

**CRITICAL ANALYSIS OF THE  
COMPONENTS OF THE TRANSFER  
PRICING PROVISIONS CONTAINED IN  
SECTION 31(2) OF THE INCOME TAX  
ACT, NO 58 OF 1962**

by  
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“I the undersigned, hereby declare that the work contained in this study project is my original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

Signature.....

Date.....

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## SUMMARY

Despite the fact that transfer pricing legislation (i.e. section 31 of the Income Tax Act, 58 of 1962 (“the Act”) has been in force in South Africa since 1995, it has only been in the last three years that the South African Revenue Service (“SARS”) has embarked on a number of assessments of taxpayers’ cross border transactions with foreign group companies. In particular, the SARS targets taxpayers that have rendered cross border services (including financial assistance) to a foreign group company for no consideration and has assessed these taxpayers on the adjusted interest/ fee amounts.

Since the burden of proof lies with the taxpayer to demonstrate that its cross border transactions with foreign group companies do not infringe the provisions of section 31(2) of the Act, this study provides taxpayers with guidance as to when its transactions would fall within the scope of application of section 31(2) of the Act and when the SARS would be excluded from applying the provision of section 31(2) of the Act.

Following upon a critical analysis of the essential components of section 31(2) of the Act the following conclusions are drawn by the author:

- If the taxpayer proves that it did not transact with a *connected party* (as defined in section 1 of the Act), or it did not supply goods or services in terms of an *international agreement* (as defined in section 31(1) of the Act), or its transfer price would be regarded as *arm’s length*, the Commissioner would be excluded from applying the provision of section 31(2) of the Act since all of the components to apply section 31(2) of the Act are not present.
- The current view held by the South African Revenue Service and tax practitioners that transactions between a South African company and an offshore company, which are both directly or indirectly held more than fifty percent by an offshore parent company, are transactions between connected persons (as defined in

section 1 of the Act) is incorrect in law. Section 31 of the Act is not applicable to such transactions.

- The Commissioner will be excluded from making a transfer pricing adjustment to a service provider's taxable income where the following circumstances are present:
  - Where the cross border transaction with a connected party does not give rise to gross income, which is the starting point in the determination of taxable income, since the service provider agreed to render services for no consideration and was therefore not entitled to receive income (i.e. no receipt or accrual) and
  - Where the service provider can provide evidence that demonstrates that there was no practice of price manipulation as regards the transaction under review.

## OPSOMMING

Alhoewel oordragprysbeleid wetgewing (artikel 31 van die Inkomstebelastingwet 58 van 1962 (“die Wet”)) al sedert 1995 in Suid Afrika van krag is, het die Suid Afrikaanse Inkomstediens (“SAID”) eers werklik gedurende die laaste drie jaar begin om aanslae ten opsigte van belastingpligtiges se internasionale transaksies met buitelandse groepmaatskappye uit te reik. In die besonder teiken die SAID belastingpligtiges wat dienste (insluitend lenings) aan buitelandse groepmaatskappye vir geen vergoeding lewer.

Aangesien die bewyslas op die belastingpligtige rus om te bewys dat sy internasionale transaksies met buitelandse groepmaatskappye nie die bepalings van artikel 31(2) van die Wet oortree nie, word belastingpligtiges in hierdie studie van riglyne, wat aandui wanneer transaksies met buitelandse groepmaatskappye binne die omvang van artikel 31(2) van die Wet val asook onder welke omstandighede die SAID verhoed sal word om artikel 31(2) van die Wet toe te pas, voorsien.

Na aanleiding van ‘n kritiese analise van die deurslaggewende komponente van artikel 31(2) van die Wet kom die skrywer tot die volgende gevolgtrekkings:

- As die belastingpligte kan bewys dat hy nie met ‘n *verbonde persoon* (soos omskryf in artikel 1 van die Wet) handelgedryf het nie, of dat hy nie goedere of dienste in terme van ‘n *internasionale ooreenkoms* (soos omskryf in artikel 31(1) van die Wet) gelewer het nie, of dat sy oordragprys as *arm lengte* beskou kan word, sal die Kommissaris verhoed word om die bepaling van artikel 31(2) van die Wet toe te pas, aangesien al die komponente van artikel 31(2) van die Wet nie teenwoordig is nie.
- Die huidige sienswyse van die SAID en belastingpraktisyns dat transaksies wat tussen ‘n Suid Afrikaanse maatskappy en ‘n buitelandse maatskappy plaasvind, waar ‘n buitelandse moedermaatskappy meer as vyftig persent van albei maatskappye se aandeelhouding (direk of indirek) hou, beskou kan word as

transaksies tussen verbonde persone (soos omskryf in artikel 1 van die Wet) is regstegnies nie korrek nie. Artikel 31(2) van die Wet is nie van toepassing op sulke transaksies nie.

- Die Kommissaris sal onder die volgende omstandighede verhoed word om enige oordragprysaanpassing aan 'n diensleweraar se belasbare inkomste te maak:
  - Waar die internasionale transaksie met 'n verbonde persoon nie bruto inkomste (die beginpunt van 'n belasbare inkomste berekening) voortbring nie, aangesien die diensleweraar ingestem het om dienste teen geen vergoeding te lewer, wat tot die gevolg het dat die diensleweraar nie geregtig is om inkomste te ontvang nie (dus geen ontvangste of toevalling) en
  - Waar die diensleweraar kan bewys dat die transaksie nie onderhewig aan prys manipulasie was nie.

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# 1 CHAPTER 1: INTRODUCTION

## 1.1 Background and problem statement

Transfer pricing is significant for both taxpayers and tax authorities since it determines in large part the income and expenses and therefore taxable profits of connected parties in different tax jurisdictions.

With the substantial increase in cross border trade by multinational enterprises (“MNEs”) over the last thirty years, tax authorities in many countries, including in Australia, Europe, India and the United States have implemented legislation for transfer pricing to ensure that the MNEs recognise the appropriate amount of profit and therefore tax in their jurisdiction.

The cornerstone of transfer pricing is the arm’s length principle<sup>1</sup> as reflected in the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for MNEs and Tax Administrations (“OECD Guidelines”). Most countries follow the OECD Guidelines, either by the simple recognition of the OECD principles in practice rulings/ notes (i.e. Australia and South Africa) or by the incorporation of the OECD Guidelines principles into the local legislation (i.e. the Netherlands) and regulations (i.e. India).

With South Africa’s re-emergence into international trading in 1994, transfer pricing being used by MNE’s to gain some tax advantage through price manipulation assumed greater significance in South Africa. Since there was no protection in the South African

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<sup>1</sup> PricewaterhouseCoopers. 2003. *International Transfer Pricing 2003/2004* par 202 “Simply stated, the arm’s length principle requires that compensation for any inter-company transaction shall conform to the level that would have applied had the transaction taken place between unrelated parties, all other factors remaining the same.”

tax system against inappropriate transfer pricing, transfer pricing legislation was introduced in South Africa on 19 July 1995.

The purpose of the transfer pricing legislation is to protect the South African fiscus against excessive price manipulation between connected parties who are involved in international transactions. In this regard section 31(2) of the Act gives the Commissioner the power to adjust the consideration received or paid by a taxpayer from or to a foreign connected party, for the supply of goods or services, to an arm's length price<sup>2</sup>.

It appears that the South African Revenue Service is of the view that where a South African company grants a service to a foreign connected party, the taxpayer should charge an arm's length fee and that where the taxpayer omitted to charge an arm's length fee it would make a transfer pricing adjustment. It is noted that the burden of proof lies with the taxpayer to demonstrate that the transfer pricing policies, which it has adopted for its cross border transactions with foreign group companies, do not infringe the provisions of section 31 of the Act.

The South African Revenue Service's view gives rise to the question whether there are reasonable grounds for the taxpayer to argue that the cross border services that it rendered for no consideration to a foreign group company do not fall within the scope of application of section 31(2) of the Act.

## **1.2 The subject of this study**

Section 31(2) of the Act consists of a number of components/ criteria that must be present before a transaction can fall within the scope of application of section 31(2) of the Act.

The purpose of this study is to determine, through a critical analysis of the components of section 31(2) of the Act, when section 31 (2) of the Act would apply where a South African taxpayer renders services for no consideration to a foreign group company.

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<sup>2</sup> A price between unrelated parties is known as the arm's length price.

For ease of reference the author indicates below (refer underlining) the components of section 31(2) of the Act that will be critically analysed in this study.

*“Where any goods or services are supplied or acquired in terms of an international agreement and*

*(a) the acquiror is a connected person in relation to the supplier;  
and*

*(b) the goods or services are supplied or acquired at a price which is either –*

- 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*
- ii. greater than the arm’s length price*

*then, for the purposes of this Act in relation to either the acquiror or supplier, the Commissioner may, in the determination of taxable income of either the acquiror or supplier, adjust the consideration in respect of the transaction to reflect an arm’s length price for the goods or services.”*

### **1.3 Motivation for study**

Despite the fact that transfer pricing legislation has been in force since 1995, it has only been in the last three years that the South African Revenue Service has picked up pace in terms of transfer pricing reviews. Three of the South African Revenue Service’s current focus areas when conducting transfer pricing reviews are to identify whether:

- A taxpayer has granted an interest free loan to a foreign group company;
- A taxpayer provided cross border services for no consideration to a foreign group company;
- A taxpayer has granted a foreign group company the right to use its intellectual property (e.g. trade mark) for no consideration.

In fact, one of the questions in the company tax return (“IT14”) that a taxpayer is required to answer is whether the taxpayer has provided goods or services or anything of value to an offshore connected party for no consideration.

It is quite common for taxpayers to have granted interest free loans or the right to use its trademark or assets for no consideration to its foreign group company, in particular where the latter company is based in Africa.

Where taxpayers have granted interest free loans to foreign group companies, the South African Revenue Service has issued assessments based on the interest that the taxpayer would have charged had it granted a loan to a third party (instead of to the foreign group company). This results in the taxpayer having to pay the tax on any adjustment first and thereafter embarking on an objection process. The objection process can take years to complete and is also a costly exercise for the taxpayer.

There has not as yet been any court case in South Africa on transfer pricing. In addition, there is hardly any literature available in South Africa on transfer pricing, in particular literature that contains a detailed analysis of the components of section 31(2) of the Act.

It is accordingly clear that there is a need for research that could provide taxpayers with guidance and understanding as to when section 31(2) of the Act would apply to its cross border transactions with foreign group companies.

## **1.4 Research method**

The research that will be performed in this study is aimed at finding a solution to a problem experienced by taxpayers in practice.

The research method that will be used to achieve this aim is the historic method. In this regard, the author will consult and assimilate relevant case law (South African and as well as international case law), legislation, the OECD transfer pricing guidelines, tax practice notes and rulings (South African as well as international rulings), as well as opinions of recognised legal and tax experts that have been published in technical journals and text books.

## **1.5 Framework of this study**

The framework, as set out hereinafter, indicates the structure of the study and the relevant chapters.

### ***1.5.1 A critical analysis of the components ‘services’ and ‘international transaction’, as used in section 31(2) of the Act***

This chapter will examine what would be regarded as ‘services’ for the purposes of section 31(2) of the Act.

In addition, since section 31(2) of the Act can only apply if there is an international transaction, this chapter will determine when a transaction between a taxpayer and a foreign group company would be regarded as an international transaction.

### ***1.5.2 A critical analysis of the component ‘connected person’ as used in section 31(2) of the Act***

Since section 31(2) can only apply if there is an international transaction that takes place between *connected parties*, this chapter will determine when a foreign group company would be regarded as a connected party in relation to a South African taxpayer.

### ***1.5.3 A critical analysis of the component ‘arm’s length price’ and ‘the transaction’ as used in section 31(2) of the Act***

In this chapter, the author will conduct a critical analysis of the words ‘arm’s length price’ and ‘the transaction’ as contemplated in section 31 (2) of the Act.

### ***1.5.4 A critical analysis of the component ‘determination of taxable income’ as used in section 31(2) of the Act***

It is noted that section 31(2) of the Act gives the Commissioner the discretion, when determining the taxable income of a taxpayer, to adjust the consideration in respect of a transaction between a South African resident and its non-resident connected party.

Since the starting point in the determination of a taxpayer’s taxable income is ‘gross income’, it will be determined whether the adjustment made by the Commissioner in terms of section 31(2) of the Act falls within the definition of ‘gross income’. In this regard, case law will be consulted.

An analysis of the ‘determination of taxable income’ component of section 31(2) of the Act cannot be performed without evaluating whether the court would follow a literal or purposive approach when it has to determine whether section 31(2) of the Act applies to services rendered between a taxpayer and a foreign connected party for no consideration. In this regard, case law will be consulted to determine the courts’ approach when interpreting articles of the Act, in particular anti-avoidance provisions. A conclusion in

this regard is important to determine whether section 31(2) applies to services that a taxpayer renders to a foreign connected party for no consideration.

