REPUBLIC OF SOUTH AFRICA

IN THE TAX COURT OF SOUTH AFRICA

(HELD AT JOHANNESBURG)

CASE NO: IT 14305

1. REPORTABLE: YES/**NO**
2. OF INTEREST TO OTHER JUDGES: YES/**NO**
3. REVISED.

..... **.....**
SIGNATURE **DATE**

BEFORE THE HONOURABLE JUSTICE BAM AJ
ON 3 DECEMBER 2020

In the matter of:

ABC (PTY) LTD APPLICANT/APPELLANT

AND

COMMISSIONER FOR THE RESPONDENT
SOUTH AFRICAN REVENUE SERVICE

J U D G M E N T

THIS JUDGMENT HAS BEEN HANDED DOWN REMOTELY AND SHALL BE CIRCULATED TO THE PARTIES BY EMAIL. ITS DATE AND TIME OF HAND DOWN SHALL BE DEEMED TO BE 2021/01/07 AT 14H00

BAM AJ

A. Introduction

[1] This is 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[1] relevant to this court. The application is opposed by respondent. In the background of this application is a pending income tax appeal before this court. I refer to the appeal as the main proceedings. Applicant, appellant in the main proceedings, launched the application.

[2] The pending appeal is against an additional assessment raised by respondent, giving effect to its adjustment of appellant's taxable income. The adjustment, according to respondent, is based on section 31(2) of the Income Tax Act (ITA),[2] as it was in year 2011.[3]

[3] Broadly stated, section 31 was aimed at protecting the fiscus by ensuring that the tax payable in international transactions involving transfer pricing reflects the arm's length principle. It gave the Commissioner certain powers in the event the requirements of that section were met. Simply put, the rationale behind section 31 was to counter the manipulation of prices by Multinational Entities (MNEs), where members of a MNE transfer goods and services among themselves using non-market related values (inadequate or excessive consideration) with the result that the income calculated for each of the members would be inconsistent with their relative economic contribution. Such distortion impacts on the tax revenues of the relevant jurisdictions in which the MNEs operate and is recognized as one of the main drivers of Base Erosion and Profit Shifting (BEPS) in the report provided by the Davits Tax Commission's sub-committee on BEPS.[4]

B. Parties

[4] Applicant is ABC (Pty) Ltd, a company incorporated in terms of the company laws of South Africa, with its registered office situated at XXX, Gauteng. Respondent is the Commissioner for South African Revenue Service with its Head Office at Lehae la SARS 271 Bronkhorst Street, Nieuw Muckleneuk, Pretoria, Gauteng.

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1 Promulgated in terms of section 103 of the Tax Administration Act, Act 28 of 2011.
In terms of Rule 42 (1), if these rules do not provide for a procedure in the tax court, then the most appropriate rule under the Rules for the High Court made in accordance with the Rules Board for Courts of Law Act, and to the extent consistent with the Act and these rules, may be utilised by a party or the tax court.

2 Act 58 of 1962.

3 All references to section 31 of the ITA in this judgment refer to the section as it was in 2011.

4 See extract from the Davis Tax Commission's BEPS sub-committee report: The report was released in May 2016: accessed at **www.taxcom.org** as at 2020/12/15.

[5] Prior to introducing the issue proposed for separation, it makes sense to first refer to the relevant aspects of section 31 of the ITA as it read then, followed by a brief background.

[6] Section 31(2) of the ITA then titled: *"Tax payable in respect of international transactions to be based on arm's length principle"*, provided:

> "Where any supply of goods or services has been effected—
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> (i) (*aa*) between a resident; and
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> (*bb*) any other person who is not a resident; …
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> (*b*) between those persons who are connected persons in relation to one another; and
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> (c) at a price which is either—
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> (i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price); or
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> (ii) greater than the arm's length price,
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> the Commissioner may, 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, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services."

C. Background

[7] The common cause facts between the parties are as follows: Applicant is in the business of manufacturing, importing, and selling chemical products. It has a catalyst division that is focused on manufacturing and selling catalytic converters (catalysts). Catalysts are used in the abatement of harmful exhaust emissions from motor vehicles. To produce the catalysts, applicant requires, *inter alia*, some metals known as the Precious Group of Metals (PGMs). It purchases the PGMs from a Swiss entity ("the Swiss Entity"). The PGMs are liquified and mixed with other chemicals to create coating for substrates, all being part of the manufacturing process. Once the manufacturing is complete, the catalysts are sold to customers in South Africa known as the original equipment manufacturers (OEMs). It is common cause that applicant and the Swiss Entity are connected parties as defined in section 1 of the ITA.

