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TAX & EXCHANGE CONTROL ALERT

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SOUTH AFRICA'S FIRST TRANSFER PRICING CASE?

Section 31 of the Income Tax Act, No 58 of 1962 (Act) contains South Africa's transfer pricing provisions which constitutes one of the most contentious areas of tax law not only in South Africa, but around the world. Historically, there has been no judicial precedent in South Africa regarding the application of s31 of the Act and in particular the important "arm's length" principle.

IF NO TAX DEBT, SARS MUST PAY THE REFUND: AN INTERESTING JUDGMENT ABOUT THE TAA'S REFUND PROVISIONS

It is often mentioned by taxpayers that in their opinion, the South African Revenue Service (SARS) delays the payment of refunds to taxpayers. In light of this observation, the judgment in *Top Watch (Pty) Ltd v The Commissioner of the South African Revenue Service* (Johannesburg Case No: 2017/4557 and Pretoria Case No: 2016/90099) (judgment delivered on 12 June 2018) is particularly interesting.

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SOUTH AFRICA'S FIRST TRANSFER PRICING CASE?

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Subsequent to the filing of its income tax return, the Taxpayer realised that the transfer pricing adjustment had been made in error on the basis that the shareholder loan fell outside the application of the transfer pricing provisions in terms of s31(7) of the Act.

Background

The taxpayer in *Crookes Bros* formed part of a group of companies in the commercial agriculture industry operating in Southern Africa (Taxpayer). The Taxpayer had advanced (what purports to be) an ordinary shareholder loan to one of its subsidiaries located in Mozambique (Mozco) to enable it to fund certain costs associated with the establishment of a macadamia nut farm.

In its income tax return for the 2015 year of assessment, the Taxpayer made a transfer pricing adjustment to its taxable income in terms of subsection 31(2) of the Act as well as a "secondary adjustment" in terms of s31(3) of the Act resulting in a deemed dividend *in specie* being declared and paid to Mozco.

Subsequent to the filing of its income tax return, the Taxpayer realised that the transfer pricing adjustment had been made in error on the basis that the shareholder loan fell outside the application of the transfer pricing provisions in terms of s31(7) of the Act. In an abbreviated manner, s31(7) of the Act states that a debt will not be subject to the s31 transfer pricing provisions to the extent that:

- the debt is between a resident company and a foreign company in which the resident holds at least 10% of the equity shares and voting rights in the foreign company;
- the foreign company is not obliged to repay the loan within 30 years of the date the debt is incurred;
- redemption of the debt is conditional on the value of the assets being greater than the liabilities; and
- no interest accrued on the debt in the year of assessment.

The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013 provides context to the introduction of the carve-out contemplated in the s31(7) as follows:

> [I]t is proposed that transfer pricing relief should be extended to outbound loans that clearly resemble equity. In effect, taxpayers should not be forced to pay tax on notional interest from a share loan that is in substance nothing more than share capital… A loan that meets the [relevant] criteria is in substance exposed to the same economic risk as equity and thus poses little or no risk to the South African tax base if interest is under-charged (because interest should not be charged at all as an economic matter).

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SARS disputed the taxpayer's reliance on s31(7) of the Act on the basis that Clause 7 of the loan agreement was contrary to the requirements of s31(7)(b) and s31(7)(c) of the Act.

SARS' contentions

SARS disputed the taxpayer's reliance on s31(7) of the Act on the basis that clause 7 of the loan agreement was contrary to the requirements of s31(7)(b) and s31(7)(c) of the Act. The matter therefore turned on clause 7 of the agreement, which in simple terms stated that in the event of Mozco being liquidated, going into business rescue or bankruptcy, the loan would be immediately due and payable. SARS was of the view that given that liquidation, business rescue or bankruptcy could occur within 30 years, such clause was indicative of an obligation on the part of Mozco to redeem the debt within 30 years (s31(7)(b) of the Act). Furthermore, that the debt was payable, notwithstanding the fact that the market value of Mozco's assets may be less than its liabilities (s31(7)(c) of the Act). Lastly, SARS was of the view that a subordination agreement entered into between the parties did not override clause 7 of the loan agreement and that it merely altered the taxpayer's ranking amongst creditors of Mozco. The conclusion was that the shareholder loan was more akin to debt than equity.

