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THE UNFORTUNATE DEARTH OF JUDICIAL PRECEDENT IN TRANSFER PRICING CONTINUES

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I INTRODUCTION

Despite what could be hailed as the first two transfer pricing cases in South Africa, the unfortunate dearth of judicial precedent in South Africa regrettably continues. Transfer pricing is one of the most complex areas of tax alongside provisions dealing with controlled foreign companies, foreign exchange gains and losses, currency conversions, financial instruments, and corporate reorganisations. In fact, as the list goes on, it is just more apposite to say 'tax is complex', period. With regard to transfer pricing in particular, the complexity is amplified by the fact that transfer pricing is not even tax *per se*. It is an economic allocation of contribution through the value chain. It is through transfer pricing that each contributor in the value chain gets an adequate return for their contribution in the value chain. Once that allocation is complete, the tax provisions are applied to the returns of each contributor according to the tax laws of the countries in which they are taxable.

A transfer price is a price set by a taxpayer when selling to, buying from or sharing resources with a related person. A transfer price is contrasted with a market price, which is the price set in the marketplace for the transfer of goods and services between unrelated persons where each party strives to get the utmost possible benefit from the transaction (see Arnold & McIntyre, *International Tax Primer* (Kluwer Law International 2002) 55; Danzinger, *International Income Tax* (Butterworths 1991) 303–307). Transfer prices are not negotiated in a free open market and as such have the propensity to deviate from prices agreed upon by non-related trading partners in comparable transactions under the same circumstances (Oguttu, *International Tax Law: Offshore Tax Avoidance*

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in South Africa (Juta 2015) 213). Unless prevented from doing so, related persons engaged in cross-border transactions can avoid the income taxes of a country through a manipulation of prices, mainly by shifting profits to low tax countries and expenses to high tax countries. To combat this, tax authorities across the globe have the power to adjust, in appropriate cases, the transfer prices set by related persons (Arnold & McIntyre, (Kluwer 2002) 55.

In what can be welcomed as the first transfer pricing case in the South African courts, the South Johannesburg High Court had an opportunity to decide on the applicability of s 31(7) of the Income Tax Act 58 of 1962 ('the Act'; any reference to a section or subsection are to the Act, unless otherwise stated, or the context indicates otherwise) to a debt owed by a foreign company to a South African company. The applicable provision excludes debt instruments that contain core characteristics of debt instruments from the application of transfer pricing provisions. In the second case, the same court missed out on an opportunity to gauge the legitimacy of the revenue collector to use s 31(2) of the Act to adjust prices charged between a taxpayer and third parties that are not related to the taxpayer.

II THE PROMINENCE OF TRANSFER PRICING IN INTERNATIONAL PODIA

The Organisation for Economic Co-operation and Development ('OECD') and the United Nations ('UN') have taken the lead in assisting countries in their efforts to eliminate tax avoidance, especially at an international level, including through transfer pricing. The United Nations Model Double Taxation Convention between Developed and Developing Countries ('UN Model Convention') and the Organisation for Economic Co-operation and Development Model Tax Convention on Income and on Capital ('OECD Model Convention') provide a template for countries to adopt and adapt in their design of bilateral tax treaties. Indeed there are currently over 3000 tax treaties worldwide, the majority of which are based on these two model tax conventions (see Brumby & Keen, 'Tax treaties: Boost or bane for development' Insights and analysis on economics and finance' https://www.imf.org/en/Blogs/Articles/2016/11/16/tax-treaties-boost-or-bane-for-development, accessed on 7 February 2023; Arnold, 'An introduction to tax treaties' https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020–06/TT_Introduction_Eng.pdf, accessed on 7 February 2023).

The provisions relating to transfer pricing in both models are

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contained in art 9 of the models and are largely identical. They both provide as follows:

> 1. Where
> (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
>
> 2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

In addition, the UN model convention contains a provision (art 9(3)) that excludes the application of the transfer pricing adjustment in cases where judicial, administrative, or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

A measure of whether an amount charged, or the conditions created between related parties is not different from what would have been charged if the parties were not related is an arm's length determination (Chapter 1 Part B of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2022) available on https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page407, accessed on 15 February 2023 ('OECD Transfer Pricing Guidelines')). Various methods are used to determine

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whether a price is at arm's length: comparable uncontrolled price method, cost plus method, resale price method, profit split method and the transactional net margin method (OECD Transfer Pricing Guidelines). However, the most preferred and most reliable method that is relevant to this discussion is the comparable uncontrolled price method ('CUP'). The best method to use is one that, under the facts and circumstances provides the most reliable measure of an arm's length result (see Isenberg, *International Taxation* (Foundation Press, New York 2000) 62). While there is no hierarchy of methods, the CUP is regarded as the most direct and reliable one for transactions where there are minor or no differences between the controlled transactions under scrutiny and comparable uncontrolled transactions (see OECD Transfer Pricing Methods (July 2010) available at https://www.oecd.org/ctp/transfer-pricing/45765701. pdf, accessed on 9 February 2023; Isenberg, (Foundation Press, New York 2000) 63–64). International legal precedent also demonstrates this reliability. For example, in the recent Columbian case of *Colombia vs Carbones El Tesoro S.A.* September 2021, Administrative Court, Case No. 22352, the court had to decide the appropriate transfer pricing method for the sale of coal mined by the taxpayer to its related party abroad. The court found that the CUP method was the most appropriate method.