[8] Pursuant to the audit carried out in 2014 in respect of applicant's 2011 year of assessment, respondent raised an additional assessment on 11 January 2016 to effect an adjustment it had made to applicants taxable income. In its Letter of Audit Findings dated 22 October 2015, respondent recorded that it had formed a view that the transactions involving the purchase of the PGMs between applicant and the Swiss Entity did not meet the arm's

length standard. Respondent formed this view following a detailed analysis of the total cost base incurred by applicant in acquiring the PGMs and other raw materials, including the manufacturing and distribution costs of the catalysts. Respondent also took into account the role played by applicant in purchasing and manufacturing the catalysts, the assets and the risks involved, which risks applicant had accounted for in its financial statement. Using the Transactional Net Margin Method (TNMM)[5] with a Full Cost Mark-Up (FCMU),[6] respondent conducted a benchmarking study using external companies it considered comparable to applicant's business circumstances. Following that comparability study, respondent noted that that the FCMU of 1%, declared by 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. As recommended in the OECD[7] Transfer Pricing Guidelines (TPGs) (about which I say more in the course of this judgment), and adopted by respondent in its Practice Note 7 (PN 7),[8] respondent invited applicant's comments in relation to the proposed upward adjustment of its 2011 FCMU. Although applicant had provided comments to persuade respondent against the proposed adjustment, respondent was not persuaded. It is common cause that contrary to the recommended practice[9] that taxpayers test their transfer prices for the arm's length requirements, applicant had not tested the transactions involving the purchase of the PGMs from the Swiss Entity. On the strength of the recommendations set out in PN 7, which flow directly from the TPGs, respondent adjusted applicant's FCMU to the median arm's length range achieved by the comparable companies. This resulted in an increase in applicant's income for the 2011 year of assessment by an amount of R114 157 077. Respondent contends that an adjustment of the FCMU of the transaction is an adjustment for the

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5 The transactional net margin method is one of the five methods of establishing the arm's length price. It is recommended by the OECD and endorsed by respondent in its Practice Note 7 dated 1999.

6 FCMU = EBIT (Earnings before Interest and Tax)
Total Cost of Sales + Operation Expenditure

7 The Organisation for Economic Cooperation and Development.

8 Paragraph 11.4.7 of the PN 7.

9 The OECD Guidelines and PN 7recommend that taxpayers test their transfer prices to ensure they satisfy the arm's length principle. See paragraph 2.8 of PN 7: 'The objective of this practice note is to provide taxpayers with guidelines about the procedures to be followed in the determination of arm's length prices, taking into account the South African business environment. It also sets out the Commissioner's views on documentation and other practical issues that are relevant in setting and reviewing transfer pricing in international agreements.'

Para 7.3 of PN 7 notes: The problem to be resolved is how a multinational should determine what price would have arisen if transactions between its members were subject to market forces. The solution advanced by the arm's length principle is that a comparable transaction between independent parties (an uncontrolled transaction) should be used as a benchmark against which to appraise the multinational's prices (the controlled transaction).

consideration of the PGM transactions. As I have mentioned at the start of this judgement, applicant is appealing the additional assessment.

Methods of determining the arm's length price

[9] Before moving forward with this discussion, it is apposite to say a little more on the various methods of determining the arm's length nature of a transaction. The TNMM is but one of the methods espoused by PN 7. Four further methods are provided for. They are: the Comparable Uncontrolled Price method (CUP); Resale Plus method (RP); Cost Plus method (CP); and the Profit Split method.[10] All the methods of determining the arm's length consideration enquire into the profits made or ought to have been made had the transaction been at arm's length.[11] Once it is found that the transaction was not at arm's length, adjustments are then made to the profit margins of the respective transactions to determine the taxable income. As noted in the both PN 7 and the TPGs, the method most suitable to establish the arm's length consideration in any given case will be determined by the availability of data and the circumstances of the case being considered.[12]

D. Law

[10] The purpose and the benefit of Rule 33(4) were dealt with in *The City of Tshwane Metropolitan Municipality v Blair Atholl Homeowners Association*:[13]

> "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… ."

(Footnotes omitted)

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10 Paragraph 9.2 of PN 7.
11 Paragraph 7.2 of PN 7.
12 Paragraph 8.15 of PN 7.
13 (106/2018) [2018] ZASCA 176 (3 December 2018) at paragraph 48.

[11] In S*AP Societas Europaea (SAP)* v *Systems Applications Consultants (Pty) Ltd t/a Securinfo and Another*,[14] the court heeded the words sounded in *S v Malinde:*[15]

> "When deciding an application under the sub-rule, the Court is not called upon to give a decision on the merits. But it must consider the cogency of the point concerned, because unless it has substance a separate hearing would be a waste of time and costs. So, the court should not grant an application for a separated hearing 'unless there appears to be a reasonable degree of likelihood that the alleged advantages would in fact result."

