4 MARCH 2021

TAX & EXCHANGE CONTROL **ALERT**

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South Africa's "*second*" transfer pricing case?

It is no secret that revenue authorities the world over continue to place significant emphasis on Base Erosion and Profit Shifting (BEPS), with transfer pricing being one of the key focus areas. The South African Revenue Service (SARS) is no different. In fact, the Minister of Finance (Minister) in the recent 2021 National Budget Speech specifically requested an additional spending allocation of R3 billion to SARS which would, amongst others, be used to expand SARS' specialised transfer pricing audit and investigative skills.

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South Africa's "*second*" transfer pricing case?

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Despite the significant focus of SARS on BEPS and transfer pricing, it is interesting that there is a dearth of transfer pricing cases in South Africa. We previously questioned in our 13 July 2018 Tax Alert whether the *Crookes Brothers* case was South Africa's first proper transfer pricing case. With this context in mind, when first reading the recent (as yet unreported) judgment of *ABC (Pty) Ltd v Commissioner: SARS* (IT 14305) [2021] ZATC 1 (7 January 2021), referred to herein as IT14305, the key words "*transfer pricing*"; "*arm's length price*"; "*transactional net margin method*"; and "*full cost mark-up*" certainly pique one's interest. In this article, we consider the discussion of transfer pricing principles and findings in this case.

Background

The Applicant in IT14305 was in the business of manufacturing, importing, and selling chemical products. In particular, one of its activities included the manufacture of catalytic converters, which to the layman, perform a critical environmentally protective function for motor vehicles in reducing harmful exhaust emissions. In the course of this activity, the Applicant purchased certain metals, known as the Precious Group of Metals (PGMs), from a related party based in Switzerland (Swiss Entity). On completion of manufacture, the catalysts would be sold to customers in South Africa known as original equipment manufacturers (OEMs) or more simply motor vehicle manufacturers.

SARS conducted a transfer pricing audit into the Applicant's 2011 year of assessment which included a consideration of whether the transaction between the Applicant and the Swiss Entity for the purchase of the PGMs was conducted at arm's length. After considering various aspects of the transaction including an analysis of the underlying cost base as well as the functions, risks and assets of the Applicant in purchasing and manufacturing the catalytic converters, SARS concluded that the Applicant's Full Cost Mark-Up (FCMU) of 1% fell between the minimum and lower quartile of SARS' arm's length interquartile range achieved by the comparable company dataset. Based on this, an adjustment was warranted.

While the Applicant did make submissions regarding SARS proposed transfer pricing adjustment, it would appear that the Applicant did not specifically test (and document) the transactions for transfer pricing purposes which took place prior to the introduction of mandatory transfer pricing documentation (TPD) in 2016. SARS therefore based its findings on its own transfer pricing analysis drawn from the guidance in SARS' Practice Note 7 (PN7) and the OECD Transfer Pricing Guidelines (TPG). In this regard, SARS adjusted

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The matter to be determined by the present court was whether an application for separation of a legal issue in terms of Rule 33(4) of the Uniform Rules of the High Court, as provided for in terms of Rule 42(1) of the Tax Dispute Resolution Rules, should be granted in favour of the Applicant.

the Applicant's FCMU to the median of SARS' arm's length interquartile range achieved by the comparable company dataset. This set of facts follows a fairly standard transfer pricing audit into a taxpayer's affairs.

Issue

While the Applicant disputed SARS additional assessment such that an income tax appeal on the merits is currently still pending, the matter to be determined by the present court was whether an application for separation of a legal issue in terms of Rule 33(4) of the Uniform Rules of Court, as provided for in terms of Rule 42(1) of the Tax Dispute Resolution Rules, should be granted in favour of the Applicant.

