IN THE HIGH COURT OF SOUTH AFRICA

GAUTENG DIVISION, PRETORIA

CASE NO: 20923/2015

In the matter between:

LEVI STRAUSS SA (PTY) LTD **Applicant**

And

THE COMMISISONER FOR THE SOUTH AFRICAN REVENUE SERVICE **Respondent**

JUDGMENT

SATCHWELL J:

INTRODUCTION

1. The Applicant, Levi Strauss SA ('Levi SA') has instituted an appeal in terms of sections 65(6)(a) and 49(7)(b)(ii) of the Customs and Excise Act, 91 of 1964 ('the Act') against determinations made by the respondent in relation to the value and origin of goods imported into the Republic of South Africa[1].

[1] The taxpayer's Notice of Motion set out five prayers in respect of which I was informed in argument that the applicant taxpayer now only proceeds in terms of prayers 1 (that the determinations be set aside), 2 (that the

2. Following an audit by SARS in 2012 relating to the period 1 July 2010 to 5 February 2014, SARS issued a letter detailing its *prima facie* findings in respect of the value and origin of goods imported into South Africa which had implications for determination of the value thereof and duties to be paid. Levi SA responded with detailed representations. Following thereon, SARS issued a letter of demand claiming payment of duties, VAT and penalties totaling some R 160 million. Thereafter, Levi SA notified SARS, in terms of section 96 of the Act, of its intention to institute proceedings and, once SARS had indicated that the matters in dispute were not capable of resolution through concession or compromise, Levi SA accordingly instituted this appeal against the determinations made by SARS.

3. I should mention that an interlocutory application in 2017 resulted in an order by Murphy J referring certain issues to oral evidence, the appearance of certain witnesses before the court and certain evidence to be taken on commission. This court heard the evidence of three witnesses - Walter Ettlin (Vice President Finance for the global supply chain organization of Levi Strauss San Francisco); Eldon Nelson (Finance Director of Levi Strauss SA); Samir Allie (he leader of the SARS team conducting the audit on Levi Strauss SA over the period 2012 to 2014).

4. Three disputes have been aired and argued before this court. All involve disentanglement of the intricate corporate arrangements within the Levi Strauss group and interpretation of the appropriate provisions of the Act or the SADC Treaty in the light of practices within the group. The first dispute is whether or not the commissions paid by Levi SA to Levi Strauss Asia Pacific Division Pte Ltd ('Levi APD') in Singapore APD in Singapore in terms of a Buyers Agent Agreement ('BAA') are buying agent commissions in terms of section 67 of the Act and, if not, to what extent they should be added to the value of the goods imported in terms of section 65 (4)(a)(i) of the Act - which

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SARS determinations be substituted by determinations to the contrary), 4 (that the SARS demand be withdrawn), 5 (costs).

is known as the 'Commissions Dispute'[2]. The second dispute, whether royalties paid by Levi SA to the holding company in San Francisco in terms of a Trademark License Agreement ('the TLA') should have been added to the transaction value of imported goods in terms of section 65 (4)(a)(i) of the Act - which is known as the 'Royalties Dispute'[3] . The third dispute, whether or not Levi SA is entitled to have claimed preferential tariffs or rates on importation of goods from contract manufacturers within the SADC region, is dealt with in terms of section 49(7)(a) of the Act - which is known as the 'Dispute of Origin'[4].

5. In the course of this engagement (both pre- and during the exchange of pleadings) a great deal of information was submitted or exchanged amounting to tens of boxes of volumes of ringbinder files of documents. I am indebted to the parties who, by the time this matter was ready for final argument, had managed to reduce these to some 25 bound volumes. At final hearing of this matter, this court was presented with 'Heads of Argument', 'Notes for Argument' and 'Additional Submissions' by the applicant and 'Heads of Argument', 'Replying Notes on Applicants Heads of Argument' and 'Further Reply to Levi SA Notes for Argument' by the respondent. Not all of these documents are consistent with the pleadings or internally consistent with each other and it also appeared that certain submissions were changed or abandoned in the course of these written as well as oral presentations.

LEVI STRAUSS CORPORATE STRUCTURE

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[2]Prayer 1.1 is that the determination be set aside "that Levi Strauss Asia Pacific Divison Pte Ltd ("Levi APD') is not a buying agent of the applicant and that consequently the buying commission paid by the Applicant on goods sourced by Levi APD should have been included in the value of those goods for duty purposes upon their importation".

[3] Prayer 1.2 is that the determination be set aside "that the royalties/licence fees paid by the Applicant to Levi Strauss & Co are to be included in the value for duty purposes of the goods imported by the Applicant upon their importation".