[12] As admonished by the court in *Copperzone 108 (Pty) Ltd and Another v Gold Port Estates (Pty) Ltd and O,*[16] this court has a duty to carefully consider whether the separation:

> "…will facilitate the proper, convenient and expeditious disposal of litigation. The notion of convenience is much broader than mere facility or ease or expedience. Such a court should also take due cognisance of whether separation is appropriate and fair to all the parties. In addition the court considering an application for separation is also obliged, in the interests of fairness, to consider the advantages and disadvantages which might flow from such separation. Where there is a likelihood that such separation might cause the other party some prejudice, the court may, in the exercise of its discretion, refuse to order separation. Crucially in deciding whether to grant the order or not the court has a discretion which must be exercised judiciously."

[13] So the questions in my view are: (i) Is there a cogent legal point to be tested; (ii) In the event this court were to find that there is cogency in the issue, will the determination of the issue sought to be separated advance the objects highlighted in the *Blair Atholl* of, *inter alia*, giving direction to the rest of the case and obviate the need to lead evidence?

E. Separation Arguments

[14] Applicant contends that section 31(2) only permitted respondent 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; in the event the 'jurisdictional facts' called for by section 31 were established as a matter of fact. It states that even if it had been found that it had not paid an arm's length price for the PGMs, which it denies, respondent was only entitled to adjust the price/consideration paid for the PGMs as between applicant and the Swiss Entity, not the consideration between applicant and third parties. In this regard, respondent's adjustment of applicant's profits pursuant to its application of the TNMM and the FCMU was not a legitimate exercise of transfer pricing power authorized by section 31(2). As a consequence, argues applicant, the additional assessment is legally impermissible. The issue which applicant seeks separated therefore, is whether the conduct of respondent fell within the powers set out in section 31(2). Applicant suggests that respondent overreached

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[14] (20378/2008) [2019] ZAGPJHC 241 (1 August 2019), paragraph 30.
[15] *S v Malinde and Others* 1990 (1) SA 57 AD.
[16] (7234/2013) [2019] ZAWCHC 34 (27 March 2019) at paragraph 23.

the powers provided by section 31(2) when it adjusted the consideration of a different transaction between applicant and third parties and not that of the PGMs.

[15] In furtherance of its case, applicant submits that the issue is compact, discrete and can easily be incised. It can be decided 'without reference to the underlying merits or to whether the sale of the PGMs was or was not at arm's length'. While accepting that there may be some overlap of evidence, applicant suggests that the issue sought to be separated is dispositive of the issues in the appeal in that in the event it is found that respondent acted outside its powers, the assessment cannot stand. There would thus be no need to lead evidence into the remaining issues raised in the pleadings which would, in all likelihood, require complex evidence of experts in economics and of traders knowledgeable in PGM markets. The separation, in other words, would likely lead to an expeditious disposal of the issues covered in the appeal. Applicant adds 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.

[16] Not so, submits respondent. The answer to the question raised by applicant, that is, whether respondent acted within the powers set out in section 31(2), involves a factual analysis which commences with a determination as to whether the transaction between applicant and the Swiss Entity was at arm's length or not. A simple reading of applicant's Rule 32 statement is sufficient to demonstrate that applicant is aware that there are methods involved in establishing the arm's length nature of a transaction. One cannot assume, but must establish as a fact, that a particular transaction is, or is not at arm's length. One of those methods is the Comparable Uncontrolled Price method, CUP, advocated for by applicant. It is only by understanding the nature of the transactions, and determining the arm's length nature thereof, that it can be determined how the adjustment of the consideration is to be effected. Further, once a specific method has been chosen to determine the arm's length nature of the transaction, the adjustment to the consideration is then effected in accordance with that chosen method. One cannot accordingly deal with the manner in which adjustments are to be effected without dealing with the manner in which the arm's length nature of the transaction that is to be tested. The question of adjustment in terms of section 31(2) does not even arise before one establishes as a fact whether the transactions between applicant and the Swiss Entity were at arm's length or not, submits respondent. Thus, the issue sought to be separated is neither discrete nor compact, nor can it be easily incised, says respondent. Far from being discrete, the issue is 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, which applicant denies. Respondent concludes that the enquiry into the arm's length nature of a transaction is an overriding principle in transfer pricing matters and may not be receded to the back, as applicants seek to do.