Findings

In respect of whether the shareholder loan fell within the "carve-out" provisions of s31(7) of the Act, Louw J agreed with SARS and held as follows at paragraph 17:

> In terms of clause 7 of the loan agreements, the agreements terminate with immediate effect and the loan, or any balance then outstanding, becomes immediately due and payable to the applicant in the event of an application being made for the liquidation of Mozco, or Mozco going into bankruptcy or business rescue or similar type proceedings, or judgment having been taken against Mozco and remaining unsatisfied for a period of 14 days. A situation may therefore arise which obliges the foreign company to repay the loan before expiry of 30 years. It follows that the loan agreements therefore do not comply with the requirement of s31(7)(b) of the Act.

Louw J furthermore agreed with SARS that the subordination of the loan did not override clause 7 and that it simply regulated the subordination of the taxpayer's claim against Mozco to the claims of other creditors for such time as the liabilities of Mozco exceeded its assets.

Observation in respect of the court's findings

Clause 7 of the loan agreement appears to be a common clause inserted into most shareholder loan agreements and it is interesting to note that the court was of the view that the happening of an uncertain event (ie liquidation, business rescue or similar) amounted to an obligation on the part of Mozco to redeem the debt within 30 years. In other words, even though one of the eventualities may never occur within 30 years from the date the debt was incurred, the court found that there was nevertheless an obligation to redeem the debt within the stipulated time period. Given the ongoing debate on what constitutes an "obligation to redeem", it will be interesting to monitor whether the taxpayer may in fact appeal the judgment, particularly when having regard to the intention of the legislature when it introduced the relevant provision.

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The judgment unfortunately falls short of providing any in-depth analysis of the key "arm's length" principle, which forms the crux of any transfer pricing analysis.

Development of South Africa's transfer pricing jurisprudence

Notwithstanding the initial interest that the judgment may have brought relief to the long-standing drought of South African case law dealing with the contentious transfer pricing provisions in s31 of the Act, the judgment unfortunately falls short of providing any in-depth analysis of the key "arm's length" principle, which forms the crux of any transfer pricing analysis.

That said, it is worth noting that in *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62, the Full Federal Court of Australia recently confirmed the findings of the court of first instance and upheld transfer pricing assessments issued by the Australian Tax Office in respect of cross-border interest payments made under intra-group company loans.

It is understood that the taxpayer withdrew its appeal to the High Court of Australia (Australia's apex court) and the decision thus provides guidance regarding, amongst others, the key transfer pricing issue of what constitutes "arm's length" terms of cross border loans between intra-group companies.

Jerome Brink

Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

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IF NO TAX DEBT, SARS MUST PAY THE REFUND: AN INTERESTING JUDGMENT ABOUT THE TAA'S REFUND PROVISIONS

The judgment dealt with the very pertinent and relevant issue of whether the respondent, SARS, was legally justified in refusing to pay certain value-added tax refunds to the applicant.

It is common cause that even though SARS concedes that the VAT refunds for the 2014/02, 2014/07 and 2014/08 VAT periods are due and payable, it refuses to authorise payment of the refunds.

It is often mentioned by taxpayers that in their opinion, the South African Revenue Service (SARS) delays the payment of refunds to taxpayers. In light of this observation, the judgment in *Top Watch (Pty) Ltd v The Commissioner of the South African Revenue Service* (Johannesburg Case No: 2017/4557 and Pretoria Case No: 2016/90099) (judgment delivered on 12 June 2018) is particularly interesting.

The judgment dealt with the very pertinent and relevant issue of whether the respondent, SARS, was legally justified in refusing to pay certain value-added tax (VAT) refunds to the applicant (Taxpayer), on the grounds that the Taxpayer owed an income tax debt, which SARS alleged was due and payable.

Facts

The Taxpayer claimed that VAT refunds were due to him in respect of the 2014/02, 2014/07, 2014/08 and 2017/07 VAT periods. However, in respect of the 2017/07 VAT period, SARS alleged that no refund was due, but that the Taxpayer owed an amount that the Taxpayer had paid on 29 September 2017. It is common cause that even though SARS concedes that the VAT refunds for the 2014/02, 2014/07 and 2014/08 VAT periods are due and payable, it refuses to authorise payment of the refunds.