### ***1.5.5 Conclusion***

This chapter will contain a synopsis of this study, as well as the conclusions reached by the author regarding when section 31(2) of the Act applies to services rendered by a taxpayer to a foreign group company for no consideration.



## **2 CHAPTER 2: A CRITICAL ANALYSIS OF THE CONCEPT ‘SERVICES’, AND ‘INTERNATIONAL AGREEMENT’ AS USED IN SECTION 31(2) OF THE ACT**

### **2.1 Introduction**

Section 31(2) of the Act consists of a number of components/ criteria that must be present before a transaction can fall within the scope of application of section 31(2) of the Act.

In this chapter the following components of section 31(2) of the Act will be critically analysed in the context of a taxpayer rendering services to an offshore group company:

- Services;
- International agreement.

It is considered to be of fundamental importance that taxpayers clearly understand when its transaction would be regarded as a ‘service’ and an ‘international agreement’ as defined in section 31(2) of the Act.

### **2.2 Meaning of services**

The word ‘services’ is widely defined in section 31(1) of the Act as ‘anything done or to be done’ which includes *inter alia* the granting of financial assistance (including a loan), the provision of services and the granting of the right to use a company’s intellectual property and other tangible assets.

## 2.3 Analysis of the concept of international agreement

### 2.3.1 *International agreement definition as defined in section 31(1) of the Act*

Section 31(1) of the Act, as it currently reads, provides that ‘international agreement’ means a transaction, operation or scheme entered into between:

- (i) a resident<sup>3</sup>; and any other non-resident person; or
- (ii) two non-resident persons for the supply of goods or services to or by a permanent establishment<sup>4</sup> of either of such persons in the Republic; or
- (iii) two non-resident persons for the supply of goods or services to or by a permanent establishment of either of such persons outside the Republic.

### 2.3.2 *Analysis of concepts used in the ‘international agreement’ definition*

None of the words ‘transaction’, ‘operation’ or ‘scheme’ is defined in the Act and must accordingly carry their ordinary meaning to be deduced from an everyday understanding and the context wherein they are encountered. In this regard the author sought guidance as to the ordinary meaning of the aforementioned words in the *Oxford Thesaurus*<sup>5</sup>, which defines these words respectively as meaning:

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<sup>3</sup>Section 1 of the Act defines a South African resident as *inter alia* a person (other than a natural person, such as a company) that is incorporated, established or formed in South Africa or has its place of effective management in South Africa.

<sup>4</sup> Section 1 of the Act defines permanent establishment as meaning a ‘permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Cooperation and Development’. An example of a permanent establishment as set out in the aforementioned article 5 is a branch of a company.

<sup>5</sup>Urdang, L. 1991. *The Oxford Thesaurus. An A- Z dictionary of Synonyms*. London: Oxford University Press.

**‘Transaction** *n.* 1 deal, dealing, negotiation, matter, affair, business, action, proceeding, agreement, arrangement, bargain.’

**‘Operation** *n.* 3 undertaking, enterprise, venture, project, affair, deal, procedure, business, transaction.’

**‘Scheme** *n.* 2 pattern, arrangement...’.

The author contends that the words ‘operation’ and ‘scheme’ should be interpreted *eiusdem generis* to include only things of the same class as the particular word (i.e. ‘transaction’). In other words, an ‘operation’ or a ‘scheme’ for purposes of section 31 of the Act comprises in meaning only things of the same kind as those which ‘transaction’ embraces, i.e. an arrangement or agreement.

Section 103 of the Act also uses the words ‘transaction, operation or scheme’. In this regard the author considers that in the absence of court cases specifically dealing with meaning of ‘transaction, operation or scheme’ in the context of section 31 of the Act, recourse to section 103 cases is warranted in determining whether the term ‘scheme’ embraces the same meaning as transaction, i.e. arrangement or agreement. This approach is considered appropriate, because the presumption is that when a particular form of legislative enactment, which has received authoritative judicial interpretation, is adopted in framing a later statute, the words so adopted should be construed as conveying a legislative intention that they bear the meaning which has been put on them by judicial interpretation.<sup>6</sup>

In this regard, the following interpretation of ‘scheme’ as adopted by Beyers JA in *Meyerowitz v CIR*<sup>7</sup>, is considered relevant in determining the judicial interpretation of the word ‘scheme’:

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<sup>6</sup> *De Villiers and Others v Sports Pools (Pty) Ltd and Another* 1975 (3) SA 253 (RA) at 261.

<sup>7</sup> 1963 (3) SA 863 (A)

*“I would like... to quote with approval what Donovan LJ says in Crossland (Inspector of Taxes) v Hawkings...He says at 817:*

*‘I do not think that the language of s397 requires that the whole of the eventual arrangement must be in contemplation from the very outset. Confining oneself for the moment to the facts of the case, and remembering that income tax is an annual tax, one finds the whole ‘arrangement’ conceived and in being in the one income tax year. The company is formed, the service agreement executed and the deed of settlement made, all in this one year...Even if it were otherwise, I think that there is sufficient unity about the whole matter to justify it being called an arrangement for this purpose, because the ultimate object is to secure for somebody money free from what would otherwise be the burden or the full burden of surtax. Merely because the final step to secure this objective is left unresolved at the outset and decided later, does not seem to me to rob the scheme of the necessary unity to justify it being called an ‘arrangement’.*

*In the judgement of the Special Court Watermeyer J, after listing the transactions entered into by the appellant with regard to his books, goes on to say:*

*‘The word “scheme” is a wide term to cover a series of transactions such as those mentioned above.’<sup>8</sup> (Author’s emphasis)*

The judicial interpretation of ‘scheme’ as adopted by Beyers JA in *Meyerowitz v CIR* confirms the author’s view that ‘scheme’ comprises in meaning things of the same kind as those which ‘transaction’ embraces, i.e. an arrangement. However, the difference being, as can be deduced from the above citation, that the inclusion of the word ‘scheme’

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<sup>8</sup> *Meyerowitz v CIR* 1963 (3) SA 863 (A), 25 SATC 287 at page 873.

has the effect of widening the scope of application of section 31 of the Act, since it will also need to be considered whether a series of unified transactions (as opposed to one transaction) between a resident and non-resident were conducted at arm's length. An example of a series of transactions that the author considers could be regarded as a 'scheme' for purposes of section 31 of the Act is the following:

*Instead of Company A (a South African incorporated company), providing contract research and development services directly to Company B (a non resident connected company), Company C (a South African incorporated company with an assessed loss that forms part of the same group of companies as Company A) contracts with Company B to provide the said services at cost plus a mark up. Company C then sub-contracts the said services to Company A, who only charges Company C its costs of rendering the said services.*

Since Company A and Company C are both residents section 31 (2) of the Act would not apply if the aforementioned transactions were to be looked upon in isolation. However, the author's contends that there is a risk that the series of transactions could be regarded as a unified arrangement between the three parties (i.e. a scheme) and that accordingly section 31 of the Act would apply.

Taxpayers should therefore also consider whether a series of unified transactions could fall within the meaning of international agreement as defined in section 31(1) of the Act.

### ***2.3.3 Considering whether there was an 'international agreement' in place for a specific year of assessment***

When analysing whether a company participated in an international agreement as defined in section 31(1) of the Act, careful consideration should be given to the year of assessment under review. This is due to the fact that since the introduction of transfer pricing on 19 July 1995, the definition of 'international agreement' has been extended and amended a few times. One of the amendments arose from the change in South

Africa's basis of taxation (i.e. from a source basis of taxation to a residence basis of taxation).

Prior to the residence basis of taxation coming into effect an international agreement was defined as a transaction between a person that is *managed or controlled* in the Republic and a person that is *managed or controlled* outside the Republic. With the introduction of the residence basis of taxation in 2001 the international agreement definition was amended in that the words 'managed or controlled' were replaced with 'resident'. One of the criteria, as set out in section 1 of the Act, to determine whether a company is tax resident in South Africa is to determine whether a company not incorporated<sup>9</sup> in South Africa has its place of effective management in South Africa. It is submitted that depending upon the interpretation of 'managed or controlled' versus 'effective management' a company not incorporated in South Africa may find itself to be in a position where it would be regarded as being managed or controlled in South Africa, but not necessarily effectively managed in South Africa. A detailed analysis of these concepts however is not the subject of this paper, and is merely stated here to create an awareness that the meaning of these concepts should be considered when determining whether there is an 'international agreement' as defined in section 31(1) of the Act.

A further amendment which should be considered is the extension of the concept 'international agreement' on 29 June 1998, which brought into the scope of section 31 of the Act the supply of goods and services by a non-resident (before 1 January 2001 a company managed or controlled outside South Africa) to a local permanent establishment of another non-resident (before 1 January 2001 a company managed or controlled outside South Africa). This means that for the period 19 July 1995 to 29 June 1998, a transaction would not have been subject to the South African transfer pricing provisions where a company that was managed or controlled outside South Africa transacted with a permanent establishment of another company that was managed or controlled outside South Africa.

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<sup>9</sup> A company incorporated in South Africa would automatically be regarded as being tax resident in South Africa (refer section 1 of the Act).

Similarly, on 24 November 1999, the meaning of ‘international agreement’ was further extended to also include transactions relating to the supply of goods and services by a resident (before 1 January 2001 a company managed or controlled in South Africa) to a foreign permanent establishment of another resident (before 1 January 2001 a company managed or controlled in South Africa). Accordingly, for the period 19 July 1995 to 24 November 1999 a transaction would not be subject to the South African transfer pricing provisions where a company that was managed or controlled in South Africa transacted with a permanent establishment of another company that was managed and controlled in South Africa.

The relevance of highlighting the aforementioned periods lies in the fact that the South African Revenue Service currently queries taxpayers’ international transactions with foreign connected parties as far back as 1996. It is therefore important for taxpayers to ascertain whether it entered into a transaction, operation or scheme with a connected non-resident party that would fall within the meaning of ‘international agreement’ as it read and applied for that particular year of assessment. If the transaction did not fall within the said meaning, section 31(2) of the Act would not apply.

### **3 CHAPTER 3: CONNECTED PERSON ANALYSIS FOR PURPOSES OF SECTION 31(2) OF THE ACT**

#### **3.1 Introduction**

An essential component of the South African transfer pricing provisions is the term ‘connected person’. If the one party to the transaction is not a connected party in relation to the other party to the transaction, one of the components of section 31(2) of the Act will not be met and the transfer pricing provision will not apply.

Accordingly, when analysing whether section 31(2) of the Act applies to a transaction where a South African resident company rendered services to an offshore company an analysis of the definition of connected person must be undertaken to determine whether the offshore company is a connected party in relation to the South African company.

“Connected person” is not specifically defined in section 31 of the Act, but is defined in section 1 of the Act. Section 1 of the Act defines a connected person in relation to a company as:

- Its holding company (as defined in section 1 of the Companies Act, no 61 of 1973 (“Companies Act”));<sup>10</sup>
- Its subsidiary (as defined in the Companies Act);<sup>11</sup>
- Any other company where both such companies are subsidiaries (as defined in the Companies Act) of the same holding company;<sup>12</sup>
- Any person, other than a company as defined in section 1 of the Companies Act, who individually or jointly with any connected person in relation to himself, holds directly

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<sup>10</sup> Paragraph (d)(i) of the definition of connected person as defined in section 1 of the Act.

<sup>11</sup> Paragraph (d)(ii) of the definition of connected person as defined in section 1 of the Act.

<sup>12</sup> Paragraph (d)(iii) of the definition of connected person as defined in section 1 of the Act.



or indirectly at least 20 per cent of the company's equity share capital. In this regard it is noted that 'any person' includes *inter alia* a foreign company.<sup>13</sup>

- Any company, which holds a minimum of 20% of another company's equity share capital where no shareholder holds the majority voting rights.<sup>14</sup>
- Any company, if such company is controlled or managed by any person who is a connected person in relation to another company, the first mentioned and last mentioned companies will be connected persons.<sup>15</sup>

### **3.2 Analysis of concepts used in the connected person definition**

Paragraph 1.1 of the South African Revenue Service's Practice Note 7 sets out the South African Revenue Service's view as regards the meaning of 'controlled or managed'. It is their view that a company is controlled by its directors or the directors of its holding company or ultimate holding company and that the 'question of where the shareholders may reside or meet in annual general meeting is irrelevant'. Their view seems to accord with the view held by the Special Income Tax Court at Bulawayo in *A. Company v The Commissioner of Taxes*<sup>16</sup> that control of a company rests with the directors of a company:

*"The question for decision is whether the words 'central management and control' relate to legal management and control or whether they connote effective control in a popular sense. In the absence of any indication in the Act as to the interpretation to be placed on the words 'central management and control' they must be interpreted in their legal sense. The management and control of the Appellant Company are in law vested in the directors who, and who alone, can do and perform all the acts necessary in law for the carrying on of the business of the Company."*

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<sup>13</sup> Paragraph (d)(iv) of the definition of connected person as defined in section 1 of the Act. Clause 2 of the Explanatory memorandum on the Income Tax Bill, 1997, provides that a close corporation, foreign company or any other corporate entity (excluding a South African incorporated company) would be included under paragraph (d)(iv) of the definition of connected person.

