The tax effect of terms of financing instruments

Crookes Brothers Limited v C:SARS is a rare case that deals with South African transfer pricing. The court considered the application of an exemption for equity-like loans and concluded that loans that could be payable within 30 years from the date advanced in certain circumstances did not qualify for the exemption. The reasoning followed may be relevant to consider when interpreting other provisions that also aim to distinguish between debt- or equity-type of instruments.

The case of *Crookes Brothers Limited v C:SARS* was widely commented as a rare case that deals with the South African transfer pricing provisions. The court considered the application of an exemption from the transfer pricing rules for loans with equity-like features by South African companies to offshore operations. It is submitted that the views expressed in this judgment may provide some insight when considering other provisions of the Income Tax Act (the ITA) that are also aimed at distinguishing between instruments with debt or equity characteristics.

Facts of the case

Crookes Brothers Ltd ('CBL') capitalised a 99% Mozambican subsidiary, Murrimo Macadamias Limitada ('MML') with a number of loans that had the following terms:

- MML is not obliged to repay the loan amount within 30 years from approval or advance;
- No repayment of the loan amount is required by MML if the market value of its assets is less than the market value of its liabilities on the date of payment;
- No interest is payable in respect of the loan;
- In the event of an application for liquidation of MML, MML going into bankruptcy or business rescue or similar type of proceedings, or judgment having been taken against MML and remaining unsatisfied for 14 days, the loan agreement terminates and any outstanding balance immediately becomes due and payable to CBL ('Clause 7').

In addition, CBL and MML entered into a sub-ordination agreement that back-ranked CBL's loan claims while MML's liabilities exceeded its assets. Until such time as MML's assets exceeded its liabilities, CBL was entitled to demand or sue for or accept payment of an amount owing to it.

The legislation and dispute

Section 31(7) of the ITA sets out circumstances where the transfer pricing rules do not apply. The requirements of this provision are aimed at providing relief to equity-like loans. One of the requirements is that:

> 'that foreign company *[the borrower]* is not obliged to redeem that debt in full within 30 years from the date the debt is incurred'

CBL argued that this requirement was met while SARS was of the view that Clause 7 provided for circumstances in which the loan *could* become repayable before 30 years. The court concurred with SARS on the basis that section 31(7) requires the nature of the transaction (loan) to be considered and not necessarily the prevailing facts in a particular year.

Wider relevance

A number of other provisions of the ITA also deal with instruments that have debt-like or equity-like features. These include requirements in section 8E that refer to shares that the issuer is obliged to redeem within 3 years from the date of issue and section 8F which, similarly to section 31(7), contain requirements relating to amounts that a person will not be obliged to pay within 30 years from the date of issue of an instrument. It is submitted that the views of the court in the CBL case may also be of value when considering the application of these provisions.

(September 2018)

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