[17] Respondent submits that upon perusing applicant's Rule 32 statement, it is plain that the real issue between the parties is the arm's length price of the transactions involving the PGMs. This can be traced back to applicant's letter of response to the audit findings dated 27 November 2015. Applicant, suggests respondent, resorted to this issue of challenging the powers of the Commissioner simply because it could not provide evidence of testing the PGM transactions for the arm's length requirements. It is because of this same reason that applicant's advocation of the CUP method was not persuasive, says respondent.

[18] On the question of overlap of evidence, respondent submits that on the basis of this concession made by applicant, the application ought to be dismissed. It states that in the event this application is granted, it will have to lead the same evidence to indicate how it tested the arm's length nature of the transaction as it would in explaining how it effected the adjustment. Thus, the issue is not simply a question of which consideration was adjusted, as applicant seeks to contend. There is thus an intertwining of evidence that is neither convenient nor appropriate for separation.

[19] Respondent disputes that a determination favourable to the applicant on the issue sought to be separated is dispositive of the entire appeal. On the contrary, it states that applicant seeks an academic judgement on whether the adjustment is authorised in terms of section 31(2). However, in that event, the court would still have to determine what the correct manner of effecting the adjustment should be, and the court can only do this once it has determined whether the transactions between applicant and the Swiss Entity were at arm's length. With regard to the claim by applicant that it has paid the tax raised via the additional assessment, respondent states that applicant paid a portion of the assessed tax, thus any delay in finalising the matter will simply result in an increase in costs. Finally, on the point raised by applicant that any delay would be to its detriment, respondent submits that this court consider the public interest involved. It submits that it is in the interest of the public that decisions of public functionaries be finalised without delay.

[20] Applicant makes a further point which it claims demonstrates that the scales are tipped in favour of granting the separation application. The point pertains to the reasons that led to the amendment of section 31. It is common cause that in 2011, section 31 was amended in its entirety. It was then replaced in April 2012. The point made is that a major reason for the amendment was that the section as it stood then limited the Commissioner to adjust the consideration relevant to the impugned transaction. It did not permit the wider approach that focuses on the overall profits. Applicant suggests that this is apparent from the Explanatory Memorandum that companied the Bill introducing the amendment, which stated the current wording of the Transfer Pricing Rules is causing structural problems and uncertainties. More specifically, the literal wording focuses on specific transactions as opposed to the overall arrangements driven by the overarching profit objective. The narrow focus gives rise to

artificial and excessively literal arguments by certain taxpayers. Applicant states that the wording as it stood then emphasized the CUP method over other methodologies which may be considered most appropriate as determined by the circumstances of the case. Applicant, however, says it does not accept that the arguments it intends to raise when the separated issues are addressed are excessively literal or artificial. But what is clear is that under the previous wording, SARS's powers could arguably be challenged as limited to the prices of the specific transaction/s. Respondent submits that this is a complete misdirection on the part of applicant. Respondent suggests that the amendments were effected to clarify what the legal position always had been. In this regard respondent suggests that the adjustment that is contemplated in section 31(1) is effected having regard to the profits declared by the taxpayer. The memorandum of explanation states that it is to avoid artificial arguments. The subsequent amendments merely highlight what has always been in the legislation.

[21] The remainder of applicant's submissions deals with costs. Applicant submits that respondent ought to have agreed to the separation. It did not do so, only to now advance an unmeritorious defence. On that basis, applicant seeks costs.

F. Analysis

[22] 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). During argument, counsel on behalf of applicant suggested that even if it were to be accepted that the price it had paid for the PGMs, the conduct of respondent would still be contrary to the powers set out in section 31(2). For the purposes of answering the question raised in Malindi,[17] that is, whether there is any cogent issue worth separating, I shall first temporarily park the bulk of the enquiry regarding questions of expedience, convenience to all concerned, fairness and whether or not determining the issue – sought to be separated – would be dispositive of the issues raised in the appeal. I refer to applicant's letter of response to the audit finding dated 27 November 2015 wherein it advanced points, the majority of which are entirely premised on the authoritative statement of the arm's length principle. In the first instance, applicant dealt with how it sought to meet the arm's length principle. This Arm's Length Authoritative Statement is found in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD member countries

[17] Note 17 supra.

and an increasing number of non-member countries. The statement (which forms part of the PN 7) reads:

> "[Where] conditions are made or imposed between the two [associated] 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."

