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TAX

ALERT

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PROPOSED CHANGES TO SECONDARY TRANSFER PRICING ADJUSTMENT

National Treasury and the South African Revenue Service (SARS) recently released the draft Taxation Laws Amendment Bill 2014 (Bill). One of the key proposals in the Bill is to change the secondary transfer pricing adjustment mechanism from a deemed loan to a deemed dividend.

Transfer pricing is a concern because, where for example a local party undercharges a foreign connected party for goods or services, or where the foreign connected party overcharges the local party, the parties to the transaction can effectively manipulate their income and taxable profits can be shifted from South Africa to other jurisdictions.

Section 31 of the Income Tax Act, No 58 of 1962 (Act) contains South Africa's transfer pricing rules. Essentially, where connected persons enter into international transactions on terms that are not arm's length, s31 of the Act allows SARS to disregard any such manipulations and tax the parties as if they were transacting on an arm's length basis. This is referred to as the primary adjustment mechanism.

Section 31 of the Act also provides for a secondary adjustment mechanism. Where for example a local party has undercharged a connected foreign party, or the foreign party has overcharged the local party, the actual amounts paid are not affected despite the primary adjustment.

In order to get parties to actually pay arm's length amounts, the difference in pricing is deemed to be a loan outstanding between the parties, on which arm's length interest accrues, which interest is taxable.

In the explanatory memorandum to the Bill, SARS states that the deemed loan mechanism is problematic because in practice it is simply never repaid. The reason for this is that:

- there are no contracts setting out the repayment terms because it is a deemed loan and not an actual loan; and
- there may be exchange control restrictions that prevent the repayment of a deemed loan.

It is proposed in the Bill that the relevant amount not be deemed to be a loan, but rather a dividend *in specie* paid by the local party, on which dividends tax would in principle be payable. The effective date would be 1 January 2015.

At a recent workshop hosted by National Treasury and SARS on the Bill, stakeholders voiced various concerns in respect of this proposal. Some of the comments included that:

- the Bill does not take into account the situation where the relationship between the parties is that of shareholder and subsidiary and the provision deems

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an amount to be a dividend paid by the shareholder to its subsidiary - in such circumstances the participation exemption in a relevant tax treaty might not be available;

- the Bill does not take into account the situation where the local party is a natural person, which cannot as such pay a dividend;
- the Bill does not say when the dividend is deemed to arise;
- the Bill does not say to whom the dividend is deemed to be paid; and
- it is not clear how current deemed loans will be affected and whether the Bill will have retrospective effect.

National Treasury and SARS initially appeared adamant to proceed with the proposed amendment in its current form, but eventually did take note of the concerns raised and indicated that further consultation will be held in respect of this matter.

Heinrich Louw

KEEPING THE LID ON PANDORA'S BOX

If only all judgments were formulated with the elegant reasoning and perspicacity of the judgment delivered by Rogers J in the Western Cape Division of the High Court in *Kluh Investments (Pty) Ltd v Commissioner for the South African Revenue Service* (case number A48/2014, as yet unreported) on 9 September 2014.

The appeal was against the dismissal of an appeal brought in the tax court against an additional assessment levied by the South African Revenue Service (SARS) in respect of the 2004 year of assessment. SARS added an amount of R110 million to the appellant's taxable income on the basis that the gross income giving rise to such taxable income had accrued to the appellant during its 2004 year of assessment on disposal of a plantation as contemplated in paragraph 14 of the First Schedule to the Income Tax Act 58 of 1962 (Act).

Section 26(1) of the Act provides that the taxable income of any person carrying on pastoral, agricultural or other farming operations must, to the extent that it is derived from such operations, be determined in accordance with the ordinary provisions of the Act but subject to the special provisions set out in the First Schedule to the Act. The relevant excerpt from paragraph 14 of the First Schedule to the Act states that any amount that accrues to or is received by a farmer (ie any person conducting pastoral, agricultural or other farming operations) from the disposal of any plantation, irrespective of whether such plantation is disposed of separately or with the land on which it is growing, shall be deemed not to be capital in nature and shall constitute part of the farmer's gross income.

The fact that the appellant had disposed of a plantation during its 2004 year of assessment was undisputed. The nub of the appeal was whether the appellant was conducting farming operations from whence the disposal proceeds emanated – the prerequisite for applying the statutory provisions SARS had applied in raising the additional assessment.

The facts of the case were as follows:

- The appellant, a special purpose subsidiary of a Swiss company, had been engaged by Steinhoff Southern Cape (Pty) Ltd (Steinhoff) to assume Steinhoff's place as purchaser of certain land with a timber plantation on it. The rationale behind the appellant's substitution as purchaser was Steinhoff's aversion to owning fixed property in South Africa but still wanting access to the plantation.

- Steinhoff purchased all the machinery and equipment (including a sawmill) while the appellant acquired the land, the timber plantation and certain other assets. Both transactions were executed in writing in October 2001, back-dated to 29 June 2001, and concluded as going concern acquisitions, ostensibly qualifying for zero rating in terms of s11(1)(e) of the Value-Added Tax Act (VAT Act).