Pretorius, a legal specialist employed by SARS, deposed to an affidavit in which he alleges that the Taxpayer has been assessed for an income tax liability of approximately R1.76 million, which far exceeds the refund amounts due to the Taxpayer. To substantiate this allegation, Pretorius relies on the supporting affidavit of Oberholzer, a SARS operational specialist, who says that between 25 November 2016 and 8 March 2018, he audited the Taxpayer for income tax in respect of the March 2012 – February 2015 period and concluded that the Taxpayer owed the amount of approximately R1.76 million. To substantiate this allegation, Oberholzer cites a document attached as POC1, which the court noted is almost illegible. During argument, the court was told that the document is an extract of SARS' accounting data system of which the heading read "Assessed account – remittance data view".

Judgment

Based on the facts set out above, SARS contends that is legally correct to refuse to pay the VAT refunds as there has been set-off of the Taxpayer's income tax liability against the VAT refunds. The Taxpayer argued that SARS' stance was wrong in law, but argued that SARS' argument acknowledges that the VAT refunds are due and payable, as this was a precondition for set-off, with which the court agreed.

The court considered the provisions in the Tax Administration Act No 28 of 2011 (TAA) dealing with refunds. Sections 190(1) and 190(2) of the TAA state that SARS must pay a refund if a person is entitled to it under a tax Act and if the amount refundable is reflected in an assessment unless a verification, inspection or audit of the refund is being conducted in terms of Chapter 5 of the TAA.

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The Taxpayer argued that the POC1 document is not an assessment and only an assessment that has been communicated to the Taxpayer is eligible for set-off.

Based on these provisions, the Taxpayer argued that SARS must pay the VAT refunds and raised two arguments in this regard. Firstly, it argued that the "verification, inspection or audit" referred to in s190 (2), only applies to the "refund" itself and not to all aspects of a person's tax affairs. Therefore, the outstanding income tax debt cannot prevent payment of the VAT refunds due to the Taxpayer.

Secondly, the Taxpayer argued that no tax debt was established on the papers and in this regard, the court referred to s191 of the TAA. Section 191 states, in relevant part, that if a taxpayer has an outstanding tax debt, an amount that is refundable under s190, must be treated as a payment by a taxpayer that is recorded in the taxpayer's account under s165, to the extent of the amount outstanding, and any remaining amount must be set-off against any outstanding debt under customs and excise legislation.

The Taxpayer argued that the POC1 document is not an assessment and only an assessment that has been communicated to the Taxpayer is eligible for set-off. In this regard, the court considered s169(1) of the TAA, which states that "an amount of tax due or payable in terms of a tax Act is a tax debt due to "SARS…". It also considered judgments handed down by the Supreme Court of Appeal (SCA) on what constitutes an "assessment" and what constitutes a "tax debt". In one of the SCA judgments referred to, it was held that an amount of tax cannot be regarded as having become recoverable through judicial intervention until the taxpayer has been informed of the assessment.

The court held that set-off can only take place where there are debts between persons who have reciprocal debts, which are both due and payable and if both debts are liquidated. As the alleged income tax liability was not captured in an assessment that had been communicated to the Taxpayer, there was no proof that the income tax debt existed and set-off could not take place.

The court concluded that the Taxpayer's claim for payment of the VAT refunds for the 2014/02, 2014/06 and 2014/08 VAT periods had to be paid by SARS, including interest on these amounts. The court also ordered SARS to pay Taxpayer's costs.

Comment

It appears from the court's judgment that had SARS simply issued assessments reflecting the additional income tax liability pursuant to the audit, the Taxpayer's application would have failed. It is strange that SARS did not issue these assessments before the Taxpayer brought the application, as a period of almost three months passed between finalisation of the audit and the hearing of the application.

The judgment should be seen as a positive by those taxpayers who have often experienced difficulties in getting SARS to pay VAT refunds to them, especially as the delay in paying such refunds often has a very negative impact on those taxpayers' cashflow positions.

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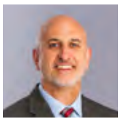

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BBBEE STATUS: LEVEL TWO CONTRIBUTOR

Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 2 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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