SOUTH AFRICAN TRANSFER PRICING COURT CASE - JANUARY 2021

Introduction

SARS recently (in January 2021) released the outcome of a transfer pricing case it was involved in - IT 14305 (IT) [2021]. This case deals with an application for separation of a legal issue in terms of Rule 33(4) of the Uniform Rules as provided for in terms of Rule 42(1) of the Rules relevant to the Tax Court.

Background

Pursuant to an audit in 2014 in respect of the taxpayer's 2011 year of assessment, SARS raised an additional assessment on the South African resident company taxpayer giving effect to SARS' adjustment of R114 157 077 to the taxpayers' taxable income in terms of section 31(2) of the Income Tax Act (ITA) as it was in 2011. SARS contended that the transactions between the South African taxpayer and its related Swiss Entity, did not meet the arm's length standard.

SARS reached this conclusion after conducting a benchmarking study using external companies it considered comparable to the taxpayer's business circumstances. Following the comparability study, SARS noted that that the FCMU of 1%, declared by the applicant in its 2011 financials, fell between the minimum and lower quartile of the range of comparable companies. On this basis, respondent concluded that the FCMU achieved by applicant was not at arm's length. The taxpayer was in the process of appealing against the additional assessment.

Separation argument

The taxpayer contended that section 31(2) only permitted SARS to adjust the consideration in respect of the transaction between itself and the Swiss Entity, not the consideration between the taxpayer and third parties. The taxpayer felt that the SARS adjustment was not a legitimate exercise of transfer pricing power authorized by section 31(2) and consequently the additional assessment is not legally permissible. Therefore, the issue which the taxpayer was seeking to be separated from the appeal against the assessment, was whether the conduct of SARS fell within the powers set out in section 31(2) of the ITA.

The taxpayer argued that should SARS be found to have acted outside its powers, the assessment cannot stand. There would thus be no need to provide evidence as to the justification that an arm's length amount was used which would, in all likelihood, require complex evidence of experts in economics and of traders knowledgeable in the specialized market in which the taxpayer conducted its trade. The separation, in other words, would likely lead to an expeditious disposal of the issues covered in the appeal. The taxpayer added that in the event there were to be a delay, it would be to its detriment as the income tax raised via the additional assessment has already been paid.

SARS on the other hand stated that it can only be determined if it acted within its powers if a factual analysis, which commences with a determination as to whether the transaction between the taxpayer and the Swiss Entity was at arm's length or not, was conducted.

Application of the law to the facts

The questions posed to the court were as follows:

1. Was there a convincing legal point to be tested?; and
2. If so, will the determination of the issue sought to be separated advance the objects of the case giving direction to the rest of the case and remove the need to provide further evidence?

Findings

The judge referred to three recent (2020) international transfer pricing court cases (*The Coca Cola Company (TCCC) and Subsidiaries v The Commissioner of Internal Revenue US, Canda v AgraCity Ltd and Denmark v ECCO A/S*). He stated that these cases illustrated that regardless of what method has been used to determine the arm's length consideration, ultimately, adjustments are made to profits of the taxpayer to ensure that tax is levied on the correct amount of taxable income.

The judge stated that the taxpayer had argued that the transactions with the Swiss Entity had no transfer pricing implication as they were 'flow-through transactions'. Thus it did not test the specific Swiss Entity transactions for the requirements of the arm's length principle, contrary to the guidance given by Practice Note 7.

The judge thus agreed with SARS that the convincing point of law to be tested and sought to be separated had no weight. He stated further that the taxpayer had not made any practical suggestion on how the transfer pricing adjustment ought to have been done in order to determine its taxable income, given that the applicable transactions took place in 2011 whereas the audit was conducted in 2014.

The judge also found, with regard to the taxpayer's contestation against SARS' reliance on the OECD Transfer Pricing Guidelines (TPG) and SARS' Practice Note 7, that not only did the respondent place reliance on these documents in advancing its case, but that these documents are evidence of practice that is internationally accepted and practice recognized by all concerned. Furthermore, the judge stated that the TPG are a world standard in transfer pricing matters and therefore the taxpayer's attack on SARS' reliance on these does not make the point sought to be separated any more persuasive and ordering any separation would be a waste of resources.

Court judgement

The judge concluded by stating that the establishment whether a consideration is or is not at arm's length precedes the question of adjustment, regardless of what method is employed. 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 receded to the back.

The judge held that ordering a separation will not achieve any practical benefit and would result in piecemeal litigation, increase costs and delay finalization of the matter. The application for separation was thus dismissed with costs.

Conclusion

This case dealt with a request to the court to split up aspects of the facts of the case (separation order). Although this case doesn't deal directly with the transfer pricing issue (for instance CUP vs TNMM) and deals with the 2011 legislation, that is, before the April 2012 change to the transfer pricing law (section 31) and Tax Administration Act section 3(j) amendment, which brought an 'international standard' (the OECD regulations) into South Africa's legislation, it does provide some valuable lessons for taxpayers.

The case highlights that determining whether a transaction is at arm's length or not, is the first step in determining whether a transfer pricing adjustment will be made by SARS. Taxpayers should note that, unless they are obligated to prepare and/or file Master File and or Local File transfer pricing documentation in terms of Government Gazette 41186 dated 20 October 2017 and Government Gazette 40375 dated 28 October 2016, should they elect to not prepare transfer pricing documentation; it is at their own risk. If no documentation is prepared, as is seen

from this case, not only will SARS most likely examine a taxpayer's transfer pricing practices in more detail but having no documentation will make it very difficult for the taxpayer to rebut any alternative arm's length amount.