The CUP method refers to sales of similar products made between unrelated persons in comparable circumstances. It then draws a direct comparison between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction, in comparable circumstances (para 2.14 of the OECD Transfer Pricing Guidelines; United Nations, 'Introduction to transfer pricing' *Working Paper* Chapter 6, 44 available at https://www.un.org/esa/ffd/wp-content/uploads/2014/09/8STM_Chap6_-Methods_20120924_v7_HC-accp.pdf, accessed on 15 March 2023). If there are no comparable products, a different method is used.

A company may use an internal CUP comparison, in terms of which the company compares its own transactions with third parties to the transaction with the related party. The company may also use an external CUP comparison, in terms of which the company compares its transaction with related parties to transactions between third parties (see OECD Transfer Pricing Methods; Transfer Pricing Solutions, 'To CUP or not to CUP: A transfer pricing dilemma' available at https://www.transferpricingsolutions.com.au/insights/to-cup-or-not-to-cup-a-transfer-pricing-dilemma/, accessed on 8 February 2023; Valentiam Group, 'The comparable uncontrolled price (CUP) method: How it works' *Latest News and Insights* (15 February 2021) available at https://

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www.valentiam.com/newsandinsights/comparable-uncontrolled-price, accessed on 8 February 2023). In both cases, availability of reliable and suitable comparables is key in determining the applicability of the method applied.

Because transfer pricing provisions apply to debt instruments, the OECD provides simplified criteria to determine whether an instrument is debt or equity, and therefore to exclude equity instruments from the application of the transfer pricing adjustment. Para 10:12 of the OECD Transfer Pricing Guidelines provides that in order to accurately delineate an advance of funds, the following economically relevant characteristics are useful indicators, depending on the facts and circumstances:

- the presence or absence of a fixed repayment date;
- the obligation to pay interest;
- the right to enforce payment of principal and interest;
- the status of the funder in comparison to regular corporate creditors;
- the existence of financial covenants and security; and
- the failure of the purported debtor to repay on the due date or to seek a postponement.

The above provisions and standards are contained in South African treaties with other countries, number 81 as of 1 December 2022 (see National Treasury, 'Media statement: Publication of gazetted multilateral convention to implement the tax treaty related measures to prevent base erosion and profit shifting (BEPS MLI)' available at https://www.treasury.gov.za/comm_media/press/2022/2022120101%20Media%20statement%20-%20Base%20Erosion%20and%20Profit%20Shifting.pdf, accessed on 7 February 2023). As is the case with most countries, South African national legislation also contains unilateral transfer pricing provisions to give legal effect to treaty provisions, augment the application of the treaty provisions and provide for specific inclusions, exemptions and exclusions where the local legislature deems fit and appropriate in accordance with the specific tax jurisprudence.

III TRANSFER PRICING LAW IN SOUTH AFRICA

Transfer pricing legislation was introduced in South Africa with effect from 19 July 1995 when a revised s 31 was enacted into the Act by s 23(1) of the Income Tax Act 21 of 1995 (see Olivier & Honiball, *International Tax: A South African Perspective* (SiberInk 2011) 621). Basically, South African transfer pricing provisions apply to transactions between residents and persons that are not resident in South Africa (see definition of

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'affected transaction' in s 31(1) of the Act). In addition, the parties to the transaction should be connected persons as defined in s 1 of the Act. In essence, a person is a connected person to another if the nature of their relationship is such that they could manipulate the prices charged between them to avoid tax, and not suffer negative economic implications as a team or group from the manipulation of the price. An example of such a relationship is husband and wife, a company and its majority shareholder, and a trust and its beneficiaries. For purposes of this article, the salient part of the definition of connected person provides that a connected person in relation to a company means any other company that holds 50% or more in that other company (see para *(d)*(i) of the definition of 'connected person' in s 1 of the Act, read together with the definition of 'group of companies' in s 1 of the Act).

