

South Africa's first case on Section 31

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Multinationals with South African group companies are required to adhere to South Africa's transfer pricing legislation as found in section 31 of the Income Tax Act, 58 of 1962 ("**Income Tax Act**"), which provisions in very simple terms require cross-border transactions (which include loans) to be conducted on an arm's length basis. Transfer pricing can be a very difficult area of tax law to manage, and unfortunately, up to now, taxpayers have not had the benefit of South African court decisions to guide them.

In *Crookes Brothers Limited v Commissioner for the South African Revenue Service [2018] ZAGPHC 311* the High Court had to decide on the application of section 31(7) of the Income Tax Act to a loan advanced by the applicant (Crookes Brothers Limited) ("**Applicant**") to its 99% owned Mozambican subsidiary ("**MozamSub**").

Under the transfer pricing rules, where a company in South Africa has made an interest-free loan to another group company in another country, interest at an arm's length rate can be (notionally) imputed to the lender (the primary adjustment), triggering income tax on that imputed amount. What is more, the South African company is deemed to have distributed a dividend equal to that amount thereby triggering dividends tax (the secondary adjustment).

In terms of section 31(7), an interest-free loan advanced by a resident company to a non-resident connected company will not be subject to the arm's length transfer pricing provisions of section 31 where:

- the resident company directly or indirectly holds in aggregate at least 10% of the equity shares and voting rights in the non-resident company;
- the non-resident company is not obliged to redeem the debt in full within 30 years from the date the debt is incurred; and
- the redemption of the debt in full by the non-resident company is conditional upon the market value of the assets of the non-resident company not being less than the market value of the liabilities of the non-resident company.

The Applicant, not being aware of the exemption provided for in section 31(7), made the primary and secondary adjustments in its income tax return for the 2015 year of assessment, but subsequently approached the South African Revenue Service ("**SARS**") for a reduced assessment on the basis that the adjustments had been incorrectly made. Having regard to the terms of the loan agreements as read with the subordination agreements, the Applicant contended that the loan met the requirements of section 31(7).

SARS rejected the request given that, in terms of clause 7 of the loan agreements, the loan terminates and becomes due and payable immediately in the event that:

- an application is made for the liquidation of MozamSub,
- MozamSub goes into bankruptcy or business rescue or similar type of proceedings, or
- judgment is taken against MozamSub.

SARS also disagreed with the Applicant's view that the subordination agreement, in terms of which it was agreed that the obligation of MozamSub to repay the loan was wholly conditional upon the market value of the assets of MozamSub not being less than the market value of its liabilities, rendered clause 7 of the loan agreement inapplicable. SARS stated that this merely altered the Applicant's ranking amongst the creditors of MozamSub.

Interestingly, the Applicant submitted that SARS committed an error of law as the assessment of tax payable is an annual event and therefore an annual determination is required as to whether or not the requirements of section 31(7) have been met. The High Court

disagreed with this submission on the basis that the requirements of section 31(7) are clearly aimed at the *nature of the transaction* and *not the prevailing facts* in a particular year.

The High Court expressed the view that if, in a particular year, the market value of the assets of the non-resident company exceeded the market value of its liabilities, such fact would not trigger the obligation of the non-resident company to repay the loan, as the non-resident company is not obliged to redeem the loan in full within 30 years from the date on which the debt is incurred. Only after expiry of the 30-year period would the obligation of the non-resident company to redeem the loan depend on whether or not the market value of its assets exceeds the market value of its liabilities. The High Court thus agreed with SARS that the requirements of section 31(7) had not been met.

In our view, the High Court's view that the requirements of section 31(7) are not dependent on the prevailing facts in a particular year, is debatably incorrect. Section 31(7)(b) states that the "*foreign company is not obliged to redeem that debt in full within 30 years from the date the debt is incurred*". It is submitted that, in terms of this wording, the requirement should be read to mean that the foreign company is not **at that point in time** required to redeem the debt, as opposed to the mere possibility or contingency that a redemption obligation may arise. If the High Court's view was to be the correct approach, the legislator should have stated that a foreign company should not be capable of being required to redeem the debt within the 30 year period, or put differently, the local lender should not have the right, or be able to obtain the right, to require the foreign company to redeem within 30 years at any time. This interpretation, in our view, aligns with the commercial terms of loan and debt arrangements, as it would lead to unjust results (as was the case in the *Crookes* matter) to place such weight on contingent and commercial redemption provisions.

It is presently unknown whether the Applicant will appeal the decision of the High Court. Being South Africa's first case on section 31 of the Income Tax Act, one would hope that the matter does go on appeal, even if just to clarify the interpretation of the section. For the moment though, multinationals are advised to review their cross-border debt arrangements that may be affected by this judgment. (Unfortunately, given the High Court's decision, if any multinational finds itself in a similar position and seeks to amend the loan agreement to cure the defect, such amendment will not assist because the damage will already have been done. At best they could also extend the loan period to end 30 years after the amendment, so as to protect the position going forward.)



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