[23] Having referred to the authoritative statement of the arm's length principle, applicant dealt with the OECD BEPS topic and went on to discuss the requirements that people's roles and functions be taken into account. On the comparability analysis conducted by respondent, applicant urged that the PGMs ought not to have been included in the cost base when analyzing its profitability, adding that the profit of the companies used as comparison may be more appropriate for testing the profitability of applicant's Catalyst division, excluding the value of the PGMs and the Substrates from the cost base. In its Rule 32 Statement of Grounds for appeal,[18] applicant advocated that respondent ought to have relied on the Comparable Uncontrolled Price (CUP) method in testing the arm's length nature of the PGM transactions. The CUP, claimed applicant, would have resulted in no adjustment being warranted or required, adding that the CUP is a more reliable traditional transactional method as opposed to the TNMM.[19] The adjustment referred to by applicant must ultimately be understood to be referring to the adjustment of profits. Based on these statements, respondent argues that it is pellucid that applicant accepted that, in the course of testing the arm's length nature of the transactions with the Swiss Entity, respondent was required to test applicant's profitability. Not only that, argues respondent, by its very own reference to the authoritative statement of the arm's length principle, applicant accepted that profits which would have accrued to it, but for the transaction which was not at arm's length, may be included in its profits and be taxed accordingly. Respondent states this is exactly what it did.

[24] All methods of determining the arm's length nature of a transaction enquire into the profits made or ought to be made, submits respondent. Once it is found that the transaction was not at arm's length, adjustments are then made to the profit margins of the respective transactions to determine the taxable income. See in this regard the arm's length authoritative statement set out in paragraph 20 of this judgment. See also PN 7 in paragraph 9.7.2 – where it states:

> "Although the TNMM is classified as a transactional profit method, it is more closely aligned to the Cost Plus, CP, and Retail Plus, RP methods than to the profit split method. As with the CP

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18 Paragraphs 13 and 14 of applicant's Rule 32 statement of grounds.
19 Paragraph 15 of Rule 32 statement.

> and RP methods, the TNMM focuses on the functions performed by an enterprise. The difference is that the TNMM compares net profit rather than gross profit."

[25] Bearing in mind that this court is not called upon to decide the merits, I had regard to a fair number of transfer pricing cases. For the purposes of this discussion, I refer to three. In *The Coca Cola Company (TCCC)* and *Subsidiaries v The Commissioner of Internal Revenue US*, November 2020, US Tax Court, 155 T.C. No. 10, respondent, CIR, had used the Comparable Profit Method to determine the arm's length nature of the controlled transactions between TCCC and its foreign affiliates, known as the Supply Points. (Controlled transaction refers to the transaction between connected persons, TCCC and each of its Supply Points.) Having concluded that the controlled transactions did not display the arm's length norms, respondent effected adjustments which saw TCCC's aggregate taxable income increased by more than $9 billion for the years 2007–2009. TCCC unsuccessfully challenged respondent's use of the CPM stating that it was inferior to the CUP (Comparable Uncontrolled Price method) provided for in the US Treasury Regulations relevant to Transfer Pricing. I interpose at this point that the US Treasury Regulations on Transfer Pricing are comparable to the OECD TPGs.[20] The court rejected TCCC's argument stating that the CUT's superiority is premised on the availability of data to run the comparability exercise.

[26] In *Canada vs AgraCity Ltd. and Saskatchewan Ltd. August 2020*, Tax Court, 2020 TCC 91. AgraCity, a Canadian company and group parent, had entered into a Services Agreement with one of its group companies by the name NewAgco Barbados, in connection with the sale by NewAgco Barbados (NewAgco) directly to Canadian farmer-users of a generic type herbicide known as ClearOut. According to the Canadian Revenue Agency (CRA), the value created by the parties to the transactions did not align with what was credited to AgraCity's and NewAgco's profits. Not persuaded that the transaction between AgraCity and NewAgco met the arm's length norms, the CRA re-allocated 100% of the net profits realized from the ClearOut sales to AgraCity. According to the CRA, the profits should have accrued only to AgraCity in the event the parties were dealing at arm's length. The CRA argued: *"arm's length commercial parties would never agree to let NewAgco Barbados have any of the profits if it served no function in the transactions given that it had no assets, employees, resources, or other role or value to contribute to the profit making enterprise or to bring thereto."* The court ultimately set aside the additional assessment having been persuaded by the AgraCity's Transfer Pricing records and its reliance on the TNMM in testing its own transfer prices. In essence, AgraCity had looked at available data on returns, margins, mark-ups on costs earned by North American corporations that are known to provide broadly similar logistics services including Canadian Freight forwarding brokerage agency companies. Based on the available numbers, it concluded that such companies would earn in the range of 5 – 15% returns over

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[20] **www.pwc.com/internationaltp** accessed on 15 December 2020.

costs. Although the court ultimately set aside the additional assessment by the CRA, it made specific references to the OECD TPGs.