The key transfer pricing provision in South Africa is contained in s 31 of the Act. Subsection 2 of the section contains the charging provision and states as follows:

'(2) Where—
(a) any transaction, operation, scheme, agreement or understanding constitutes an affected transaction; and
(b) any term or condition of that transaction, operation, scheme, agreement or understanding—
 (i) is a term or condition contemplated in paragraph (b) of the definition of "affected transaction"; and
 (ii) results or will result in any tax benefit being derived by a person that is a party to that transaction, operation, scheme, agreement or understanding or by any resident in relation to a controlled foreign company contemplated in subparagraph (iv) of the definition of "affected transaction", the taxable income or tax payable by any person contemplated in paragraph (b) (ii) that derives a tax benefit contemplated in that paragraph must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.'

In essence, this provision allows the tax administrator to adjust prices between connected parties, in cases where the manipulation of the prices results in a tax benefit, to reflect those prices that would have been charged if they were not connected parties.

IV DEBT INSTRUMENTS WITH EQUITY CHARACTERISTICS EXCLUSION

One of the main exclusions from the application of the transfer pricing provisions in South Africa is in relation to debt instruments that have

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equity characteristics. The essence of this is that debt and equity are treated differently for tax purposes in South Africa. The pertinent difference in tax treatment is with regard to the deductibility by the person paying returns from debt and equity instruments, ie, interest and dividends respectively. Interest incurred in the production of income is deductible under the general deductions formula contained in s 11*(a)* read with s 23*(g)* of the Act or s 24J of the Act. Dividend payments are not deductible, and expenditure incurred in the production of dividend income is not deductible (see s 11*(a)* read with the definition of 'income' in s 1 and s 23*(f)* of the Act; *Commissioner for Inland Revenue v Ticktin Timbers* CC (1997) 59 SATC 260 (C); *Commissioner, South African Revenue Service v Scribante Construction (Pty) Ltd* 2001 (2) SA 601 (E); *Natal Laeveld Boerdery (Edms) Bpk v KBI* [1998] 1 All SA 5 (A); *Commissioner for SARS v Van der Westhuizen* [2001] 2 All SA 297 (C)).

Because of the lack of a tax benefit in using equity payments, transfer pricing provisions do not apply to equity instruments. In terms of s 31(7), transfer pricing adjustments contained in s 31(2) do not apply to debt instruments which have equity characteristics. They apply in respect of transactions between a resident company or company in the same group of companies as the resident company, and a foreign company. There are five main requirements for the exemption from transfer pricing application to be effective:

(i) The resident company must hold 10% or more of that foreign company. This 10% can be held by the resident company alone or together with any other company that forms part of the same group of companies as that resident company (s 31(7)*(a)*).
(ii) There needs to be a loan to the resident company or company in the same group of companies (s 31(7)*(a)*).
(iii) The term of the loan should be for a duration of 30 years or more. The foreign company should not be obliged to redeem that debt in full within 30 years from the date the debt is incurred (s 31(7)*(b)*).
(iv) When the foreign company redeems the debt, it should do so when it is solvent. Thus, it cannot redeem the debt when the market value of its liabilities exceeds the market value of its assets (s 31(7)*(c)*). It is not a requirement that liquidation proceedings should be underway or have commenced.
(v) No interest should have accrued in respect of the debt during the year of assessment (s 31(7)*(d)*).

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The case of *Crookes Brothers Ltd v Commissioner for the South African Revenue Service* [2018] ZAGPHC 311 (*Crookes Brothers*) considered the applicability of s 31(7).

V THE CASE OF *CROOKES BROTHERS*

The taxpayer was a South African resident company that owned 99% of Murrimo Macadamias Limitada ('MML'), a company incorporated in Mozambique.

(a) The Agreements

The taxpayer extended loans to MML in terms of two identical loan agreements. The salient provisions of the loan agreements provided as follows:

- Clause 3.5: that 'MML shall not be obliged to repay the loan amount in full within 30 years of the approval date, as stipulated in each agreement, or the date on which the loan amount was advanced by the applicant to MML' (para 4).
- Clause 3.6: that 'any repayment or redemption of the loan amount in full by MML to the [taxpayer] shall not take place if the market value of the assets of MML are less than the market value of its liabilities as of the date of the payment or redemption' (para 4).
- Clause 3. 7: that 'no interest shall accrue or be payable in respect of the loan amount during any year of assessment' (para 4).
- Clause 7: that, 'in the event of an application being made for the liquidation of MML, or MML going into bankruptcy or business rescue or similar type proceedings, or judgment having been taken against MML and remaining unsatisfied for a period of 14 days, the agreement shall terminate with immediate effect without the necessity of notice and the loan amount, or any balance then outstanding, shall immediately become due and payable to the applicant' (para 4).

