528	1.756	46.6
25	30.04.78	05.78	3.362	5.042	1.680	50.0
26	16.10.78	10.78	4.040	5.836	1.796	44.5
27	16.01.79	01.79	4.036	5.754	1.718	42.6
28	17.04.79	04.79	3.856	5.919	2.063	53.5
29	23.07.79	08.79	3.686	5.598	1.912	51.9
30	20.10.79	10.79	3.803	6.924	3.121	82.1
31	01.03.80	03.80	5.514	8.716	3.202	58.1
32	03.05.80	05.80	4.941	7.999	3.058	61.9
		TOTAL:	**87.856**	**135.398**	**47.542**	**54.1**

Notes

[1] OECD, *Transfer Pricing and Multinational Enterprises*, Paris, 1977, p.7.

[2] UNCTAD, *Marketing and Distribution Arrangements in Respect of Export and Import Transactions: Structure of International Trading Channels*, ST/MD/25, 30 November 1981, p.vi.

[3] Oxford University Press, 1974.

[4] For a report of the UN study, see B. Khindaria, "Third World worst hit by transnationals", *Australian Financial Review*, 15 September 1981.

[5] For more detail and extensive documentation of this case, see G.J. Crough, *Taxation, Transfer Pricing and the High Court of Australia: A Case Study of the Aluminium Industry*, Research Monograph No 13, Transnational Corporations Research Project, Sydney, January 1981.

[6] Quoted in *Ibid.*

[7] *Ibid.*

[8] Australian Government Publishing Service, Canberra, 1981. ■