[27] In *Denmark*[21] *v ECCO A/S*, October 2020, High Court, Case No. SKM2020.397.VLR, a Danish parent company (appellant at appeal stage) involved in the design, production and sale of quality shoes had purchased goods from external (independent parties) and internal parties. To uphold its brand promise of high quality, the group operates from a principle known as 'From cow to shoe'. By virtue of the fact that the company is involved in all the production phases, from receipt of raw cowhide to a complete shoe placed before the consumer, the company is involved in numerous intra-company transactions. There were intra-group purchases and sales in making shoe shafts, (the upper part of the shoe) between the various members of the group. Not persuaded that the intra-group transactions met the arm's length principle, the respondent made adjustments which saw appellant's taxable income significantly increased. Appellant had prepared its set of records in support of its transfer pricing decisions. Referring to the OECD TPGs, the court found the appellant's transfer pricing records, though not perfectly aligned with the OECD TPGs because of the taxpayer's own misunderstanding, were persuasive and ordered that the additional assessment be set aside with the result that respondent had to refund appellant.

[28] The point illustrated by the reference to the above three cases demonstrates that regardless of what 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.

[29] Having placed reliance on the authoritative statement which seeks to tax profits that ought to have accrued to a party, but for the fact that they were not dealing with each other at arm's length, what made applicant decide to attack the very conduct it had acknowledged in advancing its case against respondent? I noted while perusing applicant's letter of 27 November 2015 that all along, it had pursued its case on the basis that the transactions involving the PGMs have no transfer pricing implications as they were 'flow through transactions'. Thus, it did not test the PGM transactions for the requirements of the arm's length principle. PN 7 states in paragraphs 10.2.1–10.2.2:

> "Although there is no explicit statutory requirement to prepare and maintain transfer pricing documentation, it is in the taxpayer's best interest to document how transfer prices have been determined, since adequate documentation is the best way to demonstrate that transfer prices are consistent with the arm's length principle, as required by section 31."
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> "A taxpayer electing not to prepare transfer pricing documentation is at risk on two counts. Firstly, it is more likely that the Commissioner will examine a taxpayer's transfer pricing in detail

[21] This summary is based on the translation provided.

> if the taxpayer has not prepared proper documentation. Secondly, if the Commissioner, as a result of this examination, substitutes an alternative arm's length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution, either directly to the Commissioner or in the Courts."

[30] During argument, respondent's counsel urged the court to dismiss the application on the basis that there is no cogent point of law to be tested in what applicant is raising. I agree that the point sought to be separated has no cogency. Besides arguing that respondent ought not to have adjusted its profits, applicant has not made any practical suggestion on how the adjustment ought to have been done in order to determine its taxable income, given that the PGM transactions took place in 2011 whereas the audit was conducted in 2014.

[31] I now turn to the sally launched by applicant against respondent's reliance on the OECD TPGs and PN 7and enquire whether those attacks make the point sought to be separated any more cogent. In testing the arm's length nature and effecting the adjustment, respondent placed reliance on the TPGs and PN 7. Applicant charges that section 31 makes no reference to the TPGs nor PN 7. It stated that South Africa is not even a member of the OECD, nor do the TPGs have any legal status. Thus, the powers afforded to the Commissioner by section 31(2) must be established only by reference to the statute itself.

[32] With regard to respondent's reliance on PN 7, applicant argued that the decision in *Marshall and Others v Commissioner, South African Revenue Service*[22] is proposition that a statute may not be determined with reference to how the administrative agency responsible for implementing it understands it. Accordingly, PN 7is not a permissible guide when interpreting section 31(2). Respondent referred to applicant's reliance on the Marshall case for its argument on PN 7 as misdirection. I agree. In Marshall the court posed the question first and then continued as set out below:

> "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? It might conceivably be justified where the practice is evidence of <u>an impartial application of a custom recognised by all concerned</u>, established by one of the litigating parties. 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."

(Own underlining)

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[22] [2018] ZACC 11.

[33] I have already mentioned that in advancing its case, applicant placed reliance on both PN 7and the TPGs. Such reliance demonstrates, as respondent puts it, that PN 7 evinces a practice that is internationally accepted and applied by both applicant and respondent. It must thus be assumed that it is a practice recognized by all concerned. The Marshall case in other words, supports respondent's reliance on PN7. I agree. In addition, the SCA in *Natal Joint Municipal Pension Fund v Endumeni Municipality*[23] *i*nforms that in the process of interpretation:

> "consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production."

[34] In this regard, I accept respondent's submission that PN 7 and the TPGS constitute materials known to those responsible for the production of section 31(2).