At the end of each year of assessment, after the initial loan was extended by the taxpayer to MML, the taxpayer and MML entered into a subordination agreement in relation to the taxpayer's claim against MML for the repayment of the loan amount outstanding as at the end of the particular financial year. A subordination agreement is an agreement that establishes the ranking of debts in priority for collecting repayment from a debtor (see Kopp, 'Subordination agreement: Definition, importance and example' Investopedia, (20 July 2020) available at https://www.investopedia.com/terms/s/subordinationagreement.asp#:~:text=

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What%20Is%20a%20Subordination%20Agreement,on%20payments %20or%20declares%20bankruptcy, accessed on 7 February 2023). The relevant clauses of the subordination agreement are summarised by the court as follows (para 5):

> 'Clause 1.1 provides that the applicant agrees, subject to the limitation imposed in clause 4 thereof, that the applicant subordinates for the benefit of the other creditors of MML, both present and future, so much of its claim against MML as will enable the claims of other creditors to be paid in full.
>
> Clause 1.2 provides that the claims of the creditors of MML, both present and future, will rank preferentially to the subordinated claim of the applicant.
>
> Clause 4 provides that the subordination of the applicant's claim shall remain in force and effect for so long only as the liabilities of MML exceed its assets, fairly valued and shall lapse immediately upon the date that the assets of MML exceeds its liabilities and shall not, except by further agreement in writing, be reinstated, if thereafter the liabilities of MML shall be deemed to continue to exceed its assets unless and until auditors of international standing have certified in writing that they have been furnished with evidence which reasonably satisfies them that the liabilities do not exceed the assets.
>
> Clause 5 provides that, until such time as the assets of MML, fairly valued, exceeds its liabilities, and the auditor's certificate referred to in clause 4 has been issued, it shall not be entitled to demand or sue for or accept repayment of the whole or any part of the amount subordinated owing to them by MML and set-off shall not operate in relation to the subordinated claim in respect of any debts owing by it then or in the future.'

(b) Tussle with the South African Revenue Service ('SARS')

The taxpayer submitted a tax return for the 2015 tax year therein making an arm's length adjustment in terms of s 31(2). It also made an entry in the tax return deeming the difference between the zero interest and the interest that would have been charged between unrelated parties as a dividend in terms of s 31(3). The latter section, in general terms, provides that to the extent that there is a difference between the amount applied in the calculation of the taxable income of any resident after the arm's length adjustment and any amount that would, but for the arm's length adjustment, have been applied in the calculation of the taxable income of the resident, the amount of that difference, if the resident is a company, shall be deemed to be a dividend consisting of a distribution of an asset *in specie* declared and paid by the resident to the non-resident.

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It is important to note that the deeming of the difference to be a dividend means that the amount deemed to be paid as a dividend is not deductible in the hands of the deemed of the amount. It also means that the amount deemed to be a dividend will be subject to a dividends tax at the rate of 20% of the amount so deemed in terms of s 64E(1)*(a)* of the Act. The fact that it is deemed to be a dividend *in specie*, means that the dividend tax chargeable is payable by the deemed payor of the amount in terms of s 64EA*(b)* of the Act.

The taxpayer subsequently deposed an affidavit averring that it established after the submission of the return that the adjustment which it had made to its taxable income in terms of s 31(2) had been incorrectly made, having regard to the terms of the loan agreements as read with the subordination agreement. The taxpayer requested a reduced assessment relying on the provisions of s 31(7) of the Act. (A slight side note: the court in para 8 made an error that the applicant relied on the provisions of s 31(7) of the TAA, referring to the Tax Administration Act 28 of 2011. This cannot be correct as s 31 in the latter deals with inspection of records and subs (7) does not exist in s 37 of the TAA).

SARS rejected the request for a reduced assessment, stating that clause 7 of the loan agreement states that in the event of MML being liquidated or going into bankruptcy the loan is immediately due and payable. This, SARS argued, is contrary to the requirements of ss 31(7)*(b)* and *(c)* of the Act and therefore the loan is more akin to debt rather than equity (para 11).

At this stage the taxpayer determined that the subordination agreements and effect thereof had been inadvertently omitted in the debate and sent a second request to SARS for a reduced assessment. In the second request, the taxpayer mainly argued that in terms of the subordination agreement the taxpayer 'waived its preferential ranking to call upon the debt in any and all circumstances where the liabilities of MML, fairly valued, exceeded its assets fairly valued and that, in these circumstances, the obligation for MML to repay the loans was wholly conditional upon the market value of the assets of MML not being less than the market value of its liabilities' (para 12). The taxpayer thereby contended that the subordination clause rendered clause 7 of the loan agreements inapplicable. SARS responded, again rejecting the request for a reduced assessment, stating that the events that would make the loan immediately due and payable could happen within 30 years and that the subordination agreement merely changes the taxpayer's ranking amongst the creditors of MML.