<sup>14</sup> Paragraph (d)(v) of the definition of connected person as defined in section 1 of the Act.

<sup>15</sup> Paragraph (d)(vA) of the definition of connected person as defined in section 1 of the Act.

<sup>16</sup> 1942 (1) PH T1 (R).

Huxham and Haupt<sup>17</sup>, however, states that the South African Revenue Service's views as regard to the control of a company are in conflict with certain overseas decisions, where the relevant court had held that a company is controlled by the person who has the power to appoint the majority of the company's board of directors. This implies a higher level of control, namely control exercised by the shareholder of the company.

This raises the question whether the South African Revenue Service's view on the meaning of 'control' (as expressed in Practice Note 7) carries any weight since a Practice Note does not have the force of law. In this regard the following comment made by Meyerowitz is considered appropriate to highlight:

*"...the practice of the Commissioner made known by his publication of practice notes in the Government Gazette serves a very useful function. These notes do not have the force of law, except perhaps to the extent that should the Commissioner not adhere to his practice without due warning of a change, taxpayers prejudiced thereby could raise an objection based on legitimate expectations."*<sup>18</sup>

The doctrine of legitimate expectation where there has been an adoption of regular practice has been endorsed in *Administrator, Transvaal v Traub*<sup>19</sup>. Similarly the constitution<sup>20</sup> of South Africa also endorses the doctrine of legitimate expectation. A taxpayer should therefore be able to raise an objection based on legitimate expectation if the South African Revenue Service applies a meaning of 'control' that differs from the meaning that it put forward in its Practice Note 7 and on which meaning taxpayers previously relied upon.<sup>21</sup>

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<sup>17</sup>Huxham, K., Haupt, P. 2004. *Notes on South African Income Tax*. 23<sup>rd</sup> Edition. Roggebaai: H & H Publications at 401.

<sup>18</sup> Meyerowitz, D. 2004. *Meyerowitz on Income Tax*. 2003-2004 Edition. Cape Town: The Taxpayer at 3-3.

<sup>19</sup> 1989 (4) SA 731 (A).

<sup>20</sup>Section 3(1) of the Constitution of the Republic of South Africa, Act 108 of 1996 "Administrative action which materially and adversely affects the rights or legitimate expectations of any person must be procedurally fair."

<sup>21</sup> It is interesting to note that in the Tax Board decision no 187 the chairman, H R Vorster held as follows: "I do not think that the Commissioner is lawfully entitled to issue assessments in disregard of his own Practice Notes in the manner in which the revised assessment was issued in this case. Unquestionably, for a number of reasons, a published Practice Note has legal consequences and the Commissioner is bound to observe those consequences. As this was conceded by the Commissioner's representative I need say no more about this aspect of the appeal."

The South African Revenue Service regards the place where a company is ‘managed’ as the place where the day-to-day running of the business activities takes place.<sup>22</sup> No definition/ meaning of ‘managed’ has been provided in the Act or in Practice Note 7. Accordingly, reference has been made to case law to determine the meaning of manage in the context of companies. Case law<sup>23</sup> indicates that ‘manage’ means the collective control, regulation, conduct or direction of affairs of a company, which vests in the board of directors, unless conferred otherwise in the company's articles of association.

Based upon the above analysis of the concept ‘managed or controlled’ it is the author’s view that ‘any person’ used in paragraph (d)(vA) of the connected party definition as contained in section 1 of the Act (hereinafter referred to as “paragraph (d)(vA)”) refers to a director of a company or a director of a company’s holding company (where the latter director effectively exercises the control over the business operations of another group company). Accordingly, the author contends that paragraph (d)(vA) will apply, when determining whether two companies are connected parties, if a director (or a relative or trust of such director) of the one company is a connected person<sup>24</sup> of the other company.

Paragraph (d)(ii) and (d)(iii) of the connected party definition use the definition of subsidiary as contained in section 1 of the Companies Act. Section 1 of the Companies Act defines a subsidiary as follows:

*“A company is deemed to be a subsidiary of another company (the holding company) if-*

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<sup>22</sup> Republic of South Africa. 1999. *Practice Note No 7- Section 31 of the Income Tax Act, 1962: Determination of the taxable income of certain persons from international transactions: Transfer Pricing* at par 1.1.

<sup>23</sup> Ex Parte Bennett 1978 (2) SA 380 (W) where Le Grange, J. held at 386 – 387 that “The ordinary meaning of management in this context is ‘the action or manner of managing’, and to manage is ‘to control the affairs of’. See Shorter Oxford English Dictionary sv ‘management’, 1 and ‘manage’... In Ex Parte Jacobson 1994 OPD 112 De Beer J said at 117 that the management of a company ‘is the collective control, regulation, conduct or direction of the affairs of the business’... It is a company’s articles of association, which determine the persons by whom management of the company is to be conducted... So in the case of companies, the management which is regulated by Table A or Table B, that management is vested in the directors, and it may be exercised by a person or persons to whom the directors have entrusted their powers and authorities.”

<sup>24</sup> In terms of section 1 of the Act, a person (including a natural person) will be connected in relation to a company if such person individually or jointly with any connected person in relation to himself, holds, directly or indirectly, more than 20% of the equity share capital or voting rights of the other company.

- *The other company is a member thereof, and-*
  - *Holds the majority of the voting rights therein;*
  - *Has the right to appoint or remove directors holding a majority of the voting rights at meetings of the board; or*
  - *Has the sole control of a majority of the voting rights therein, whether pursuant to an agreement with other members or otherwise;*<sup>25</sup>
- *It is a subsidiary of any company which is a subsidiary of that other company;*<sup>26</sup> *or*
- *Subsidiaries of that other company, or that other company and its subsidiaries together hold the rights referred to in the first bullet above;*<sup>27</sup>

*A body corporate or other undertaking which would have been a subsidiary of a company, had the body corporate or other undertaking been a company for the purposes of the Companies Act, is deemed to be a subsidiary of that other company*<sup>28</sup>.”

A ‘company’ as referred to in the aforementioned definition of subsidiary, assumes the definition of ‘company’ as set out in section 1 of the Companies Act, which includes only companies that have been incorporated in terms of Chapter IV of the Companies Act (in other words a South African incorporated company and not a foreign incorporated company). This definition therefore differs from the ‘company’ definition as contained in the Act, which includes foreign incorporated companies.

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<sup>25</sup> Section 1(3)(a)(i) of the Companies Act.

<sup>26</sup> Section 1(3)(a)(ii) of the Companies Act.

<sup>27</sup> Section 1(3)(a)(iii) of the Companies Act.

<sup>28</sup> Section 1(3)(c) of the Companies Act.

For a company to be deemed to be a subsidiary of another company (as envisaged in section 1(3) of the Companies Act), the latter company must be a registered member of that other company.<sup>29</sup>

“Body corporate” as referred to in section 1(3)(c) of the Companies Act is not defined in the Companies Act. Accordingly it must be assumed that the Legislature used it in its popular sense, unless the context or the subject matter clearly shows that it was intended to be used in a different sense.<sup>30</sup> In construing the meaning of ‘body corporate’ and determining whether ‘body corporate’ is used in the popular sense and could include a foreign company it was considered helpful to revert to the Afrikaans version of the Companies Act. In this regard, section 1(3)(c) of the Afrikaans version of the Companies Act reads as follows:

*“’n Regspersoon of ander onderneming wat ’n filiaal van ’n maatskappy sou gewees het indien daardie regspersoon of ander onderneming ’n maatskappy was, word geag ’n filiaal van daardie maatskappy te wees”.*

In *SIR v Somers Vine*<sup>31</sup>, Ogilvie Thompson JA, who delivered the majority judgment of the Appellate Division (Faure Williamson and Wessels JJA dissenting), also reverted to the Afrikaans text of the Act to construe the meaning of the words ‘contract of employment or service’ in para (f) of the definition of ‘gross income’ in s 1 (see § 4.70). In this regard Ogilvie Thompson JA held as follows:

*“In the Afrikaans text of the Act, the words ‘contract of employment or service’ in para (f) are rendered by the single word “dienskontrak”.*  
*While the English text of the Act is the signed version, it is, on the*

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<sup>29</sup> Delpont, P., Kunst, J.A., Vorster, Q. 2003. *Henocheberg on the Companies Act*. Durban: LexisNexis Butterworths, at 12. Blackman, M.S., Everingham, L.A.C., Jooste, R.D. 2002. *Commentary on the Companies Act*. Volume 1. Landsdowne: Juta & Co Ltd at 14 “*The new definition makes membership an absolute prerequisite, whether the relationship involves control of the board or of the voting rights in the company. In terms of s 103(2) of the Act, to qualify for membership of a company a person’s name must be entered in the company’s register of members... Membership is still a requirement of the holding/ subsidiary relationship and if one holds shares in a company through a nominee, this still does not make one a member of that company.*”

<sup>30</sup> Van Coller v Commissioner of Child Welfare, Vrede 1956 4 SA 807 (O) at 810.

<sup>31</sup> 1968 (2) SA 138 (A), 29 SATC 179.

*principle set out in Peter v Peter & others 1959 (2) SA 347 (A) at 350–1, and applied in CIR v Witwatersrand Association of Racing Clubs 1960 (3) SA 291 (A) at 302,118 in my opinion permissible to refer to the Afrikaans text.”*<sup>32</sup>

In addition, the author also referred to V.G Hiemstra and H.L Gonin’ s Trilingual Legal Dictionary<sup>33</sup> to determine the meaning of ‘body corporate’. In this dictionary the Afrikaans definition of ‘body corporate’ is provided as ‘regspersoon, korporatiewe liggaam, liggaam met regspersoonlikheid’.

Based upon the above translations and definitions, the author contends that a foreign company could fall within the meaning of ‘body corporate’ as used in section (1)(3)(c) of the Companies Act.

### **3.3 Assessing when connected person definition will apply under different factual scenarios**

The author has experienced that both the South African Revenue Service and tax practitioners regard transactions between a South African company and an offshore company that are both directly or indirectly held more than fifty percent by a parent company, which is located outside South Africa, as being connected parties and that accordingly section 31(2) of the Act applies (provided all the other components of section 31(2) of the Act are present). Accordingly the author considered it important to determine whether the view held is correct in law.

Four different scenarios are used below to analyse the application of the connected person definition where a South African company for example grants financial assistance to an offshore company.

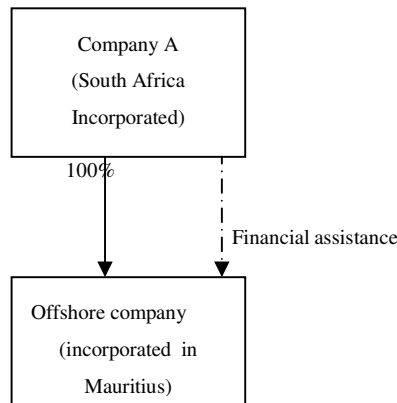
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<sup>32</sup> 1968 (2) SA 138 (A), 29 SATC 179 at 187.

<sup>33</sup> Gonin, H.L, Hiemstra, V.G. 1992. *Trilingual Legal Dictionary*. 3<sup>rd</sup> Edition. Cape Town: Juta & Kie bpk.

### 3.3.1 Scenario 1

Company A, a South African incorporated company that forms part of a multinational group grants financial assistance to an offshore company. Company A holds a 100% equity interest in the offshore company.



In *Scenario 1* it needs to be determined whether the offshore company could be regarded as a subsidiary of Company A or as a fellow subsidiary as defined in the Companies Act. It is submitted that the offshore company would not fall within the definition of subsidiary as defined in section 1(3)(a)(i) and 1(3)(a)(ii) of the Companies Act, since it is not a South African incorporated company and ‘company’ used in sections 1(3)(a)(i) and 1(3)(a)(ii) specifically refers to South African incorporated companies.

However, the effect of section 1(3)(c) of the Companies Act is that a body corporate, which is not a company as defined in section 1 of the Companies Act, is deemed to be a subsidiary of Company A if, had the offshore company been a company as defined, it would have been a subsidiary of Company A. It is submitted that a foreign company falls within the ordinary meaning of ‘body corporate’.

