

BINDING PRIVATE RULING: BPR 243

DATE: 7 July 2016

ACT : INCOME TAX ACT NO. 58 OF 1962 (the Act)
SECTION : PARAGRAPHS 1 – DEFINITION OF “ASSET” AND 11(1)(b) OF THE EIGHTH SCHEDULE
SUBJECT : TERMINATION OF A SUBCONTRACTING AGREEMENT AND IMPLEMENTING OF A TOLL MANUFACTURING ARRANGEMENT

1. Summary

This ruling determines whether the termination of a subcontracting agreement including a concomitant supplies plan between connected persons and the implementation of a toll manufacturing arrangement will have capital gains tax consequences.

2. Relevant tax laws

This is a binding private ruling issued in accordance with section 78(1) and published in accordance with section 87(2) of the Tax Administration Act No. 28 of 2011.

In this ruling references to paragraphs are to paragraphs of the Eighth Schedule to the Act applicable as at 9 May 2016. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of the provisions of –

- paragraph 1 – definition of “asset”; and
- paragraph 11(1)(b).

3. Parties to the proposed transaction

The Applicant: A company incorporated in and a resident of South Africa

The Co-Applicant: A company incorporated in and a resident of South Africa which is a wholly-owned subsidiary of the Applicant

4. Description of the proposed transaction

The Applicant's business involves the marketing of agriculture related raw material and products that can be manufactured therefrom and logistics concerning those.

The Co-Applicant's business constitutes the processing of the agricultural related raw material, marketing and distributing of the processed products and the management of logistics at loading facilities at a local port of entry.

As part of the Applicant's ordinary business operations it entered into a memorandum of agreement (MOA) with Company X, a non-resident entity, for the sale of one of its products (product A) on, amongst others, the following material terms:

- a) The Applicant is authorised to subcontract the supply of product A under the MOA to the Co-Applicant, provided that in so doing, the Applicant shall not –
 - i) in any way be relieved from its obligations under the MOA; or
 - ii) be entitled to any greater protection from liability under the MOA than it otherwise would have had if it had not subcontracted the supply of product A to the Co-Applicant.
- b) The Applicant may authorise the Co-Applicant to issue an invoice to Company X and to collect payment in the Co-Applicant's own name from Company X after which Company X's obligation to the Applicant is fully performed.
- c) The MOA shall have an initial term of two years. It will automatically be renewed for a further year on the same terms and conditions, unless either party gives written notice to the other party of its intention not to renew prior to the expiry of the initial two year term.

In terms of its current business model, and specifically with reference to the MOA, the Applicant implements its contract of its manufacturing business of product A with the Co-Applicant as follows:

- a) The Applicant enters into a 12 month supplies plan with the Co-Applicant in terms of which the Applicant supplies the raw material to the Co-Applicant for consideration. Ownership of the raw material passes to the Co-Applicant upon the supply thereof.
- b) The Applicant does not have formal written agreements in place with the Co-Applicant. The supplies plan is entered into in advance and is updated throughout the year to meet the Co-Applicant's distribution requirements. The Co-Applicant's production plan per week or month becomes the raw material order that the Applicant is required to supply to the Co-Applicant.
- c) The Co-Applicant processes the raw material. This process of manufacture produces product A.

The Co-Applicant may therefore effectively sell product A to Company X for consideration, issue invoices and collect payments.

On the renewal of the MOA, Company X was informed that the Applicant intends changing its business model. The Applicant will no longer subcontract its rights under the MOA, but it will supply raw material to the Co-Applicant under a toll manufacturing arrangement. The relevant terms of the toll manufacturing arrangement will be as follows:

- a) The Co-Applicant will manufacture product A for the Applicant in terms of the toll manufacturing arrangement, in accordance with the Applicant's specifications. Ownership of the raw material will remain with the Applicant.

- b) The Co-Applicant will charge a fee for the services rendered to the Applicant.
- c) The Applicant will sell the manufactured product A directly to various third party buyers, including Company X. The Applicant will undertake all the business functions, such as the marketing and distribution, previously performed by the Co-Applicant.
- d) The Co-Applicant will continue to manage the loading logistics at the local port of entry and to charge a fee to the Applicant. Other administrative duties related to orders placed by Company X will be carried out by the Applicant.

5. Conditions and assumptions

This binding private ruling is not subject to any additional conditions and assumptions.

6. Ruling

The ruling made in connection with the proposed transaction is as follows:

- The termination of the subcontracting agreement including the concomitant supplies plan between the Applicant and the Co-Applicant, and the implementation of the toll manufacturing arrangement in accordance with the proposed transaction will not constitute a disposal of an asset as contemplated in the Eighth Schedule. The proposed transaction will not give rise to a capital gains tax liability for the Applicant.

7. Period for which this ruling is valid

This binding private ruling is valid for a period of 3 years from 9 May 2016.