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SARS stated in its response (para 14):

- 'Clause 7 of the loan agreement states that in the event of an application being made for the liquidation of MML, MML going into bankruptcy or business rescue or similar type of proceedings, or judgment having been taken against MML, then the loan agreement terminates and the loan is immediately due and payable. This could happen within 30 years.
- In terms of the subordination agreement, Crookes waived its preferential ranking to call upon the debt in any and all circumstances where the liabilities of MML, fairly valued, exceed its assets fairly valued.
- If any of the conditions described in clause 7 occur, the loan agreement terminates and the loan is immediately due and payable. The subordination agreement merely changes Crookes ranking amongst the creditors of MML. However, this doesn't detract from the fact that the loan is immediately due and payable.
- Therefore, I am of the opinion that the subordination agreement does not override clause 7 of the loan agreement.
- The existence of clause 7 of the loan agreement means that the requirements of sections 31(7)(b) and (c) of the IT Act are not met.
- The loan is therefore more akin to debt rather than equity.'

(c) Court decision

In its appeal to the High Court, the taxpayer contended that SARS committed an error of law in that the assessment of tax payable is an annual event and that, therefore, it must be determined from year to year whether the requirements of s 31(7) have been met. If in a particular year the facts show that they have not, then the provisions of s 31(2) kick in. The Court outright disagreed with this contention on the basis that the requirements of s 31(7) are clearly aimed at the nature of the transaction and not at the prevailing facts in a particular year (para 16). The Court argued that if, in a particular year, the market value of the assets of the foreign company exceeded the market value of its liabilities, such fact would not trigger the obligation of the foreign company to repay the loan as the foreign company is not obliged to redeem the loan in full within 30 years from the date on which the debt is incurred. Further, that it is only after expiry of the 30-year period that the obligation of the foreign company to redeem the loan will depend on whether the market value of its assets exceeds the market value of its liabilities (para 16).

The Court also agreed with SARS's position that the loan agreement did not meet the requirements of s 31(7) on the basis that the eventuality giving rise to the loan being immediately due and payable may occur

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within 30 years (para 17). With regards to the effect of the subordination agreement, the Court also agreed with SARS that the subordination clause simply regulated the subordination of the applicant's claim against MML to the claims of other creditors for such time as the liabilities of MML exceed its assets (para 19), and dismissed the application with costs (para 20).

VI ANALYSIS

The taxpayer submitted that the assessment of tax payable is an annual event and that, therefore, it must be determined from year to year, whether or not the requirements of s 31(7) have been met. The taxpayer proceeded that if, in a particular year the facts show that they have not been met, then the provisions of s 31(2) kick in. Louw J's response to that was: 'I respectfully disagree with the submission.' It would be more apt to say that the judge dismissed this argument, than that he disagreed with the submission. The judge's explanation of his 'disagreement' is as follows:

> 'The requirements of s 31(7) are clearly aimed at the nature of the transaction and not at the prevailing facts in a particular year. If, in a particular year, the market value of the assets of the foreign company exceeded the market value of its liabilities, such fact would not trigger the obligation of the foreign company to repay the loan as the foreign company is not obliged to redeem the loan in full within 30 years from the date on which the debt is incurred. It is only after expiry of the [30-year] period that the obligation of the foreign company to redeem the loan will depend on whether or not the market value of its assets exceeds the market value of its liabilities.'

The provision in question, s 31(7)*(b)* in particular, states that where the 'foreign company is not obliged to redeem that debt in full within 30 years from the date the debt is incurred', the adjustment does not apply. On the other hand, clause 7 of the contract provides for a possible, undesirable eventuality, that the parties involved do not hope for: 'in the event of an application being made for the liquidation of MML, or MML going into bankruptcy or business rescue or similar type proceedings, or judgment having been taken against MML and remaining unsatisfied for a period of 14 days'. This eventuality had not occurred in the years up to, or in, the 2015 tax year when the taxpayer sought to apply s 31(7). Thus, the trigger for the obligation to redeem had not been set off. It remained a resolutive condition that may not ever be satisfied. It is untenable to think that only at the expiry of the 30-year period would the taxpayer be

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able to look back and determine that the undesired eventuality did not occur, then therefore the taxpayer could claim the s 31(7) benefit.

The wording of s 31(7) is clear and peremptory. The instruction is that the foreign company *is* not obliged to redeem the debt. This is determined in the present perfect tense. It does not use 'will not', 'may not' or 'cannot', or use any other subjunctive constructions Therefore, at what point does the determination of the absence of the obligation to redeem happen? And for what tax year would that determination be made? I submit that the determination is made on an annual basis for that particular tax year. If that obligation arises within a particular year, s 31(7) cannot be claimed in that particular year. Yes, indeed the solvency of the foreign company is ordinarily (that is, absent clause 7) of no relevance if the obligation to redeem arises within the 30-year period. Clause 7 links the insolvency to the redemption of the debt. And because clause 7 does not provide for an option to redeem or not, insolvency would trigger the redemption automatically.