The purpose and rationale of separation as per Rule 33(4) of the Uniform Rules of Court was set out in *The City of Tshwane Metropolitan Municipality v Blair Atholl Homeowners Association* 2010 (3) SA 382 (SCA) as follows:

> *"If, in any pending action, it appears to the court mero motu that there is a question of law or fact which may conveniently be decided either before any evidence is led or separately from any other question, the court may make an order directing the disposal of such question in such manner as it may deem fit and may order that all further proceedings be stayed until such question has been disposed of, and the court shall on the application of any party make such order unless it appears that the questions cannot conveniently be decided separately...The entitlement to seek the separation of issues was created in the rules so that an alleged lacuna in the plaintiff's case can be tested; or simply so that a factual issue can be determined which can give direction to the rest of the case and, in particular, to obviate the leading of evidence... ."*

In simple terms therefore, it allows a separation of a question of law or fact to be decided first before any evidence is led in the main matter. Essentially it saves costs and time particularly where the separated issue is determined in such a way that puts paid to the matter proceeding thereafter. In civil cases, an obvious example is where the parties first agree to determine liability for damages whereas the quantum of damages is then determined subsequently. By determining liability first, it may be that determination of quantum becomes moot.

Para 22 of the judgment neatly summarises the crux of the issue in the present case as follows:

> *"As a reminder, the point raised by applicant, which it seeks to separate from the issues raised in the appeal, concerns the powers of respondent as sanctioned by section 31(2) of the ITA. Applicant challenges that on a proper reading of section 31(2), respondent was only entitled to adjust the price/consideration paid for the PGMs as between itself and the Swiss Entity. Consequently, the act of adjusting its profits, pursuant to the application of the TNMM and the FCMU, was not a legitimate exercise of transfer pricing power authorized by section 31(2)."*

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SARS argued that the issue under consideration was inextricably bound with the main issue in the appeal, and that is whether the transactions between Applicant and the Swiss Entity were at arm's length.

It thus follows that while IT14305 raised an issue of separation, the court was nevertheless tasked with unpacking the provisions of the previous section 31(2) of the Income Tax Act, 58 of 1962 (Act) in determining whether the application for separation should be granted.

Arguments made by the parties

The Applicant essentially argued that section 31(2) of the Act (as it then read in 2011) only permitted SARS to adjust the consideration in respect of the transactions between it and the Swiss Entity to reflect an arm's length price for the purchase and supply of PGMs. It was submitted that SARS' powers thus did not extend to adjust the consideration between the Applicant and third party customers (i.e. overall profitability of the Applicant). SARS' adjustment was (according to the Applicant) outside the scope of section 31(2) and was legally impermissible. The Applicant thus argued that the court should first determine whether SARS acted outside the scope of section 31(2) in adjusting the Applicant's profitability. If that was the case, then the matter would end there. On the other hand, SARS argued that the issue under consideration was inextricably bound with the main issue in the appeal, and that is whether the transactions between Applicant and the Swiss Entity were at arm's length.

Interestingly, reference was also made to the amendment to section 31. In 2011, section 31 was substantially amended for purposes of introducing modernisation changes to the transfer pricing rules in accordance with the OECD TPGs. The Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 further stated that the new wording of the section also removed previous uncertainties. In particular, it stated that the literal wording focused on separate transactions, as opposed to overall arrangements driven by an overarching profit objective.

The Applicant thus contended that the amendment to section 31 supported its argument for the separation of the issues. The point made by the Applicant was that

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The court held that the question of adjustment does not even arise prior to determining the arm's length nature of a transaction. The inquiry into the arm's length nature of a transaction is an overriding principle in transfer pricing matters and cannot be back-ranked.

a major reason for the amendment was that the section (as it then stood) limited SARS to adjust the consideration relevant to the impugned transaction. According to the Applicant, it did not permit the wider approach that focused on overall profits.

SARS counter-argued that the Applicant was misguided in its understanding of the amendments. SARS stated that the amendments were effected to clarify what the legal position had always been. In this regard, SARS submitted that the adjustment contemplated in section 31 was always with reference to the profits declared by the taxpayer. The amendments in 2011 merely highlighted what was already in the legislation.

Judgment

Given the dearth of South African transfer pricing cases, the court first discussed [at paras 25 to 27] three international transfer pricing cases to illustrate the point that regardless of what transfer pricing method has been used to determine the arm's length consideration, ultimately, adjustments are made to the profits of the taxpayer to ensure that tax is levied on the correct amount of taxable income.