Accordingly, if Company A holds<sup>34</sup> the majority of voting rights in the offshore company, the offshore company would be deemed to be a subsidiary in relation to Company A and would therefore be a connected person. Similarly, if the offshore

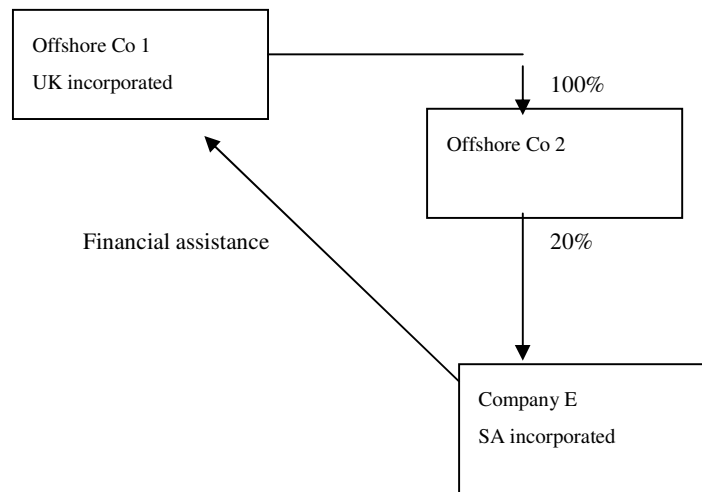
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<sup>34</sup> For the purposes of section 1(3)(c) of the Companies Act “hold” refers to the registered or beneficial holder (direct or indirect) of shares conferring a right to vote. (Section 1(3)(c)(A) of the Companies Act).

company is deemed to be a subsidiary of Company A's holding company, it would also be regarded as a connected person in relation to Company A, since the two companies would be deemed to be fellow subsidiaries of the same holding company.

### 3.3.2 Scenario 2

Company E, a South African incorporated company that forms part of a multinational group grants financial assistance to an offshore company (i.e. Offshore Co 1). Offshore Co 1 holds a 20% equity interest via another offshore company (i.e. Offshore Co 2) in Company E.

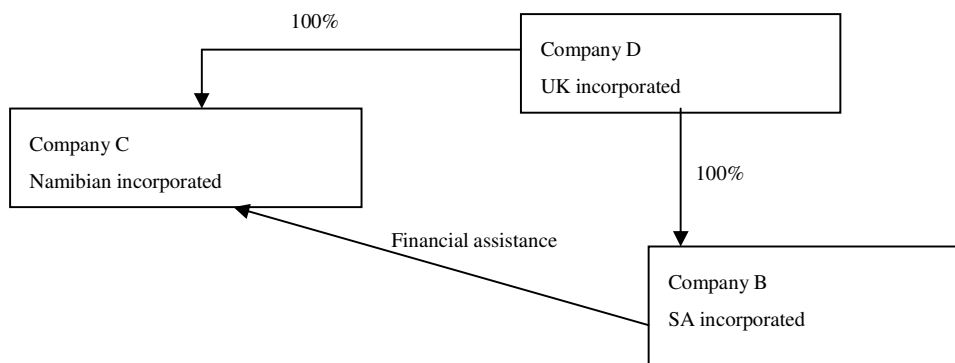


In *Scenario 2*, Company E would be regarded as a connected person in relation to Offshore Co1, since Offshore Co1 holds indirectly at least 20 per cent of Company E's equity share capital. Accordingly, paragraph (d)(iv) of the definition of connected person as defined in section 1 of the Act applies.



### 3.3.3 Scenario 3

Company B, a South African incorporated company that forms part of a multinational group grants financial assistance to an offshore company, Company C. Another offshore company, Company D holds a 100% equity interest in both Company B and Company C. Company C does not hold an equity interest in Company B or vice versa. The director that manages and controls Company B is not a connected person in relation to Company C.



In *Scenario 3*, Company B and C would not be regarded as connected parties and section 31 of the Act would not apply. This is due the fact that for a company to fall within the definition of subsidiary as defined in section 1 of the Companies Act, it must be a subsidiary of a holding company (as defined in section 1 of the Companies Act). It is the author's view that 'holding company', as defined in section 1 of the Companies Act, could only mean a South African incorporated holding company. This view is based on the wording of the definition of 'company' and 'holding company' as set out respectively in section 1(1) and section 1(4) of Companies Act. For ease of reference these definitions, as extracted from the Companies Act, are set out below:

*Section 1: Definitions— (1) In this Act, unless the context otherwise indicates—*

*“**company**” means a company incorporated under Chapter IV of this Act and includes any body which immediately prior to the commencement of this Act was a company in terms of any law repealed by this Act;*

*“**holding company**” means a holding company as defined in subsection (4);*

*Section 1- (4) “For the purposes of this Act, a company shall be deemed to be a holding company of another company if that other company is its subsidiary.” (Author’s emphasis)*

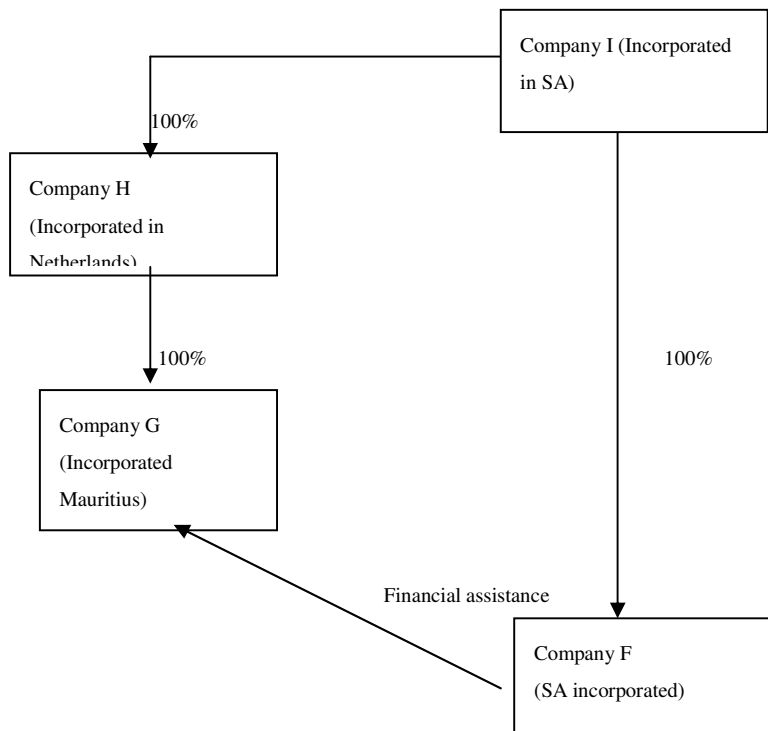
Based upon the aforementioned definition, Company D could therefore not be regarded as a holding company as defined in the Companies Act and Company B and Company C can therefore not be fellow subsidiaries for Companies Act purposes. As result paragraphs (d)(i) to (d)(iii) of the definition of ‘connected person’ as defined in section 1 of the Act would not be applicable as:

- Company D is not Company B or Company C’s holding company (as defined in the Companies Act).
- Consequently Company B and Company C cannot be regarded as subsidiaries (as defined in the Companies Act).
- Consequently Company B and Company C cannot be regarded as subsidiaries of the same holding company for purposes of paragraph (d)(iii) of the definition of ‘connected person’ as defined in section 1 of the Act as neither falls within the definition of subsidiary as defined in the Companies Act.

In addition, Company C does not hold, individually or jointly, directly or indirectly any equity share capital in Company B and therefore also falls outside the scope of application of paragraph (d)(iv) and (d)(v) of the definition of ‘connected person’ as defined in section 1 of the Act.

### 3.3.4 Scenario 4

Company F, a South African incorporated company that forms part of a multinational group grants financial assistance to an offshore company, Company G. Another offshore company, Company H holds a 100% equity interest in Company G. Company I, a South African incorporated company holds a 100% equity interest in both Company H and Company F. Company G holds no equity interest in Company F. The director that manages and controls Company F is not a connected person in relation to the Company G.



In *Scenario 4*, the following parties would fall within the meaning of connected party as defined in section 1 of the Act:

- Company F and Company H would be connected parties in relation Company I, since Company I is their holding company as defined in section 1(4) of the Companies Act.

Company F and Company H is therefore also connected persons in relation to each other.

- Company G would be a connected person in relation to Company H since Company H holds at least 20% of Company G's equity share capital (refer section (d)(iv) of the connected party definition as contained in section 1 of the Act).

It needs to be determined whether Company F and Company G falls within the meaning of connected person as defined in section 1 of the Companies Act. Company F and Company G would be connected persons as defined if they could be regarded as subsidiaries of the same holding company (i.e. Company I).

Company G would be precluded from being deemed to be a subsidiary of Company I for the following reasons:

- Company I is not a registered member of Company G and accordingly, Company G would be precluded from being deemed to be a subsidiary of Company I as contemplated in section 1(3)(a)(i) of the Companies Act.<sup>35</sup>
- Section 1(3)(a)(ii) of the Companies Act deems 'a company to be a subsidiary of another company if it is a subsidiary of any company which is a subsidiary of that other company'. Company G does not fall within the definition of 'company' as defined in the Companies act, since it is not a South African incorporated company. Accordingly Company G is precluded from being deemed to be a subsidiary of Company I as contemplated in section 1(3)(a)(ii) of the Companies Act.
- Section 1(3)(a)(iii) of the Companies Act deems 'a company to be a subsidiary of another company if subsidiaries of that other company or that other company and its subsidiaries together hold the rights referred to in subparagraph (i) (aa), (bb) or (cc).' As indicated in the aforementioned bullet, Company G does not fall within the definition of 'company' as defined in the Companies act. Accordingly Company G is

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<sup>35</sup>Blackman, M.S, Everingham, L.A.C, Jooste, R.D. 2002. *Commentary on the Companies Act*. Volume 1. Landsdowne: Juta & Co Ltd at 14.

precluded from being deemed to be a subsidiary of Company I as contemplated in section 1(3)(a)(ii) of the Companies Act.

As a result paragraph (d)(iii) of the definition of ‘connected person’ as defined in section 1 of the Act would therefore not be applicable, since Company F and Company G could not be regarded as subsidiaries (as defined in the Companies Act) of the same holding company (as defined the Companies Act).

In addition, even though Company H is a subsidiary of Company I, Company H would not be a holding company (as defined in section 1 of the Companies Act) of Company G, since Company H is a foreign incorporated company and it is the author’s opinion that the holding company definition contained in the Companies Act only applies to South African incorporated companies.

In addition, Company G does not hold any equity share capital in Company F and therefore it also falls outside the scope of application of paragraph (d)(iv) and (d)(v)<sup>36</sup> of the definition of ‘connected person’ as defined in section 1 of the Act. Accordingly, transactions between Company G and Company F would fall outside the scope of application of section 31 of the Act.

The Commissioner of the South African Revenue Service may seek to argue that paragraph (d)(iii) of the definition of connected person as defined in section 1 of the Act applies to transactions between Company B and Company C (refer scenario 3) and to transactions between Company F and Company G (refer scenario 4) taking into account the context in which the word is used in section 31(2) of the Act. The Commissioner may rely on the preamble to section 1, namely ‘unless the context otherwise indicates’ to argue his point that the definition of holding company should not be confined to South African holding companies.

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<sup>36</sup> Paragraph (d)(v) of the definition of ‘connected person’ as defined in section 1 of the Act defines a connected person in relation to a company as any company, which holds a minimum of 20% of another company’s equity share capital where no shareholder holds the majority voting rights.

“Unless the context otherwise indicates”, which is normally found as a preamble to the definition section in a specific statute, indicates that the statutory definition would not in all cases fit a specific context in which the defined word may be found in the statute. Clegg and Stretch<sup>37</sup> state that before it can be held that ‘the context otherwise indicates’ it will need to be proven that the Legislature could not have intended, having regard to what goes before the specific section and after it as well as to the rest of the Act<sup>38</sup>, to use the statutory definition in that specific section.

It is considered appropriate to consult court cases, which addressed the question whether a word that is defined in the definition/ interpretation section of a statute should always carry its defined meaning, regardless of the context in which it is used. In this regard reference is made to *CIR v Simpson*<sup>39</sup> where Watermeyer CJ gave effect to the rule that Halsbury has laid down in *Laws of England* at paragraph 591 of Volume 31, namely:

*“ A definition section does not necessarily apply in all the possible contexts in which a word may be found in the statute. If a defined expression is used in a context which the definition will not fit, it may be interpreted according to its ordinary meaning.” (Author’s emphasis)*

In *CIR v Simpson*<sup>40</sup>, Watermeyer CJ held that in applying the term ‘income’ in the context of section 9(2) of the Income Tax Act, 1941, it should not be interpreted according to the statutory definition (i.e. ‘gross income’ less exemptions), but according to its ordinary meaning, namely profits and gains.

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<sup>37</sup> Clegg, D, Stretch, R. 1996. *Income Tax in South Africa*. Volume 1. Butterworths at chapter 2.

<sup>38</sup> In *Glen Anil Development Corporation Ltd v SIR* 1975 (4) SA 715 (A) at page 727, 37 SATC 319 Botha JA held as follows: “In *CIR v Delfos* 1933 AD 242 Wessels CJ, however, after referring to the rule stated by Lord Cairns in *Partington v Attorney General*....said at 254:

*‘I do not understand this to mean that in no case in a taxing Act are we to give to a section a narrower or wider meaning than its apparent meaning, for in all cases of interpretation we must take the whole statute into consideration and so arrive at the true intention of the legislature.’*”

<sup>39</sup> 1949 (4) SA 678 (A), 16 SATC 268 at 282.