The effect of clause 7 was to address and codify the consequences of a business possibility. Absent clause 7, the same consequences would apply. In South African insolvency law, once a debtor commits an act of insolvency, any of the creditors can make an application for the compulsory sequestration of the debtor (see ss 9 and 10 of the Insolvency Act 24 of 1936 ('the Insolvency Act'). This application can be made following simple commercial conduct, such as if the debtor makes or offers to make an arrangement to be released partly from a debt (s 8*(e)* of the Insolvency Act), writes to the creditor stating that it is not able to pay its debt (s 8*(g)* of the Insolvency Act) or makes a disposition that would in some way prejudice any creditor (s 8*(e)* of the Insolvency Act). Clause 7 did not require the application to even be successful. It is therefore not a commercially meticulous clause because the unsuccessful application would not change any legal or economic position of the parties and of the contract itself. Unfortunately, as previously stated, it does not give the parties the option to either terminate the contract or not.

Even if that were not the case, if a debtor becomes insolvent and is liquidated by other creditors and not the taxpayer, the foreign company would, at the point of liquidation, redeem the debt in full, albeit that the taxpayer would only receive a portion of the amount due as determined by the laws of insolvency. In other words, the debtor immediately redeems the debt. It is then bad law to say that if parties to a loan agreement include this legal fact in a contract, then they lose the tax benefits arising from that contract.

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The effect of the subordination contracts was to determine the ranking of creditors at a possible insolvency of the foreign company. Based on the high value of the loans provided by the taxpayer to the foreign company, the taxpayer had the ability to forestall or halt any attempt to liquidate the foreign company, simply by not demanding repayment of the loan. Thus, while they did not neutralise the effect of clause 7, they reduced its effect, as the taxpayer would actually not be able to be paid in full because it would be a lowest ranking creditor in insolvency, but with high levels of loans, which would in all likelihood save the foreign company from liquidation. And without liquidation, its insolvency means that the taxpayer would not be paid or be paid in full.

Jerome Brink avers that clause 7 of the loan agreement appears to be a common clause inserted into most shareholder loan agreements (Brink, 'South Africa's first transfer pricing case' *Tax & Exchange Control Alert* 13 July 2018 available at https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Tax/tax-alert-13-july-south-africas-first-transfer-pricing-case.html, accessed on 7 March 2023). It therefore follows that, if Brink's averment is accepted, clause 7 has an important business purpose in these financing contracts, which should not be sabotaged by the loss of the tax benefit on a genuine contract. This would amount to restricting the availability of a tax benefit legally and purposefully granted by the legislature, by over extending the reach of a simple and necessary contractual term. Brink finds it interesting to note that the court was of the view that the occurrence of an uncertain event amounted to an obligation on the part of MML to redeem the debt within 30 years. He comments that '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'.

In the end, it was only upon the default by MML that the resoluteness of the condition and the obligation to redeem arises. It is incorrect to say that the subordination contracts change the impact of clause 7.

VII A SECOND TRANSFER PRICING CASE?

In an unreported case of *ABC (Pty) Ltd v Commissioner for the South African Revenue Service* Case No: IT 14305, the taxpayer was a manufacturer of catalytic converters. To produce these catalytic converters, the taxpayer required metals which it acquired from a Swiss entity. The taxpayer and the Swiss entity were connected parties as defined in s 1 of the Act. SARS assessed the taxpayer applying an adjustment purportedly in terms of s 31(2) of the Act.

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The issue contested was whether SARS had the power to make an adjustment to the profits of a company in terms of s 31(2) including profits from transactions with third parties. The taxpayer challenged the use of the transactional net margin method (TNMM) by SARS with a full cost markup to determine that the transactions were not at arm's length and that the adjustment was therefore inappropriate. The taxpayer suggested that CUP was the most appropriate method to use but did not have transfer pricing documentation to support this argument. The taxpayer also argued that even if it had been found that it had not paid an arm's length price in its transactions with the Swiss entity (which it denied) the tax authorities were only entitled to adjust the price as between it and the Swiss entity, not the consideration between applicant and third parties. In this regard, the argument continued, the tax authorities' adjustment of its profits pursuant to its application of the TNMM was not a legitimate exercise of transfer pricing power authorised by s 31(2). The taxpayer hence sought to separate the issue of whether the adjustment of the price fell within the powers afforded to SARS by s 31(2), and that this should be decided first.

This case was decided based on the law as it stood in 2011, prior to an immense amendment that substituted the salient provision with s 57 of the Taxation Laws Amendment Act 24 of 2011. The court ruled in favour of SARS that the issues could not be separated as the establishment of the arm's length nature, which is regarded as an overriding principle in transfer pricing matters, is the first step to consider and involves a factual inquiry that cannot be determined without reference to the merits of the case (para 40). The judge held that separating the legal and factual question would result in piecemeal litigation, increased costs and a delay in finalisation of the matter (para 40).