[35] There is a further reason why applicant should be precluded from raising its argument about respondent's reliance on PN 7and the TPGs. Applicant made its case placing reliance on both the PN 7 and the TPG. This is plain from its Rule 32 and Rule 33 statements. Respondent contends that it is now not open to applicant to divorce itself from the case it has made in its pleadings and that parties should be held to their cases as pleaded. I am bound by the law as set out in *National Commissioner of Police and Another v Gun Owners South Africa*:[24]

> "This Court has, on more than one occasion, emphasised that the adjudication of a case is confined to the issues before a court:
>
> > '[I]t is for the parties, either in the pleadings or affidavits (which serve the function of both pleadings and evidence), to set out and define the nature of their dispute, and it is for the court to adjudicate upon those issues. That is so even where the dispute involves an issue pertaining to the basic human rights guaranteed by our Constitution, for 'it is impermissible for a party to rely on a constitutional complaint that was not pleaded'. There are cases where the parties may expand those issues by the way in which they conduct the proceedings. There may also be instances where the court may *mero motu* raise a question of law that emerges fully from the evidence and is necessary for the decision of the case. That is subject to the proviso that no prejudice will be caused to any party by its being decided. Beyond that it is for the parties to identify the dispute and for the court to determine that dispute and that dispute alone.' "[25]

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[23] (920/2010) [2012] ZASCA 13 (15 March 2012) at paragraph 18.

[24] (561/2019) [2020] ZASCA 88 (23 July 2020).

[25] *Fischer and Another v Ramahlele and Others* [2014] ZASCA 88, paragraph 13; *Vermeulen and Others v Minister van Veiligheid en Sekuriteit en Anders* (1377/2008) [2011] ZANWHC 85 (10 March 2011) paragraph 11.

[36] There is a yet another reason applicant should not succeed in its attack of respondent's reliance on the OECD TPGs. This is especially directed at the points that the OECD TPGs have no legal status and South Africa is not even a member of the OECD. In this regard, respondent submitted that the TPGs are followed by many non-member countries and are becoming a global standard. It added that the TPGs are aimed at promoting tax equity and reducing the possibility that South Africa may contribute to what is referred to as a 'Harmful Tax Regime'.[26]

[37] This extract below from the Davis Tax Commission's Base Erosion and Profit Shifting sub-committee (BEPS sub-committee) is highly relevant. The BEPS sub-committee issued its report in May 2016.[27] I have summarised the relevant aspects here below:

> Over the last few years, there have been stories in the media about companies paying little or no corporation tax in the countries they do business in. For example, investigations carried out in the UK on multinational companies (MNEs) such as Google, Amazon, Starbucks, Thames Water, Vodafone and Cadbury (before takeover by Kraft) showed that the amount of corporation tax a company pays in any one country can be determined by how aggressively the company seeks to shift its profits to other low [tax rate] countries.
>
> Most world leaders agree that globalisation has boosted trade, increased foreign direct investment, and has encouraged free movement of capital and labour. Globalisation has also shifted manufacturing bases from high tax regimes to low cost locations. These developments have also encouraged multinational enterprises (MNEs) to exploit the legal arbitrage opportunities due to asymmetries in the tax laws of different countries so as to minimise their global tax burdens.
>
> It is the aggressive tax positions taken by the MNEs that impact on countries' corporate income tax regimes since MNEs represent a large proportion of global Gross Domestic Product, GDP. Even though there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting (BEPS), which focuses on moving profits to where they are taxed at lower rates and expenses to where they are relieved at higher rates. As a direct response to these developments, national leaders in their summit in Mexico in 2012 explicitly referred to 'the need to prevent base erosion and profit shifting'. They further called for coordinated action to strengthen international tax standards and for states to back the OECD's efforts to identify loopholes in tax laws.

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[26] Described in PN 7 and the OECD TPGs.

[27] Report released in May 2016: accessed at **www.taxcom.org** as at 2020/12/15.

As to the importance of corporate taxes in developing countries, the report notes that while corporate taxes across the OECD account for around 3% of GDP or about 10% of total tax revenues, in developing countries, corporate taxes amount to over 24% of total revenues. Corporate income taxes therefore, are important for developing countries.

As to the reason South Africa needs to align itself with the OECD standards or regulations relating to Transfer Pricing, the report notes that South Africa is the only African country that is a member of the G20. Although it is not a member of the OECD and only has OECD observer status, it is a member of OECD BEPS Committee.[28] As a major power on the African continent, it is important that South Africa champions the cause of Africa in the OECD BEPS committee. Also, as a member of the G20, South Africa plays an important role in conveying the views of African economies. Due to the fact that South Africa has made major investment in the African continent and the fact that it has signed many tax treaties with other African countries, it is important that South Africa is seen as a leader in the BEPS debates in Africa. The report further notes that it is within South Africa's interest as a country aspiring to be the 'Gateway for investment into Africa' to use its membership of the G20 and OECD BEPS sub-committee to set the 'tone' in Africa around key OECD recommendations on BEPS.