- In May/June 2001 by virtue of the relationship of trust between them, Steinhoff and the appellant agreed orally that Steinhoff would be entitled to conduct the plantation business on the appellant's land for Steinhoff's own profit and loss. Steinhoff was granted access to the land on which the plantation stood and was entitled to harvest the timber for its own account. Steinhoff used its own equipment to conduct the plantation operations, employed employees to work on the plantation and contracted with service providers in relation to the plantation operations. All plantation operational income and expenditure was earned and incurred by Steinhoff and reflected in its accounts. It was

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not obliged to render reports to the appellant regarding the plantation operations.

- The appellant owned no equipment and had no employees. It had no expertise in operating plantations. It was common cause that the appellant considered the acquisition of the land and plantation as a strategically advantageous long-term investment. To protect its investment, the appellant and Steinhoff agreed that upon termination of the oral agreement, which was to subsist indefinitely, Steinhoff would ensure that the plantation comprised trees of the same volume and quality as at commencement.

- The oral arrangement was terminated by agreement in June 2004 when Steinhoff changed its policy, in light of escalating timber prices and the scarcity of timber resources, and became amenable to purchasing fixed property in South Africa.

- The purchase price was determined by an independent valuer and heads of agreement were concluded in terms of which 'the plantation business' was to be sold by the appellant to Steinhoff as a going concern, zero-rated in terms of s11(1)(e) of the VAT Act.

- Certain disputes arose between the parties which were duly settled and recorded in a settlement agreement in terms of which the reference to the sale of 'the plantation business' was altered to refer to the sale of immovable property, standing timber, the plantation sale assets, machinery and equipment and plantation contracts. In addition it was recorded that VAT at the standard rate may be payable on the transaction in respect of which the appellant was to issue invoices to Steinhoff. Further it was agreed that the appellant was to pay Steinhoff a 'bonus management fee' for the exemplary manner in which it had looked after the appellant's investment.

- In its 2004 tax return the appellant treated the disposal proceeds as capital in nature. It declared a capital gain of R45,6 million being the difference between the disposal proceeds of R144,7 million and the CGT valuation of the plantation of R99,1 million as at 1 October 2001 (as opposed to the lesser purchase consideration actually paid as at 29 June 2001). The appellant also claimed a s11(a) deduction of R12 million in respect of the 'bonus management fee' due to Steinhoff.

- SARS issued an additional assessment in August 2010 in terms of which it rejected the appellant's treatment of the plantation disposal proceeds as capital in nature. SARS averred that s26(1) read with paragraph 14 of the First Schedule deemed the disposal proceeds to be part of the appellant's gross income. The appellant objected to the additional assessment. In its grounds of assessment SARS maintained its stance. However, SARS contended in the alternative that if the appellant was correct in treating the disposal proceeds as capital in nature, it had calculated the gain incorrectly. The CGT issue was left over by agreement pending the outcome of the main issue.

Before the tax court SARS had argued that the mere disposal of a plantation was sufficient to trigger the relevant statutory provisions. In effect SARS submitted that it was not necessary to satisfy s26(1) of the Act as a separate jurisdictional fact before rendering the deeming provision of paragraph 14 of the First Schedule applicable to the plantation disposal proceeds. Plainly put, it was not necessary to first establish whether or not the appellant was conducting farming operations. The mere fact that the appellant sold a plantation was sufficient to render paragraph 14 applicable and deem the plantation disposal proceeds to be part of the appellant's gross income.

In the alternative SARS argued that even if Steinhoff had conducted the plantation operations independently of the appellant, such operations had been physically conducted on the appellant's land, the appellant retained a direct interest in such operations and Steinhoff was required to restore the plantation in the same condition upon termination of the oral agreement as it had stood at commencement. As such SARS argued that there was a sufficiently close connection between the disposal proceeds and the plantation operations during the subsistence of the oral arrangement to render s26(1) of the Act and paragraph 14 of the First Schedule applicable.

The tax court found it unnecessary to consider SARS' first argument as it found in SARS' favour on strength of the alternative basis. In so finding, Rogers J concludes that the tax court conflated two distinct issues:

"Section 26(1) of the Act does not apply merely because there has accrued to the taxpayer income which has 'derived from' farming operations; the section applies to a person carrying on farming operations to the extent that his income is derived from such operations. Two

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questions must therefore be answered: (i) Was the person whom SARS wishes to tax a person carrying on farming operations during the year of assessment in question? (ii) If so, did the particular item of income in dispute derive from those farming operations?"

Rogers J then proceeds to review the relevant case law and concludes that a number of tax court decisions[1] have similarly conflated the two questions. In rejecting SARS' first argument he states that the objective of "paragraph 14 is not to define what constitutes the carrying on of farming operations, but to characterise a particular type of accrual as gross income rather than capital." The mere disposal of a plantation previously acquired by a taxpayer is insufficient to constitute the carrying on of farming operations; and the conduct of farming operations is the prerequisite for triggering the paragraph 14 deeming provision.

Rogers J concludes in favour of the appellant on the basis it was not conducting farming operations. As s26(1) of the Act was inapplicable the characterisation of the plantation disposal proceeds fell to be determined in accordance with the normal provisions of the Act.

In upholding the appeal, he wryly observes that had SARS' contentions been upheld, a Pandora's Box may have been opened for non-farming taxpayers disposing of pastoral, agricultural or farming assets. Good job the lid remains firmly closed!

Lisa Brunton

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[1] ITC 166 (1930) 5 SATC 85, ITC 1630 (1996) 60 SATC 59

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