The court noted that the Applicant itself had in fact referred to the authoritative statement in both the TPGs and PN7 which seeks to tax profits that ought to have accrued to a party. On that basis, the court surmised that the Applicant had pursued its case on the basis that the transactions involving the PGMs had no transfer pricing implications as they were "*flow through transactions*". Therefore, the Applicant did not test whether the PGM transactions complied with the requirements of the arm's length principle. Given this, the court agreed with SARS that the issue sought to be separated raised no cogent point of law.

In dismissing the application for separation, the court held [at para 40] that the question of adjustment does not even arise prior to determining the arm's length nature of a transaction. The inquiry into the arm's length nature of a transaction is an overriding principle in transfer pricing matters and cannot be back-ranked. In other words, the establishment as a fact whether a consideration is or is not at arm's length precedes the question of adjustment, regardless of what transfer pricing method is employed. The ordering of separation was therefore, according to the court, of no practical benefit but would instead raise piecemeal litigation, increase costs, and delay finalisation of the matter.

Discussion of applicability of Practice Note 7 and OECD Transfer Pricing Guidelines to South African transfer pricing

SARS had relied on both PN7 and the TPGs in testing the arm's length nature of the transactions and adjusting the Applicant's taxable income. The Applicant on the other hand raised the argument that section 31 makes no reference to the TPGs or PN7.

In relation to PN7 (which also refers to the TPGs with authority), the Applicant submitted that SARS reliance thereon is misplaced given the judgment in *Marshall and Others v Commissioner, South African Revenue Service* 80 SATC 400.

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The court concluded that one cannot deny that the TPGs are a world standard in transfer pricing matters.

In the *Marshall* case, the Constitutional Court held as follows in considering the authoritative nature of SARS interpretation notes:

> "*Why should a unilateral practice of one part of the executive arm of government play a role in the determination of the reasonable meaning to be given to a statutory provision? <u>It might conceivably be justified where the practice is evidence of an impartial application of a custom recognised by all concerned, established by one of the litigating parties.</u> In those circumstances it is difficult to see what advantage evidence of the unilateral practice will have for the objective and independent interpretation by the courts of the meaning of legislation, in accordance with constitutionally compliant precepts. It is best avoided.*" *[Our underlining]*

With reference to the fact that the Applicant itself had referred to PN7 and the TPGs in its pleadings, the court held that the *Marshall* case in fact supported SARS' reliance on PN7 in that PN7 and the TPGs demonstrate a practice that is internationally accepted and applied by both taxpayers and SARS alike.

In addition, while the Applicant raised the argument that South Africa is not a member of the OECD such that reliance on the TPGs is tenuous, the court held that it is in fact necessary for countries to align themselves with the OECD TPGs to overcome challenges brought about by BEPS. Interestingly, the court commented on the decision of the *Australian Full Federal Court in Commissioner of Taxation v Glencore Investments Pty Ltd* [2020] FCAFC 187, in which the Australian court purportedly rejected to apply the OECD TPGs. The court (in the present matter) stated that, given that the judgment was handed down in relation to the 2007 to 2009 financial years, it was doubtful that the same court would reach the same conclusion now. Even though judgment was handed down in the *Glencore* case in 2020, this was by virtue of the observation by the present court that BEPS now stood on a different footing as compared to when the assessments were raised.

The court then concluded that one cannot deny that the TPGs are a world standard in transfer pricing matters. Given the dearth of transfer pricing cases in South Africa, many taxpayers and SARS refer to the TPGs and PN7 for guidance. It is in this context, that taxpayers would be well advised to take heed of this aspect of the judgment.

Concluding remarks

It is evident that while IT14305 fell a putt short of being South Africa's first true transfer pricing case, there is no doubt that it discussed various important issues pertaining to the application of section 31 of the Act. In particular, it highlights the need for taxpayers to properly test whether their related party transactions comply with the arm's length principle. Given the increasing focus on transfer pricing matters by SARS and the emergence (albeit slow) of judicial precedent, it may be that South Africa's first full transfer pricing case is just beyond the horizon.

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