So, the court did not entertain the question of whether s 31(2) as it stood then allows SARS to adjust the profits of the taxpayer, ie, including prices charged between it and third parties. The relevant part of the provision as it stood then gave SARS the power 'for the purposes of this Act in relation to either the acquirer or supplier, in the determination of the taxable income of either the acquirer or the supplier [to] adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services'. The current provision provides for the calculation of the taxable income of any person that derives a tax benefit from a transaction as if that transaction 'had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length'. Thus, in my view, the change in legislation does not affect the amounts that can be adjusted.

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The amount to be adjusted is only, and is limited to, the prices charged between connected persons. The consideration charged in transactions with third parties does not pose a transfer pricing risk, and therefore it would have been *ultra vires* for SARS to adjust those prices, in terms both of the law as it was then and as it is now.

Indeed, the guidelines in the OECD and UN models, which filter into the South African treaties, provide that where prices are manipulated, 'any profits which would, but for those conditions, have accrued *to one of the enterprises*, but, by reason of those conditions, have not so accrued, may be included in the profits of *that enterprise* and taxed accordingly' (emphasis added). Any application of the South African law to prices charged in transactions with third parties would therefore also be in breach of the South African treaty, where applicable. Indeed the OECD Commentary on article 9 states that paragraph 1 of article 9 'provides that the taxation authorities of a Contracting State may, for the purpose of calculating tax liabilities of *associated enterprises*, re-write the accounts *of the enterprises* if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that state' (emphasis added) (OECD Commentary on the Model Tax Convention on Income and on Capital, (2017) available at https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page609, accessed on 8 March 2023). This does not provide any room for an adjustment of profits of any enterprise other than the associated enterprises that are the subjects in the manipulation of the prices).

The court discussed three recent international transfer pricing cases (*The Coca Cola Company (TCCC) and Subsidiaries v The Commissioner of Internal Revenue US*, November 2020, US Tax Court, 155 T.C. No. 10; *Canada vs AgraCity Ltd. and Saskatchewan Ltd*. August 2020, Tax Court, 2020 TCC 91; and *Denmark v ECCO A/S*, October 2020, High Court-,Case No. SKM2020.397.VLR) to illustrate that regardless of what transfer pricing method is 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 (paras 25–27).

Thus, the main takeaway from this case (or what cannot be taken away from it) is that it highlights the need for taxpayers to properly test whether their related party transactions comply with the arm's length principle. It demonstrates that courts are unlikely to entertain arguments regarding comparable agreements, where a proper study has not been conducted to analyse the comparability of such agreements in

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terms of any method (see Brink, 'South Africa's "second" transfer pricing case?' *Tax and Exchange Control Alert* (4 March 2021) available at https://www.cliffedekkerhofmeyr.com/en/news/publications/2021/Tax/Tax-Alert-4-March-2021-South-Africas-second-transfer-pricing-case.html, accessed on 14 February 2023; Du Toit, 'What can we learn from South Africa's latest transfer pricing case' *Mazars* (2021) available at https://www.mazars.co.za/content/download/1037743/54131955/version//file/Transfer%20Pricing_Slipsheet_SAs%20latest%20TP%20case.pdf, accessed on 15 February 2023.)

The need to document and provide adequate evidence applies not only to the method used but also to the elements of the method used. The OECD Guidelines expound on this, stating that if the relevant terms of the controlled transaction such as the price or margin 'are outside the arm's length range determined by the tax administration, the taxpayer should be given the opportunity to argue how stating the terms of the controlled transaction satisfy the arm's length principle, and whether the result falls within the arm's length range (ie, that the arm's length range is different from the arm's length range determined by the tax administration)'. Should the taxpayer fail to demonstrate these averments, the tax administration should be allowed to determine the point within the arm's length range to which to adjust the condition of the controlled transaction (para 3.61 of the OECD Guidelines; see also the Spanish case of *Spain vs Ikea*, March 2019, Audiencia Nacional, Case No SAN 1072/2019).

VIII CASES 'NOT REPORTABLE' AND OF 'NO INTEREST TO JUDGES'

As stated in the introduction, tax is complex, and more so transfer pricing due to its hybrid nature, complexity of transactions and evidence required to prove that the prices charged are at arm's length. One would expect that any case that involves transfer pricing that is heard by the High Courts would be reported and brought to the attention of taxpayers, practitioners and judges. I note with concern that the cases of *Crookes Brothers* and *ABC* are both marked 'not reportable' and 'not of interest to other judges'. This is quite disheartening considering the scarcity of transfer pricing cases and the need for judges to acquire knowledge of tax and to deal with tax cases (see Temkin, 'Tax judges need to be experts' *Business Day* (8 November 2013) available at https://www.thesait.org.za/news/145391/Tax-Judges-need-to-be-experts.htm, accessed on 9 February 2023). Elsewhere, the sharing of information and views on tax cases is encouraged. For example, the

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International Association of Tax Judges (IATJ) has, since its inception in 2010, been a dedicated forum for judges to share information, knowledge and an exchange of their views on tax and economic matters (see International Association of Tax Judges available at https://iatj.net/, accessed on 9 February 2023).