<sup>40</sup> 1949 (4) SA 678 (A), 16 SATC 268 at 269.

Similar to the ‘gross income’ definition contained in the Act, the word ‘connected person’ is also given an artificial meaning in the Act, with specific guidelines to the taxpayer as to what would constitute a connected person for the purposes of the Act. It is questionable what the ‘ordinary meaning’ of connected person should be and whether the ordinary meaning would provide a more reasonable result which the Legislature could have supposed to be intended within the context of section 31(2) of the Act. In the search to answer the question of whether the ordinary meaning would provide a more reasonable result, reference is made to *Hoban v Absa Bank Ltd t/a United Bank and Others 1999*<sup>41</sup>, where Howie AJ confirmed the rule laid down in *Canca v Mount Frere Municipality*<sup>42</sup>:

*“The question whether a word in a particular section of a statute should be given its statutory definition or the ordinary meaning has come up for decision in a number of cases. Mr Findlay, for respondent, cites as an example the case of Limbada v Principal Immigration Officer 1993 NPD 146 at 150, and amongst the cases to which I have also had reference are ...Commissioner for Inland Revenue v Simpson. In some of these cases the Court was concerned with a definition section which expressly provided (as here) that the definition should be applied “unless inconsistent with the context” and in other the definitions section did not contain those qualifying words. In all cases, however, the same basic approach was adopted, albeit such approach was formulated in different ways. Strictly the ‘context’ of a word or passage in a text would consist of “the parts which immediately precede or follow” that word or passage (see in this regard the definition of “context” in The Shorter Oxford English Dictionary) but in no case to which I have had reference did the Court define itself to so narrow an examination of the Act in determining the question in issue. The principle which emerges is that the statutory definition should prevail unless it appears that the Legislature intended otherwise and, in deciding whether the Legislature so intended, the Court has generally*

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<sup>41</sup> 1999 (2) SA 1036 (SCA).

<sup>42</sup> 1984 (2) SA 830 (Tk) at 832B-G.

asked itself whether the application of the statutory definition would result in such injustice or incongruity or absurdity as to lead to the conclusion that the Legislature could never had intended the statutory definition to apply”.<sup>43</sup> (Author’s emphasis)

In the light of the *above* citation the question to be asked is whether the application of paragraph (d)(iii) of the connected party definition as contained in section 1 of the Act would result in such injustice/incongruity as to lead to the conclusion that the Legislature could never have intended the statutory definition to apply to section 31(2) of the Act.

The author contends that the application of paragraph (d)(iii) of the connected person definition does not lead to an injustice/ absurdity in the context of section 31(2) of the Act and that the courts should uphold the statutory definition. This opinion is based upon the following analysis:

- In *P v COT*<sup>44</sup> the court held that when the provisions of a taxing measure are definite and free from ambiguity the fact that they permit avoidance of taxation, if interpreted literally, does not justify a departure by the court from the ordinary meaning of the language used.
- According to Meyerowitz<sup>45</sup> the problem of interpretation does not arise where the meaning of the words of a section is perfectly clear. It is only when the provision in question is ambiguous or vague that problems of interpretation arise.
- Paragraph (d)(iii) of the connected party definition usurps the definition of subsidiary as defined in the Companies Act. Similarly, paragraph (d)(iv) of the connected person definition also usurps a definition from the Companies Act (i.e. the definition of

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<sup>43</sup> 1999 (2) SA 1036 (SCA). at page 1043-1044.

<sup>44</sup> 1966 (2) SA 208 (R), 28 SATC 55 at 61.

<sup>45</sup> Meyerowitz, D. 2004. *Meyerowitz on Income Tax*. 2003-2004 Edition. Cape Town: The Taxpayer at 3-2.



‘company’). According to Devinish<sup>46</sup> the determination of the intention of the Legislature (i.e. the determination of how the words “as defined in the Companies Act” should be interpreted in section 1 ‘connected party’ of the Act) is not a search for the psychological intention, but rather a search for the Legislature’s intention through the consultation of internal and external sources that relate to the specific section in the statute. In this regard, the author consulted an external source, namely clause 2 of the Explanatory memorandum on the Income Tax Bill, 1997<sup>47</sup> to determine the Legislature’s intention. Clause 2 of the said Explanatory memorandum specifically provides that the ‘company’ definition as defined in the Companies Act is used to make it clear that foreign companies are included under paragraph (d)(iv) for the purposes of determining whether such person is a connected person in relation to a company. The said Explanatory memorandum provides support that the Legislature follows a literal approach in the application and interpretation of the words “as defined in the Companies Act’ which is used in paragraph (d)(iv) of the connected person definition.

- The South African courts have upheld the common law presumption that where a Legislature uses the same word in the same Act more than once the presumption is that it is used in the same sense throughout, except if there is a clear indication that the legislature intended the words to have a different or wider interpretation.<sup>48</sup> In this regard, Botha AJ held in *Pantonowitz v SIB*<sup>49</sup>:

*“Ek meen dus that die woorde ‘a right acquired under this section to carry on business upon a trading site’ in artikel 5(7) van Wet 13 van 1910 nie die reg insluit van ‘n deur die grondeienaar gemagtigde persoon om, ingevolge artikel 5(5) quarter, op’n kragtens artikel 5(5)ter aangewysde handelsterrein, handel te dryf. Die wesenlik gelykluidende*

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<sup>46</sup> Devinish “Teleological evaluation: a theory and modus operandi of statutory interpretation in South Africa” 1991 SA *Public Law* 62 at 69.

<sup>47</sup> Republic of South Africa. 1997. *Explanatory memorandum on the Income Tax Bill*, Pretoria: Government Printer at 8.

<sup>48</sup> S v Mashoai 1975 3 SA 117 (O) at 124; *Durban City Council v Shell and BP Petroleum Refineries (Pty) Ltd* 1971 4 SA 446 (A) at 456.

<sup>49</sup> 1968 (4) SA 872 A, 30 SATC 190 at 196.

*woorde ‘a right acquired under sub-section (5) or (5) quarter’ in artikel 5(5) quinquies sou dus ook nie so ‘n reg van ‘n gemagtigde persoon insluit nie, want dit word vermoed dat dieselfde uitdrukking in dieselfde Wet, of uitdrukkings, so meen ek, wat in wese dieselfde is of na ‘n dergelike onderwerp verwys, ‘n gelyke betekenis dra’.*

- Since there is not a clear indication in paragraph (d)(i), (d)(ii) and (d)(iii) that the Legislature intended the words ‘as defined in the Companies Act’ to have a different or wider interpretation than the words ‘as defined in the Companies Act’, which the Legislature also used in paragraph (d)(iv) of the connected party definition, it is submitted that the words ‘as defined in the Companies Act’ have the same meaning/ application (i.e. literal meaning) in paragraphs (d)(i), (d)(ii), (d)(iii) and (d)(iv) of the connected party definition.
- Giving a similar meaning/ application and interpretation of the wording “as defined” in paragraph (d)(i), (d)(ii), (d)(iii) and (d)(iv) of the connected party definition provides legal certainty to the users of the Act, which is what a statute is aimed to do.<sup>50</sup>
- In addition, it is accepted in law that the court cannot insert words to mend omissions by the Legislature, since the courts would then be usurping the functions of the Legislature.<sup>51</sup> It is the author’s opinion that the Legislature omitted to insert into the connected party definition words that indicate that where the connected person definition is applied in the context of section 31 of the Act, the company law

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<sup>50</sup> According to Acuilus, as quoted in Joubert, N. 1991. *Die Finansiële Huurkontrak*. Johannesburg: Navorsingseenheid vir Bankreg van die Randse Afrikaanse Universiteit at 94: “*The legislature...stood and stands as a bulwark between the Executive and the liberties of the people. Consent to encroachments upon freedom of action is therefore not deemed to extend further than the intention of the Legislature as expressed, with due regard to modern canons of construction, and it is the duty of the Courts jealously to guard the liberties of the subject against encroachment. If therefore Parliament devises a measure to repress some mischief, it should direct its words to the mischief itself: if it chooses to set about its task by indirect methods, that is by barring avenues to the realisation of the mischief and does not succeed in doing so exhaustively, that is the misfortune of the Executive, not the subject. In accordance with this constitutional principle statutes creating disabilities are not extensively interpreted or in a manner favourable to the curtailment of rights. The analogical method of extensive interpretation may be suitable to simple states of society in which legislative activity was infrequent: in modern conditions and with a number of legislative authorities affecting our daily lives, it would be intolerable.*”

<sup>51</sup> Hippo Holding Co Ltd v CIR 1949 (2) SA 503 (T), 16 SATC 112.

definitions should be applied to a foreign company *as if* they were South African incorporated companies. Since the Legislature did not specifically state this, there is a *casus omissus*. Silke<sup>52</sup> describes a *casus omissus* as an apparent gap in a statute, which should have been inserted by the Legislature, but has not been so inserted. In *Union Government v Thompson*<sup>53</sup> it was held that it is not the court's function to insert missing words and that the court should therefore interpret a statute to avoid a *casus omissus* when its language allows a reasonable construction that is in accordance with the rest of the statute. The author contends that the language used in the 'connected person' definition allows a reasonable construction that is in accordance with the rest of the Act and that avoids a *casus omissus*.

- From the analysis of scenarios 1 and 2 it can be seen that the connected person definition, as set out in section 1 of the Act and which usurps certain definitions of the Companies Act, allows a reasonable construction that brings an international transaction within the scope of application of section 31(2) of the Act. In the light of the aforementioned, it is the author's opinion that it would not be appropriate to argue that the connected party definition leads to an absurdity where under one scenario (e.g. scenario 3) or specific factual situation the connected party definition does not bring a transaction within the scope of application of section 31(2) of the Act.

### **3.4 Conclusion**

The author regards the view held by both the South African Revenue Service and tax practitioners that transactions between a South African company and an offshore company that are both directly or indirectly held more than fifty percent by a parent company, which is located outside South Africa, as transactions between connected parties as incorrect in law. Section 31(2) of the Act should not apply to such transactions.

At the time of writing this study, the author, via her employer, has verbally presented this viewpoint to the South African Revenue Service.

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<sup>52</sup> De Koker, A. 2004. *Silke on South African Income Tax*. Electronic version. Update issue June 2004. Butterworths at par 25.11.

<sup>53</sup> 1919 AD 404.

## **4 CHAPTER 4: ANALYSIS OF THE CONCEPTS ‘ARM’S LENGTH PRICE AND ‘THE TRANSACTION’ IN THE CONTEXT OF SECTION 31(2) OF THE ACT**

### **4.1 Analysis of the arm’s length price as contemplated in section 31(2) of the Act**

Section 31(2) of the Act refers to the arm’s length price. Practice Note 7<sup>54</sup> states that South Africa has adopted the arm’s length principle as defined in paragraph 1 of Article 9 of the OECD Model Double Taxation Convention, which forms the basis of many bilateral tax treaties and which has also been adopted by OECD Member countries. Paragraph 1 of Article 9 of the OECD Model Tax Convention provides:

*“[When] conditions are made or imposed between ...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.”<sup>55</sup>*

Accordingly, under the arm’s length principle, as defined above, connected taxpayers must set transfer prices for any inter-company transaction as if they were unrelated entities but all other aspects of the relationship were unchanged. The arm’s length price should therefore equal a price determined with reference to the interaction between independent companies in the open market.

The arm’s length principle is based on the concept of comparability. In the context of the arm’s length principle comparability means:

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<sup>54</sup> Republic of South Africa.1999. Practice Note No 7- Section 31 of the Income Tax Act, 1962: Determination of the taxable income of certain persons from international transactions: Transfer Pricing at par 2.7.

<sup>55</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 1.6.

*“ To be comparable means that none of the difference (if any) between the situations being compared could materially affect the condition being examined in the methodology (price or margin), or that reasonable accurate adjustments can be made to eliminate the effect of any differences.”*<sup>56</sup>

When analysing the comparability of a connected party transaction against a transaction between independent parties, the OECD Guidelines<sup>57</sup> recommend that the following factors should be considered:

- The specific characteristic of the goods or services. In this regard the nature and extent of the service would be relevant to determine whether transactions meet the arm’s length comparability criteria. *“Differences in the specific characteristics of property or services often account, at least in part for differences in their value in the open market”*<sup>58</sup>;
- The functions that the parties who are being compared perform, as well as the risks that they assume and the asset that they utilise. *“In dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed)”*<sup>59</sup>;
- The terms and conditions of the relevant agreement. *“The contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between parties”*<sup>60</sup>;
- Economic circumstances such as the nature and extent of government regulation. *“Arm’s length prices may vary across different markets even for transactions involving the same property or services”*<sup>61</sup>;

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<sup>56</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 8.1.2.

<sup>57</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 1.19 to 1.35.

<sup>58</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 1.19.

