Disputes Mauritius Legit Expect judgment.mp3

The facts are as set out in the FACTS document.

JUDGEMENT

The taxpayer argued that the Practice Note 7 issued by SARS incorporating the OECD Transfer Pricing Guidelines must be adhered to by SARS in issuing an assessment for the adjustment of the arm's length price in respect of a royalty charge between a parent company in South Africa and its offshore subsidiaries. Section 31 of the Income Tax Act, which is the transfer pricing charging section, does not specify what an arm's length price is. In this regard, Practice Note 7 deflects to the OECD Transfer Pricing Guidelines which sets out five methodologies. The methodology applied by the taxpayer was the profit split method. This was partially accepted by SARS in that they acknowledged that the profit split method was applicable and that the profit to be split would be the brand earnings of each of the subsidiaries. However, SARS did not apply the second step of the profit split method. They simply allocated all the profits to the parent company and none of the profits to the offshore subsidiaries. This the taxpayer held was contrary to OECD Transfer Pricing Guidelines and contrary to the legitimate expectation created by SARS in issuing the Practice Note 7 that the OECD Transfer Pricing Guidelines would be followed, including the profit split method.

SARS argued that the Practice Note 7 is not law. It has not been legislated as law and in terms of paragraphs 3.1, 9.1.1 and 17.1, as well as 7.6 the Practice Note is merely issued as a guideline and that transfer pricing is not an exact science, but more of an art. SARS argued that no clear legitimate expectation was created in that there was no clear unqualified promise made by SARS that it would adhere as if entering into a bilateral agreement with the taxpayer to Practice Note 7. Therefore, they argued the legitimate expectation doctrine did not apply.

Is the Practice Note a promise which is enforceable? Does it reflect a regular practice adhered to consistently by SARS? Is it a clear policy that can be demonstrated to exist? Is it a bilateral binding agreement entered into between SARS and the taxpayer? In my view, no clear evidence was presented by the taxpayer to answer any of these questions in the affirmative. Furthermore, it is clear from the Authorities that such a promise must be clear, unambiguous and unqualified. That does not appear to be the case with the Practice Note in that it is clearly stated as being be a guideline.

Procedural legitimate expectation principles, in accordance with the Authorities, expect that a fair procedure is to be followed in line with a legitimate expectation created, in this instance, by SARS. Therefore, before SARS can take a decision, it is expected to adhere to the legitimate expectation created by it in terms of its procedures.

Section 31 clarified by Practice Note 7 attempts to give the taxpayer an opportunity to present an arm's length price with justification. It is clear that transfer pricing and the arm's length principle is not a science, but rather an art.

Guidance may then be sought on what art form should be applied, such as the OECD Transfer Pricing Guidelines and Practice Note 7.

In *KwaZulu Natal vs MEC Education*, a Constitutional Court judgment, the Constitutional Court was not prepared to entertain an extension of the existing procedural legitimate expectations doctrine in South Africa to developing the substantive legitimate expectations doctrine into South African law, for various reasons. The complainants were looking to enforce against the MEC a promise that had been made that certain education subsidies would be paid.

From various academic writers it is clear that, besides enforcing promises or practices, giving officials the power to effectively enact laws through Practice Notes giving rise to substantive legitimate expectations would fly in the face of the constitutional principle of the separation of powers. That power to create laws is specifically given to the legislature or parliament in this case.

In adhering to these observations, and in light of the *KwaZulu Natal* judgement, the substantive legitimate expectations doctrine is something that should not be applied in this instance.

What about procedural legitimate expectations? It could be said that SARS did not follow procedural fairness and should have given notice to address its deviation from Practice Note 7. However, this no doubt has played out in the objection and appeal process before the matter came to court. Therefore, there was an opportunity for the taxpayer to lodge its complaint and argue it's position that SARS should adhere to its Practice Note 7 Guideline and the OECD Transfer Pricing Guidelines. Thus the procedural legitimate expectations doctrine would also not apply for this reason. Furthermore, a clear unambiguous, unqualified enforceable promise was not in fact made by SARS.

However, in turning to the relief granted in the KwaZulu Natal case, the Constitutional Court looked to enforce a publically promulgated promise to pay the subsidy on the ground of reliance, accountability and rationality.

Looking at what happened in this particular case, it is clear that SARS had deviated from international best practice as set out in the 'soft law' known as the OECD Transfer Pricing Guidelines. Is this reliable, accountable, or rational conduct on the part of SARS? I believe not. I believe SARS would be acting in an irrational, unaccountable and unreliable fashion by not following the main stream best international practice in applying one of the five methods, which in this case is the profit split method, which requires two clear steps to be followed. The failure by SARS to do so would be contrary to the principle of legality on the basis that their conduct is not reliable or reasonable, and not rational.

SARS argued that the OECD Transfer Pricing Guidelines 2010 at paragraph 2.155 and 3.5 in effect grant an opening for a deviation from one of the five standard methodologies. This is a misreading of this ‘soft law’ in that it gives the taxpayer the opportunity to motivate a deviation if sufficient comparability cannot be found in an attempt to execute one of the five methodologies. It does not state that a Revenue Authority can do so.

Therefore, it would be appropriate to refer the assessment back to the Commissioner to reassess on the basis of applying the profit split method in the manner that the OECD Transfer Pricing Guidelines (as incorporated in Practice Note 7) has been given as guidance by SARS to taxpayers, and to this taxpayer.