My conclusion is that the decision in *Crookes Brothers* is incorrect. I also submit, that due to the lack of precedent in transfer pricing, the judge in *ABC* could have opined on the legitimacy of SARS applying the adjustment to the consideration charged between unrelated parties. It is not surprising that these decisions went the way they did. This could be attributed to the lack of 'interest' in tax cases as perpetuated by the categorisation of cases as not reportable, and of no interest to other judges.

Having said that of South African cases, it should be noted that situations where potential judicial precedent is lost or missed due to legal technicalities are common and not only limited to South Africa. For example, in a similar near miss, in the Romanian case of *Romania vs 'Electrolux' A. SA,* November 2020, Supreme Court, Case No 6059/2020, the court had to determine the appropriate transfer pricing method for a loss-making entity in a group of companies. The Supreme Court referred the case back to the lower court for the completion of the evidence. This was in compliance with the rulings given on questions of law brought up and decided on in the Supreme Court.

I applaud judges like Wallis JA who, in the case of *Roshcon (Pty) Limited v Anchor Auto Body Builders CC & others* (49/13) [2014] ZASCA 40; [2014] 2 All SA 654 (SCA); 2014 (4) SA 319 (SCA), which was not even a tax case, took an opportunity to clarify the import of the decision in *South African Revenue Services v NWK Limited* 2011 (2) SA 67 (SCA). This was in response to a proposition that NWK took the law in a new direction with regard to substance over form. In a separate and concurring judgment, and after a lengthy and proper analysis of the cases decided on the subject, the judge concluded that '[n]othing said subsequently in any of the judgments of this court dealing with simulated transactions alters those original principles in any way or purports to do so'. The original principles that the judge was referring to are those laid out in cases such as *SA Pulp and Paper Industries Ltd v Commissioner for Inland Revenue* 1955 (1) SA 8 (T); *Du Plessis v Joubert* 1968 (1) SA 585 (A); *Bozzone & others v Secretary for Inland Revenue* 1975 (4) SA 579 (A); *Commissioner of Inland Revenue v Saner* 1927 TPD 162; *Commissioner of Customs and Excise v Randles Brothers & Hudson Ltd* 1941 AD 369; *Secretary for Inland Revenue v Hartzenberg* 1966 (1) SA

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40 (A). Wallis JA's analysis went a long way in clarifying the jurisprudence about the principle of substance over form.

IX CONCLUSION

I somehow expected the taxpayer to appeal the decision in *Crookes Brothers*. Perhaps I just hoped they would, in order to give some strength to South Africa's transfer pricing jurisprudence. The challenge will always be that transfer pricing is so complex that precedent would only apply in very specific circumstances. The wide array of commercial transactions and variables therein makes the saying that 'no two cases can be exactly the same' is very fitting, and that 'each case should be decided on its own merits', relevantly authoritative.

Precedent is sensitive to facts and circumstances. A lot of distinguishing factors could kick out precedent. For example, even with transfer pricing adjustments, factors like location, economic factors such as the changes in interest rates, business environment, prevalence or frequency of business of goods and/or services traffic, the nature and structure of the service provider or service recipient, could affect the applicability of precedent. Basically, anything and everything can exclude a particular judgment from being followed. For example, in *Commissioner of Taxation v SNF (Australia) Pty Ltd* ([2011] FCAFC 74; 193 FCR 149). the inadmissibility of evidence of certain allegedly comparable transactions was questioned because the parties did not have the same features as the taxpayer, being a history of making losses.

The *Crookes Brothers* case is indeed appealable, regardless of the fact that the appeal to the Supreme Court of Appeal was dismissed with costs. It is also quite a challenge to build up tax jurisprudence because it is costly, and not many people would be willing to pay the price of an appeal to the Supreme Court of Appeal for the benefit of South Africa's jurisprudential wealth.

Brink (Tax & Exchange Control Alert) writes with regards to *Crookes Brothers*:

> '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 s 31 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.'

While the tax academics, researchers, lawyers and accountants could have hoped that the arm's length principle as it applies in South African

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law could have been elaborated on in *Crookes Brothers*, this was not a case that could provide that. This court correctly concerned itself with the compliance by an arrangement with the exclusion provisions in respect of debt instruments that have equity characteristics. It also seems like South African tax jurisprudence, in light of *IT14305*, hits its own *aberratio ictus* on addressing the actual substance of transfer pricing, for example whether the CUP method should be applied over the other methods such as the transactional net margin method.

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