<sup>59</sup> OECD Guidelines paragraph 1.20.

<sup>60</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 1.28.

- Business strategies. *“Business strategies would take into account many aspects of an enterprise such as innovation and new product development, degree of diversification, risk aversion, assessment of political changes, input of existing and planned labour laws, and other factors bearing upon the daily conduct of business”*<sup>62</sup>

It should be noted that, as stated in paragraph 8.1.5 of Practice Note No 7, comparisons with controlled transactions by other taxpayers could not be regarded as arm’s length comparisons.

The application of the arm’s length principle is not without problems, since the OECD Guidelines acknowledge that in certain cases associated enterprises may engage in transactions that independent enterprises would not undertake and for which no third party comparable data exist.<sup>63</sup> As noted by the OECD Guidelines:

*“Associated enterprises may engage in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance but may occur because in transacting business with each other, members of an MNE group face different commercial circumstances than would independent enterprises... Where independent enterprises seldom undertake transactions of the type entered into by associated enterprises, the arm’s length principle is difficult to apply because there is little or no direct evidence of what conditions have been established by independent enterprises”.*

Francescucci<sup>64</sup> also concluded, following upon research that he performed, that in a number of cases, such as with intermediate transactions (i.e. transfer of semi-finished

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<sup>61</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 1.30.

<sup>62</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 1.31.

<sup>63</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par 1.10.

<sup>64</sup> Francescucci, D.L.P. 2004. The arm’s length principle and group dynamics- Part 1: The conceptual shortcomings. *International Transfer Pricing Journal*, March- April, at 69.

goods within a vertical integrated multinational group) it is very difficult, if not impossible, to find an appropriate third party comparable.

*“ It has become increasingly clear that in a large number of cases involving intra-group trading, it is not possible to find adequate comparables to apply the traditional transaction based TNMs (and even the TNMM/CPM in some cases), and that in any event an attempt to do so involves significant administrative costs. The arm’s length principle is thus unworkable in many instances because there is just no reason why comparable uncontrolled transactions should exist when, as alluded above, market imperfections lead to the development of MNEs”.*<sup>65</sup>

Francescucci criticises the use of the arm’s length principle as it is currently applied by countries who adopted the OECD Guidelines, since he believes that the arm’s length principle is unable to account for the efficiency premium that multinational groups derives in most cases on controlled transactions. Francescucci explains ‘efficiency premium’ to mean the ‘additional profit attributable to the benefits of integration (i.e. cost savings due to economies of scale, economies of scope, economies of learning, increased efficiency etc.) less governance costs.’<sup>66</sup>

Hamaekers<sup>67</sup> states that internationally economists have also questioned the appropriateness of the arm’s length principle and that these economists have held that the arm’s length principle is against economic reality. In this regard Hamaekers highlighted the following viewpoint of the economists:

*“It starts from the fiscal myth that every subsidiary and permanent establishment within a group is a separate entity which conducts trade under free-market conditions with other entities in the group. The*

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<sup>65</sup>Refer footnote 46.

<sup>66</sup>Francescucci, *supra* at 68.

<sup>67</sup>Hamaekers, H. 2001. Arm’s length-how long? *International Transfer Pricing Journal*, March-April, at 34.

*essence of an MNE, however, is the potential to act as one entity in the world market and so to gain competitive advantages. The higher efficiency usually realized within MNEs is not recognized by the arm's length principle. Advantages of scale and synergy-effects which are inherent in MNEs cannot be divided amongst the group in an objective way via the arm's length principle according to these economists.”<sup>68</sup>*

The OECD Steering Committee has acknowledged that there are problems in the application of the arm's length principle in that it is often difficult to obtain sufficient information to apply the arm's length principle and they have therefore taken the initiative by inviting comments on how to solve these problems.<sup>69</sup>

Up until the stage that a suitable solution is found, it is the author's view that South Africa will continue to apply the arm's length principle as defined in paragraph 1 of Article 9 of the OECD Model Double Taxation Convention and seek guidance from the OECD's commentary on applying the arm's length principle.

In *CIR v Downing*<sup>70</sup> the court held that South Africa should take cognisance of the guidelines for interpretation issued by the OECD in its commentaries on the concepts utilised in the OECD Model Double Taxation Convention as South Africa has adopted that Model for its double taxation agreements.

Accordingly, where a situation arises that no suitable comparables could be identified when applying the arm's length principle it is the author's submission that the South African Revenue Service should, bearing in mind the *CIR v Downing* decision, in such case take into account the following guidance provided in the OECD Guidelines when exercising its discretion in terms of section 31(2) of the Act, namely:

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<sup>68</sup> Hamaekers, *supra*, at 49.

<sup>69</sup> Fris, P. 2003. Dealing with arm's length and comparability in the years 2000. *International Transfer Pricing Journal*. November-December at 201.

<sup>70</sup> 1975 (4) SA 518 (A), 37 SATC 249 at 259 and 261.



- That controlled transactions may not necessarily be motivated by tax avoidance due to the fact that the multinational group faces different commercial circumstances than would independent enterprises;
- That *“the taxpayer should not be expected to incur disproportionately high costs and burdens to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles of the Report, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue.”*<sup>71</sup>

The author contends that if the taxpayer can demonstrate that there is no element of tax avoidance present in the international transaction with its foreign connected party, as well as can provide defensible reasons why it believes that no comparable data exists, that the South African Revenue Service should accept the transfer price adopted as being appropriate for South African transfer pricing purposes.

Emslie<sup>72</sup> highlighted a factual situation where he considers due to the unique nature of the loan, section 31(2) of the Act is incapable of application and that accordingly the Commissioner is prevented from using section 31(2) of the Act to deem interest to accrue to the South African taxpayer. The factual situation that Emslie refers to relates to the situation where a shareholder grants a loan to an offshore subsidiary in terms of a shareholder agreement. In terms of the shareholder agreement a shareholder is obliged to inject and withdraw an amount of interest free shareholder's loan capital that is in proportion to the shares that it acquires or sells. In addressing the question of comparability to determine an arm's length price, Emslie commented as follows:

*“In other words, s 31(2) is simply incapable of application to the postulated facts under consideration because the transaction under consideration is a shareholder's loan, i.e. a loan made by a*

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<sup>71</sup> Organisation for Economic Co-operation and Development. 1995. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at par. 5.6.

<sup>72</sup> Emslie, *supra* at 338.

*shareholder to its subsidiary company, and it would be nonsensical to use an inquiry predicated on independent persons dealing at arm's length when the transaction in question is one which inherently cannot involve independent persons dealing at arm's length. As Nicholas AJA states supra: 'A shareholder with a loan account ... is in a special position vis-à-vis the company'*

*One cannot treat the 'transaction' as if it were a loan which is not a shareholder's loan because shareholder loans are unique transactions. To compare a shareholder's loan with a notional loan by an independent person dealing at arm's length would be to compare apples with oranges, and this would be contrary to the provisions of section 31(2) which itself enjoins one to have regard to 'the transaction' in question.*

*If a holding company were, for example, selling maize to its African subsidiaries, it would make sense to inquire as to the terms on which independent persons dealing at arm's length would have bought and sold maize, but when it comes to the terms of a shareholder's loan, it is simply nonsensical to do so.”<sup>73</sup>*

The author agrees with the conclusion reached by Emslie. The nature of a shareholder loan is such that it can only exist between connected parties and it is the author's view that no accurate adjustments could be made to eliminate the differences between a shareholder loan and a loan from non-shareholders to determine the 'arm's length price'. In addition, comparisons with controlled transactions by other taxpayers (i.e. other shareholder loans) could not be regarded as arm's length comparisons.

A further example where taxpayers may be unable to identify suitable third party comparables is where a South African holding company grants an interest free loan to its offshore mining exploration subsidiary that uses the finance to fund its exploration or

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<sup>73</sup> Emslie, *supra* at 338.

prospecting activities. The offshore mining exploration company does not have any assets that could be provided as security for a loan and the said company would not have an income flow for some time. The offshore mining exploration company tried to obtain finance from a third party, but due to risks involved and the fact that it did not have any assets that it could provide as security the said company was unable to obtain third party finance. Would it be regarded as appropriate for purposes of section 31(2) of the Act not to charge interest?

The Australian Tax Authority has recognised in its Taxation Ruling 92/11<sup>74</sup> that due to the unique nature of the business of a mining company, which is in the prospecting or exploration stage of its business, this would be a transaction that independent enterprises would not undertake and that accordingly there would be not arm's length lender and no appropriate comparable data.

It is the author's opinion that under the abovementioned circumstances it should be acceptable to grant the interest free loan since there is no indication of what independent parties would have done and comparing it to any other loan would be inappropriate. In addition, the taxpayer would be able to demonstrate that the interest free loan was not motivated by tax.

#### **4.2 Analysis of the term 'the transaction'**

Section 31(2)(b) of the Act reads as follows:

*“the goods or services are supplied or acquired at a price which is ...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).” (Author's emphasis)*

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<sup>74</sup> Australian Taxation Office. *Taxation ruling, Income Tax 92/11*. <http://law.ato.gov.au/autolaw>. at 16.

The words ‘the transaction’ indicate that not any transaction between independent parties should be compared to the transaction between the connected parties. The transactions to be compared should be similar. It is the author’s opinion that the choice of the words ‘the transaction’ emphasises the importance of comparability, which as discussed above is fundamental to the application of the arm’s length principle, when determining the arm’s length price.

The author agrees with Emslie’s comment that where a South African resident granted its non-resident subsidiary a shareholder loan with specific terms (‘the transaction), the transaction cannot be compared with a loan from a non-shareholder because the latter is a different transaction with substantially different terms and could not be regarded as ‘the transaction’ as contemplated by section 31(2)(b).<sup>75</sup> Emslie emphasised the importance of the principle of comparability when applying the arm’s length principle in the context of section 31(2) of the Act.

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<sup>75</sup> Emslie T.S. 2002. Shareholder’s Loans to Offshore Subsidiaries. *Acta Juridica* at 339.

## **5 CHAPTER 5: ANALYSIS OF THE CONCEPT OF ‘DETERMINATION OF TAXABLE INCOME’ IN THE CONTEXT OF SERVICES RENDERED FOR NO CONSIDERATION**

### **5.1 Introduction**

The starting point in the determination of taxable income is to determine whether there is gross income. If a transaction does not give rise to gross income there can rest no tax liability on the person in respect of such transaction.<sup>76</sup>

Accordingly, it needs to be determined whether the services that a South African taxpayer renders to a foreign connected company give rise to gross income as defined in section 1 of the Act.

One of the criteria that must be present before there can be gross income as defined, is that an amount must have accrued or have been received by a person.

### **5.2 Does an amount accrue where services are rendered?**

In *CIR v Butchers Bros (Pty) Ltd*<sup>77</sup> Feetham JA held that it was essential for the Commissioner, in order to support his assessment, to show that some amount has accrued to or been received by Butchers Bros (Pty) Ltd. The court found in this case that since the Commissioner was unable to establish an actual amount, the benefit that the taxpayer received from the improvement to its leasehold property, which flowed from a lease agreement that the taxpayer concluded with another party, did not constitute gross income in the hands of the taxpayer.

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<sup>76</sup> Huxhaum, K. Haupt, P..*supra*, at 9.

<sup>77</sup> 1945 AD 301, 13 SATC 21.

In the light of the *CIR v Butchers Bros (Pty) Ltd* decision, Huxham and Haupt<sup>78</sup> is of the view that a notional amount cannot constitute gross income and they demonstrated this point by the following example:

*“If a person has money in his possession which does not earn interest he cannot be subjected to tax on the notional interest which he could have earned had he invested it into an interest bearing investment.”*

In *CIR v People’s Stores (Walvis Bay) (Pty) Ltd*<sup>79</sup> the court upheld the decision in *Lategan v CIR*<sup>80</sup> that the word accrued meant ‘becomes entitled to’.

In the next few paragraph the author will consider whether there could be gross income as defined in the following scenarios:

- Where a company grants an interest free loan to a foreign connected party;
- Where a company grants a foreign connected party the right to use certain tangible assets for no consideration.

### ***5.2.1 Scenario 1: Where a company grants an interest free loan to a foreign connected party.***

In the context of a loan there can only be accrual when the person who granted the loan becomes entitled to the right to receive interest from the borrower. It is the author’s opinion that there could be no actual amount if the lender does not have a right to receive interest.

It is therefore essential to determine when a person becomes entitled to the right to receive interest from the borrower and in this regard an understanding of the nature of a loan agreement relating to money is required.

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<sup>78</sup> Huxham, K. Haupt, P. *supra* at 10.

<sup>79</sup> 1990 (2) SA 353 (A), 52 SATC 9.