[38] It is necessary for countries to align themselves with the OECD TPGs to overcome the challenges brought about by BEPS. A high level survey of Transfer Pricing cases on the international front demonstrates that OECD TPGs are applied in many countries. In *Australia v Glencore*, November 2020, Full Federal Court of Australia, Case No FCAFC 187, the court did not heed the OECD TPGs and refused outright to acknowledge them. But that was in 2007. It is doubtful that the same court would adopt the same attitude today. I use the word doubtful, given the centre stage that BEPS has claimed in many a country's agenda. As BEPS impacts development, South Africa must be the lighthouse for Africa as the BEPS subcommittee notes. There is no gainsaying that TPGs are a world standard in Transfer Pricing matters. I conclude that neither the attack on respondent's reliance on the TPGs and PN 7 make the point sought to be separated any cogent. Ordering the separation would thus be a waste of resources.

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[28] South Africa is an Associate in 6 OECD Bodies and Projects, and a Participant in 15. It has also adhered to 19 OECD instruments, including most recently the **Recommendation of the Council for Development Co-operation Actors on Managing the Risk of Corruption** (2016). It is also an Associate in the Base Erosion and Profit Shifting (BEPS) project and a key and active member of the Inclusive Framework for BEPS Implementation Steering Group, feeding its own perspectives into the BEPS process as well as supporting the efforts of developing countries to provide input through the African Tax Administration Forum (ATAF) Technical Committee: accessed from: **www.oecd.org** as at 2020/12 15.

[39] In the event I am wrong in my assessment of the cogency of the point sought to be separated, against the background arguments already set out, would the separation achieve the objects set out in the *Blair Atholl* case? In *Consolidated News Agencies (Pty) Ltd (In Liquidation) v Mobile Telephone Networks (Pty) Ltd & O*,[29] the court noted:

> "This court has warned that in many cases, once properly considered, issues initially thought to be discrete are found to be inextricably linked. And even where the issues are discrete, the expeditious disposal of the litigation is often best served by ventilating all the issues at one hearing. A trial court must be satisfied that it is convenient and proper to try an issue separately…Piecemeal litigation which defeats the object of rule 33(4) and consequent piecemeal appeals are equally to be eschewed."

G. Conclusion

[40] Applicant refers to the process of establishment of the arm's length nature of a transaction between connected persons as jurisdictional facts. Plain from its own advocation of the CUP method is that it accepts that there are various methods that can be employed in establishing the arm's length nature of a transaction. The appropriateness of a method to test the arm's length nature of a transaction however, is determined by the circumstances of a case. See in this regard PN 7 and the TPGs. It cannot merely be artificially assumed as applicant argued during the hearing of this matter. In this regard, and for the purpose of advancing the separation application, applicant submitted that the court may accept (artificially so) that the price it paid for the PGMs to the Swiss Entity was not an arm's length price, even though this is denied. But this cannot be done and applicant knows this. For example, in furtherance of its preferred CUP method, applicant went further and stated that there would have been no need for adjustment had respondent adopted the CUP method. From the preceding statement, it must be accepted that applicant is aware that the establishment as a fact whether a consideration is or is not at arm's length precedes the question of adjustment, regardless of what method is employed. The establishment of the arm's length nature of a transaction is the first step in transfer pricing matters and it involves a factual inquiry which culminates in a decision being made as to which of the methods endorsed by PN 7 is to be employed. Applicant is also wrong in its submission that the question of respondent's powers – in terms of section 31(2) – can be determined without reference to the merits or to the question of whether the PGM transactions were or were not at arm's length. As respondent puts it, 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. I agree. Respondent at one point likened applicant's approach with the separation application to determining quantum in a damages claim prior to determining the question of liability. I agree. On the conspectus of

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[29] [2009] ZASCA 130; 2010 (3) SA 382 (SCA) paragraphs 90–91.

evidence before this court, ordering a separation will not achieve any practical benefit. On the contrary, it would result in piecemeal litigation, increase costs, and delay finalisation of the matter. At first, one may be allured by the points raised by applicant. However, on close interrogation there is neither a cogent point worthy of testing nor will the objects set out in *Blair Atholl* be served with the separation.

H. Costs

[41] Each of the parties had asked the court to grant it costs including the costs occasioned by the employment of two counsel. I see no reason why the costs should not follow the outcome in this case.

I. Order

1. The application for separation is dismissed with costs. Such costs include the costs occasioned by the employment of two counsel.

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NN BAM
ACTING JUDGE OF THE HIGH COURT,
JOHANNESBURG