<sup>80</sup> 1926 CPD 203, 2 SATC 16

The granting of financial assistance can be classified as a loan for consumption, since the lender gives money to the borrower, which the latter can consume by use in for example its business. In return the borrower is bound to return the same amount of money to the lender. In the common law it was only permitted to charge interest in respect of the loan of money if the lender specifically stipulated to the borrower that it would charge interest. This is still the case today, since the lender will only be entitled to interest if specifically expressed in the loan contract or if can be implied through circumstantial evidence. Payment of interest therefore arises out of a contractual arrangement between the parties to the agreement.<sup>81</sup>

It is the author's opinion that if there is no expressed or implied agreement between the lender and borrower regarding the payment of interest there is no question of entitlement and there can be no interest amount received or accrued to the lender and therefore no gross income.

Since a transaction involving the granting of an interest free loan does not give rise to gross income there can rest no tax liability on the lender in respect of such transaction. Accordingly the Commissioner will be excluded from making an adjustment to the lender's taxable income, unless the courts follow the approach adopted in *CIR v Ocean Manufacturing Ltd*<sup>82</sup> where it was held that section 103 (which is an anti avoidance section and not a taxing section) should be construed in such away as to advance the remedy provided by the section and to suppress the mischief against which it is directed. The Commissioner's powers should not be restricted unnecessarily by interpretation.

In section 5.3 of this chapter the author examines whether a court will follow a literal or contextual/ purposive approach in interpreting whether section 31(2) applies to interest free loans.

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<sup>81</sup> Joubert D J. Loan. *Law of South Africa*. 15 First Reissue at par. 268, 269 and 277.

<sup>82</sup> 1990 (3) SA 610 (A), 52 SATC 151.

### **5.2.2 Scenario 2: Where a company grants a foreign connected party the right to use certain tangible assets for no consideration**

The granting of the right to use assets is regarded as a 'service' as defined in section 31(1) of the Act.

In the context of the right to use of an asset there can only be accrual when the person who granted the right of use becomes entitled to the right to receive income from the borrower. In addition, it is the author's opinion that there could be no actual amount if the person does not have a right to receive income.

It is therefore essential to determine when a person becomes entitled to the right to receive income from the borrower and in this regard an understanding of the nature of an agreement relating to the right to use someone else's property is required.

The granting of the right to use of an asset could either be classified as a loan for use (i.e. commodatum) or as a lease. A contract for loan for use is entered into when a lender agrees to grant a borrower the right to use an asset for a fixed period without any agreement for reward.<sup>83</sup> If, however, the borrower agrees to pay the lender a monetary consideration for the use of the asset, the contract would be one of letting.<sup>84</sup> Whether rental income will be paid by the borrower or not is therefore an essential element (i.e. essentialia<sup>85</sup>) in determining whether an agreement should be classified as a commodatum or as a lease agreement. From the aforementioned it can be deduced that an obligation to pay rental income only arises where it is specifically agreed upon between the lender and the borrower.

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<sup>83</sup>Kopel, S. 2003. *Guide to Business Law*. Second Edition. Cape Town: Oxford University Press Southern Africa at 116.

<sup>84</sup>Joubert, D.J. *supra*, at par 254.

<sup>85</sup>Van der Merwe, S., Van Huyssteen, L.F., Reinecke, M.F.B, Lubbe, G.F., Lotz, J.G. 1994. *Kontraktereg Algemene Beginsels*. Eerste Uitgawe. Kenwyn: Juta en Kie, Bpk at 202 says: "Essentialia is bedinge wat wesenlik is vir die klassifikasie van 'n kontrak as behorende tot a besondere kategorie kontrakte. Essentialia is nie vereistes vir die geldigheid van 'n kontrak nie. Indien by 'n ooreenkoms derhalwe een of meer van die essentialia van een kontraktipe ontbreek, mag dit nog altyd al die essentialia van 'n ander tipe kontrak bevat, of dit mag 'n kontrak sui generis wees".



Accordingly where the lender granted a borrower the right to use an asset for no consideration the agreement would be classified as a commodatum, which means that the lender would not be entitled to receive any rental income. As a result, there can be no amount received or accrued to the lender and therefore no gross income. Since there can rest no tax liability on the lender in respect of such transaction, the Commissioner will be excluded from making an adjustment to the lender's taxable income, unless the courts follows the approach adopted in *CIR v Ocean Manufacturing Ltd*<sup>86</sup> where it was held that section 103 should be construed in such away as to advance the remedy provided by the section and to suppress the mischief against which it is directed.

In section 5.3 of this chapter the author examines whether a court will follow a literal or contextual/ purposive approach in interpreting whether section 31(2) of the Act applies to commodatum agreements.

### **5.3 An analysis of the courts' approach when interpreting articles of the Act, in particular anti-avoidance provisions**

It is important to consider whether the South African courts would follow a literal or contextual/ purposive approach in interpreting whether section 31(2) of the Act applies to interest free loans or commodatum agreements.

Since section 31 of the Act is an anti avoidance section<sup>87</sup>, case law that dealt with the interpretation of anti avoidance provisions is analysed and considered below. In this regard reference is made to *Glen Anil Development Corp Ltd v SIR*<sup>88</sup> and *CIR v Ocean Manufacturing Ltd*.

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<sup>86</sup> 1990 (3) SA 610 (A), 52 SATC 151.

<sup>87</sup> In the Explanatory Memorandum on the Income Tax Bill, 1995 page 114 it is stated that "section 31 will be used to address tax avoidance schemes involving the manipulation of prices for goods and services under cross border transactions between connected persons."

<sup>88</sup> 1975 (4) SA 715 (A), 37 SATC 319.

In addition, the author considers case law hereinafter, where the court deviated from following a literal approach in interpreting a specific section, where the literal interpretation led to a glaring absurdity.

### ***5.3.1 Interpretation of anti-avoidance provisions***

In *Glen Anil Development Corporation Ltd v SIR*, Botha JA considered the application of section 103(2) as it read in 1966. Section 103(2) in 1966 read as follows:

*"Whenever the Secretary is satisfied that any agreement or any change in the shareholding in any company, as a direct or indirect result of which income has been received by or has accrued to that company..."*  
*( Author's emphasis)*

In *Glen Anil Development Corporation Ltd v SIR* council for the applicant argued that the words 'that company' refer to the company in the shareholding in which there was a change and as the words 'any agreement' are not related to any company, the words cited above in relation to 'any agreement' did not make sense. Accordingly, council argued that if a company in which the shareholding has not changed received income, section 103(2) couldn't be invoked, even if the income was a direct or indirect result of an agreement, which was entered into for the purpose contemplated in section 103(2). The council found support for his argument in the following citation from *CIR v Simpson*:

*". . . in a taxing Act one has to look at what is clearly said. There is no room for any intendment. There is no equity about tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used."*<sup>89</sup>

Botha JA did not accept the council's argument and set out the principles to be applied when the words of a statute do not make sense:

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<sup>89</sup> *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A) at 854.

*“ The principle to be applied in such a case is set out by Wessels ACJ in Ex parte The Minister of Justice: In re Rex v Jacobson and Levy 1931 AD 466 at 477 as follows-*

*‘if the language of the statute is not clear and would be nugatory if taken literally, but the object and the intention are clear, then the statute must not be reduced to a nullity merely because the language used is somewhat obscure’”.*

*“In Minister of Labour v Port Elizabeth Municipality 1952 (2) SA 522 at 534 Centlivres CJ referred to this principle and approved of the principle stated in Halsbury Laws of England vol 31 para 635 (Hailsham ed) that-*

*‘it may in certain circumstances be permissible to supply omitted words or expressions’ and it is clear from what the learned Chief Justice said at 534-5 of the report that it would be necessary to do so in order to give effect to the clear intention of the legislature.” <sup>90</sup>(Author’s emphasis)*

Williams<sup>91</sup> views Glen Anil Development Corp Ltd as a leading authority for the principle of interpretation that only where the intention of the legislature can be ascertained beyond doubt from other sources will it be justified to deviate from the literal interpretation of a statute.

In *Glen Anil Development Corp Ltd v CIR* Botha JA ascertained the clear intention of the legislature by considering the context and purpose of section 103 as a whole as well as considering the history of section 103. In considering the history of section 103, Botha JA determined that it was clear from the prior version of section 103 that the Secretary intended to invoke the section 103 provision in both cases, namely where a change in the shareholding resulted in income being received by any company and in the case where an

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<sup>90</sup> *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A) at 729-730.

<sup>91</sup> Williams, R. C. 1995. *Income Tax in South Africa Law and Practice*. 2<sup>nd</sup> Edition. Durban: Butterworths at 12.

agreement had that result. In considering the context of section 103, Botha JA held as follows:

*“ Section 103 of the Act is clearly directed at defeating tax avoidance schemes. It does not impose tax, nor does it relate to the tax imposed by the Act or to the liability therefore or to the incidence thereof, but rather to schemes designed for the avoidance of liability therefore. It should, in my view, therefore, not be construed as a taxing measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed...The discretionary powers conferred upon the Secretary should, therefore, not be restricted unnecessarily by interpretation. ”*<sup>92</sup>

Botha JA held that, having regard to the prior legislation and the mischief, which it aimed at, that the legislature’s intention was clear and that accordingly the words ‘any agreement’ should be construed as if the words ‘affecting any company’ were inserted after the words ‘any agreement’.<sup>93</sup>

In *CIR v Ocean Manufacturing Ltd*<sup>94</sup>, Nicholas AJA adopted the approach followed in the *Glen Anil Development Corp Ltd* case, namely that an anti avoidance section such as section 103 should be construed in such away as to advance the remedy provided by the section and to suppress the mischief against which it is directed. Nicholas AJA also emphasised that the Commissioner’s powers should not be restricted unnecessarily by interpretation.

It is the author’s opinion that the *Glen Anil Development Corp Ltd* case has created an exception to the *casus omissus* rule, in that it would be regarded as justifiable for the court to insert missing words where the court has satisfied itself that the intention of the legislature is clear, even though the wording used in the specific section is unclear.

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<sup>92</sup> *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A) at 727.

<sup>93</sup> *Glen Anil Development Corp Ltd v SIR* 1975 (4) SA 715 (A) at 729.

<sup>94</sup> 1990 (3) SA 610 (A) at 618.

### 5.3.2 Case law where a literal interpretation led to a glaring absurdity

*R Koster & Son (Pty) Ltd & Another v CIR*<sup>95</sup> confirmed the following rule of interpretation:

*“that in construing a provision of an Act of Parliament the plain meaning of its language must be adopted unless it leads to some absurdity, inconsistency, hardship or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the Legislature could not have intended. ‘The words of a statute never should in interpretation be added to or subtracted from, without almost a necessity’: per Lord Bramwell in Coweper Essex v Acton Local Board (14, AC 153, 169)”.*

Innes J laid down the following principle in *Venter v Rex*<sup>96</sup>

*“when to give the plain words of the statute their ordinary meaning would lead to an absurdity so glaring that it could never have been contemplated by the legislature or where it would lead to a result contrary to the intention of the legislature, as shown by the context or by such other considerations as the court is justified in taking into account, the court may depart from the ordinary effect of the words to the extent necessary to remove the absurdity and give effect to the true intention of the legislature.”*

In *Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of Sale of the MV Jade Transporter*<sup>97</sup> Corbett JA adopted the principle laid down by Innes J in *Venter v Rex* when Corbett held as follows:

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<sup>95</sup> 1985(2) SA 831 (A), 47 SATC 24 at 32.

<sup>96</sup> 1907 TS 910 at 915.

<sup>97</sup> 1987 (2) SA 547 (A).

*“The general rule is that the words of a statute must be given their ordinary, grammatical meaning unless to do so-*

*‘would lead to absurdity so glaring that it could never have been contemplated by the Legislature...’*

*In that event the Court may depart from the ordinary effect of the words to the extent necessary to remove the absurdity and give effect to the true intention of the Legislature.”<sup>98</sup>*

However, Corbett JA cautioned that it is dangerous to speculate on the intention of the legislature and that the court should only depart from the ordinary meaning where the legislature’s contrary legislative intent is clear and unquestionable, since it is not the court’s function to supplement a statutory provision in order to provide for a *casus omissus*.<sup>99</sup>

In *ITC 1584*<sup>100</sup>, Seligson AJ held that it would be a glaring absurdity if the exemption in section 10(1)(u) did not apply also to maintenance paid by the estate of a former spouse, since such a construction would be in conflict with the Legislature’s intent and does not accord with the context or object of the exemption provision. Seligson AJ found support for his decision in the judgements of respectively *Venter v Rex* and *Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of the Sale of the MV Jade Transporter*, as can be seen from the following extract from Seligson’s judgement:

*“ It is a well established rule of statutory construction that, where the usual, everyday, meaning of the words of an enactment is in conflict with the clear intention of the Legislature as gleaned from the statute as a whole and other relevant circumstances, it is permissible to depart*

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<sup>98</sup> *Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of Sale of the MV Jade Transporter* 1987 (2) SA 547 (A), at 596.

<sup>99</sup> *Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of Sale of the MV Jade Transporter* 1987 (2) SA 547 (A) at 596.

<sup>100</sup> 57 SATC 63.

*from such meaning to give effect to the real intention. See Venter v R 1907 TX910 at 914-15...I am mindful that a Court should be cautious about departing from the literal meaning of a statutory provision by supplementing it and should only do so-*

*‘where the contrary legislative intent is clear and indubitable’ (per Corbett JA, as he then was, in Summit Industrial Corporation v Claimants against the Fund Comprising the Proceeds of the Sale of the MV Jade Transporter 1987 (2) SA 583 (A) at 596-597).”<sup>101</sup>*

### **5.3.3 Application of the case law**

As indicated above<sup>102</sup>, a literal interpretation of section 31(2) of the Act has the affect that the Commissioner will be excluded from making an adjustment to the taxable income of the company that granted an interest free loan or free use of assets to an offshore connected party.

Since the golden rule of interpretation is that the words of a statute must be given their ordinary, grammatical meaning unless to do so would lead to an absurdity or would lead to a result contrary to the intention of the legislature as shown by the context or by such other considerations, it needs to be determined whether there is a clear and unquestionable legislative intent that section 31(2) of the Act applies where a taxpayer renders a service to an offshore connected for no consideration. It is the author’s opinion, that if the legislative intent cannot be ascertained beyond any doubt from internal or external sources, the literal interpretation should be followed. Accordingly the context of section 31 of the Act as a whole as well as the history of section 31 should be considered.

The following extract from the Explanatory Memorandum on the Income Tax Bill, 1995<sup>103</sup> places section 31 of the Act into context:

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<sup>101</sup> 57 SATC 63 at 71.

<sup>102</sup> Refer paragraph 6.2.10 and 6.2.16.

<sup>103</sup> Republic of South Africa. 1995. *Explanatory Memorandum on the Income Tax Bill*. Pretoria: Government Printer, at 114.

*“section 31 will be used to address tax avoidance schemes involving the manipulation of prices for goods and services under cross border transactions between connected persons.”.*

In considering the history of section 31 to determine the legislature’s intent, reference should be made to the First and Second Interim report of the Commission of Inquiry into certain aspects of the tax structure of South Africa (the Katz Commission), since section 31 of the Act was built upon the transfer pricing recommendations that are contained in these two reports.<sup>104</sup> As the Katz Commission worked closely with the legislature in preparing section 31 of the Act, the author considers it relevant to cite the following extracts from the First and Second Interim report of the Katz Commission.

*“The Commission is of the view that well conceived transfer pricing plans assist companies to avoid a significant portion of their tax liabilities...The Commission recommends that...greater attention be paid by the Commissioner for Inland Revenue to eliminate abusive transfer pricing.*

*What is clear is that the South African tax system needs some legislative teeth with which to protect itself against excessive price manipulation between related parties. At this stage such teeth would not be used over aggressively, but they would be there to use when taxpayers move beyond the parameters of reasonable pricing”.*<sup>105</sup>

*“ In its first Interim Report the Commission recommends the introduction of transfer pricing rules to protect the tax system against abuse.”*<sup>106</sup>

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<sup>104</sup>Brincker, E., Honiball, M., Olivier, L. 2003. *International Tax A South African Perspective*. Cape Town: Siber Ink at 190.

<sup>105</sup> Republic of South Africa. 1994. *First Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*. Pretoria: Government Printer, at 66 and 231.

<sup>106</sup> Republic of South Africa. 1995. *Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*. Pretoria: Government Printer, at 357.



*“The world’s tax systems have developed basically four approaches to countering transfer pricing:...*

*(c) The third approach also has anti-transfer pricing legislation, but relies on arm’s length concepts to dictate acceptable pricing practices, as in the United Kingdom and other countries which rely strongly on OECD guidelines...the Commission therefore prefers the third approach.”<sup>107</sup>*

*“On the other hand there does seem to be a balance between protecting the tax system against gross excess and not seeking to throw a net so tightly that the measures become a disincentive for legitimate business.”<sup>108</sup>*

The above extracts from the First and Second Interim Reports of the Katz Commission indicates that section 31 of the Act is aimed at enabling the Commissioner to counteract the mischief of transfer pricing, namely to protect the South African fiscus against abusive transfer pricing between connected persons in an international context. It should be noted, however, that the Katz Commission recommended that the transfer pricing legislation should be used to protect the South African fiscus against *excessive* price manipulation and that care should be taken that the transfer pricing legislation is not applied over aggressively in that it becomes a measure that deters legitimate business. The Katz Commission therefore recommended that the international accepted arm’s length concept be used to determine what a reasonable price would be. As can be seen from the wording of section 31(2) of the Act, the arm’s length concept was adopted by the legislature.

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<sup>107</sup> <sup>107</sup> Republic of South Africa. 1994. *First Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*. Pretoria: Government Printer, at 232.

<sup>108</sup> Republic of South Africa. 1995. *Second Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa*. Pretoria: Government Printer, at 357.

From the analysis of the abovementioned external sources, it is clear that the legislature's intent with section 31 of the Act is to prevent abusive transfer pricing between connected parties in an international context.

#### 5.4 Conclusion

It is the author's opinion that where it can be shown that the services rendered for no consideration by a South African company to an offshore connected company does not give rise to an arm's length result due to price manipulation, it would be justifiable for the court to depart from the literal meaning of the words 'taxable income' contained in section 31(2) of the Act to the extent necessary to give effect to the true intention of the legislature (i.e. to prevent the mischief of excessive price manipulation).

The author contends that when the court is faced to consider whether a contextual approach should be followed to interpret section 31(2) of the Act in the context of an interest free loan or commodatum, the court should guard against adopting an interpretation that would be a disincentive for legitimate business.

In the author's opinion a decisive factor of whether the South African courts should follow a literal or contextual/ purposive approach in interpreting whether section 31(2) of the Act applies to interest free loans and commodatums, should be whether there is evidence of price manipulation. This should be determined from circumstantial evidence, which includes *inter alia* determining what the arm's length price would be if the same transaction took place between independent companies in the open market (i.e. identifying third party transactions that are suitably comparable to 'the transaction').

This opinion finds support in the commentary made by respectively Burt<sup>109</sup> and Emslie<sup>110</sup> where they considered the scope of section 31(2) of the Act as far as shareholder loans to offshore subsidiaries are concerned. Burt<sup>111</sup> comments that it is plausible that the court

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<sup>109</sup> Burt K. 2003. Shareholders' Loans to Offshore Subsidiaries: A critique. *Taxpayer*, 52.

<sup>110</sup> Emslie, T.S, *supra*.

<sup>111</sup> Burt, K. *supra* at 229.

would, in considering the scope of application of section 31(2) of the Act, apply a contextual approach to interpret section 31(2) of the Act and would take account of external sources (such as the First and Second Interim Report of the Katz Commission) which they would consider to be relevant to contextualise section 31(2) of the Act. He furthermore comments that if the court contextualises section 31(2) of the Act by employing the Katz Commission's First and Second Interim Report, it would find that a pre-condition of the application of section 31(2) of the Act is evidence of the practice of price manipulation.

Similarly Emslie<sup>112</sup> puts forward that the mischief of transfer pricing may well be a pre-condition of the application of section 31(2) of the Act:

*“The purpose of section 31(2), it seems, is to enable the Commissioner to counteract the mischief of transfer pricing whereby connected persons manipulate the prices of goods and services in order to optimise their tax position in an international context...*

*If the transaction had not been an ‘international agreement’ but had taken place between the holding and subsidiary companies operating exclusively within South Africa, it would have been perfectly normal for no interest to be payable on the shareholder’s loan as indicated by Nicholas AJA supra. Why then should the position be any different just because the agreement is an international agreement, given that no mischief in the form of transfer pricing is present?*

*The mischief of transfer pricing may well be the jurisdictional fact required to be present before the provision of section 31(2) can validly be called into operation, and this is not the case on the postulated facts.”<sup>113</sup>*

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<sup>112</sup> Emslie, T.S, *supra*.

<sup>113</sup> Emslie, T.S, *supra* at 339.

The postulated facts that Emslie refers to in the above extract relate to the situation previously stated in this study, namely where a shareholder grants a loan to an offshore subsidiary in terms of a shareholder agreement. In terms of the said shareholder agreement a shareholder is obliged to inject and withdraw an amount of interest free shareholder's loan capital that is in proportion to the shares that it acquires or sells. Both Burt and Emslie concluded that due to the absence of price manipulation in the postulated facts, section 31(2) of the Act should not be applicable.

## **6 CHAPTER 6: CONCLUSION**

It appears that the South African Revenue Service is of the view that where a South African company grants a service to a foreign group for no consideration, it could make a transfer pricing adjustment in terms of section 31(2) of the Act. The burden of proof rests with the taxpayer to demonstrate that its cross border transactions with foreign group companies do not infringe the provisions of section 31(2) of the Act.

Section 31(2) of the Act consists of a number of essential components/ criteria, which must be present before section 31(2) of the Act can apply. These components are as follows:

- Goods or services are supplied or acquired in terms of an international agreement;
- The international agreement takes place between connected parties;
- The price of the goods or services arising from ‘the transaction’ under review is not an arm’s length price, when compared against comparable third party transactions;
- The Commissioner makes an adjustment to the consideration in respect of the transaction in determining the taxable income of the taxpayer.

The author concludes that if the taxpayer can prove that one of the above stated components is not present in a transaction under review it would have discharged its burden of proof that its cross border transaction does not infringe the provision of section 31(2) of the Act.

The author therefore recommends that when the South African Revenue Service queries a taxpayer’s cross border transaction in terms of section 31(2) of the Act, that taxpayers undertake a careful analysis of its cross border transactions to determine the following:

- In light of the fact that the ‘international agreement’ definition was amended and extended a few times since 1995, whether the taxpayer entered into a transaction,

operation or scheme with a connected non-resident party that would fall within the meaning of 'international agreement' as it read and applied for that particular year of assessment. If the transaction did not fall within the said meaning, section 31(2) of the Act could not apply. For example, for the period 19 July 1995 to 24 November 1999 a transaction could not be subject to section 31(2) of the Act where a company that was managed and controlled in South Africa transacted with an offshore branch of another company that was managed and controlled in South Africa. After 24 November 1999, the aforementioned transaction would, however, fall within the meaning of 'international transaction' and, provided that all the other components are present, section 31(2) of the Act would apply.

- Whether the offshore group company with whom the taxpayer transacted could be regarded as a connected person, as defined in section 1 of the Act. The author concludes that the view held by both the South African Revenue Service and tax practitioners that transactions between a South African company and an offshore company, which are both directly or indirectly held more than fifty percent by a offshore located parent company, are transactions between connected parties as incorrect in law. The author contends that the parties to this stated transaction does not fall within the meaning of 'connected person' as currently defined in section 1 of the Act. Accordingly, section 31(2) of the Act could not apply to such transactions, since one of the essential components of section 31(2) is not present. The author is of the opinion, based on the current wording of the connected person definition as defined in section 1 of the Act, if the South African court had to decide whether the transaction stated in this paragraph is a transaction between connected parties the court would rule in favour of the taxpayer.
- Whether the taxpayer can identify third party transactions that are substantially similar to the transaction under query. The author concludes that the arm's length principle is in certain instances difficult to apply, since third party comparable data does not exist due to the fact that group companies may engage in transactions that independent enterprises would not undertake. The author contends that if the taxpayer can demonstrate that there is no element of tax avoidance present in the international

transaction with its foreign connected party, as well as can provide defensible reasons why it believes that no comparable data exists, that the South African Revenue Service should accept the transfer price adopted as being appropriate for South African transfer pricing purposes.

- Whether in terms of the agreement with its foreign connected party, the taxpayer is entitled to receive income for the services (such as financial assistance or right to use a tangible asset) that it rendered to its foreign connected party. The author concludes that where the lender agrees with the borrower that it grants a service (such as financial assistance or right to use a tangible asset) for no consideration, the lender would not be entitled to receive any income. As a result, there can be no amount received or accrued to the lender and therefore no gross income. Since the starting point in the determination of taxable income is to determine whether there is gross income, if a transaction does not give rise to gross income there can rest no tax liability on the person in respect of such transaction. Accordingly, the author contends that since there can rest no tax liability on the lender in respect of such transaction, the Commissioner will be excluded from making an adjustment to the lender's taxable income, unless the courts follows a contextual approach in interpreting section 31(2) of the Act.
- The author contends that when the court is faced to consider whether a contextual approach should be followed to interpret section 31(2) of the Act in the context of services rendered for no consideration, the court should guard against adopting an interpretation that would be a disincentive for legitimate business. In the author's opinion the courts should contextualise section 31(2) of the Act with reference to the Katz Commission's First and Second Interim Report, where it is indicative that section 31(2) of the Act was aimed to counteract excessive price manipulation and the mischief of transfer pricing. Accordingly, where the taxpayer can provide evidence that demonstrates that there was no practice of price manipulation, it should not be justifiable for the court to depart from the literal meaning of the words 'taxable income' as contained in section 31(2) of the Act.

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