[4] Prayer 1.3 is that the determination be set aside "that the Southern African Development Community Certificates of Origin were invalidly used in respect of goods imported by the Applicant from SADC manufacturers/suppliers contracted by Levi APD or Levi Strauss Global Trading Compan y Ltd ('Levi GTC') resulting in the Applicant claiming preferential duty rates".

6. Levi Strauss & Co (' Levi Delaware') is the ultimate holding company of a multi-national group of companies. For this purposes of this application, Levi Delaware wholly owns Levi San Francisco which wholly owns Levi Nederland which wholly owns Levi SA[5]. Levi SA (and other entities dealing with Levi branded apparel) are known as 'affiliates' within the multinational Levi group.

7. Levi SA is licensed to manufacture and sell Levi branded apparel in the Republic of South Africa and Sub-Saharan Africa in terms of the Trademark License Agreement ('TLA') into which it has entered with Levi San Francisco.

8. Levi SA manufactures some 40% of the retailed goods at it's plant in Cape Town (i.e. within the Republic of South Africa), imports some 40% of the retailed goods from SADC suppliers and imports a further 20% of goods from non SADC member(s).

9. By reason of the apparently extensive reach of the Levi group throughout the globe, a number of functions are performed by the group for and on behalf of the "affiliates" such as Levi SA which services include what are called 'treasury' and/or 'global procurement' functions which fall under the rubric of what seems to be known as the Global Sourcing Organisation ("GSO") facilitated, in the case of Levi SA, by Levi APD (until January 2011) and thereafter (since January 2011) by Levi GTC.

10. It is essentially these 'global procurement' and/or 'treasury' functions which have given rise to the first and third disputes – the ' commission dispute' and the 'dispute of origin'.

11. The witness Ettlin explained that within the Levi group is an internal bank used to facilitate payments on behalf of various affiliates, such as Levi SA, for different services which have been provided. Such intra-company payments are made as a result of and in relation to

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[5] The citations of the interlinked companies are more complex and clarified in an organogram of the Levi Strauss & Co group of companies to which reference was made by both parties. For purposes of this judgment, this court is only concerned with Levi San Francisco which is really Levi Strauss International, California and Levi Strauss South Africa (Pty) Ltd.

such internal treasury functions. Levi APD/GTC act as the treasury centre for affiliates such as) Levi SA and Levi APD/GTC would facilitate payments at the regional level to (and from) Levi SA.

12. Ettlin also outlined the numerous services provided by Levi APD/GTC as set out in the Buying Agents Agreement ('BAA') whereby Levi APD and Levi GTC assist 'affiliates' such as Levi SA in the "development of product, sourcing of product, testing and quality, development and production of samples, selection of vendors, supplying goods to various markets "[6]. Ettlin referred to these services provided to affiliates as including "to basically source and develop product on behalf of the affiliates".[7] This is the GSO function dealt with under the Buying Commission Dispute.

13. Levi SA imports apparel from contract-manufacturers in Madagascar and Mauritius (members states of the Southern African Development Community ('SADC')) through the aforesaid global procurement system. Stated in a most simplistic manner, the contract manufacturers within the SADC region manufacture apparel in those countries for delivery of those goods to Levi SA. However, it appears that the contract manufacturers invoice not only Levi SA but also either Levi APD or Levi GTC for their full price and are paid in full by Levi APD or Levi GTC. The contract manufacturers ensure the necessary certificates of origin in respect of the requirements of SADC manufacture and SADC consignment are obtained and the goods are despatched to Levi SA which operates within the SADC region. Levi APD and Levi GTC invoice Levi SA in respect of the sale price paid to the SADC contract manufacturers and also in respect of a buyers commission (Levi APD) and a mark-up (Levi GTC) for the services which they provide to Levi SA.

14. Throughout the relevant period, Levi SA had paid royalties in respect of goods sold at the point of re-selling to Levi San Francisco in terms of the TLA.

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[6] Summary of evidence on page 7of transcript.
[7] Page 14 of transcript.

15. It is these intergroup transactions which have given rise to the determinations made by SARS:

    1. Firstly, that the so-called 'buying commissions' paid by Levi SA to Levi APD and Levi GTC are not properly buying commissions and must be included in the value of goods purchased by Levi SA from/through Levi APD and are therefore subject to duty. Initially, SARS determined that and pleaded that either Levi APD and Levi GTC or Levi San Francisco were the owners of the goods and that Levi SA was not entitled to exclude the 'buying commissions' from the value of the goods but this ownership contention has now been abandoned. It has now been argued that the commissions were partly paid as a 'buying commission' and partly paid on another basis in unspecified proportions.

    2. Secondly, that the royalties/license fees paid by Levi SA to Levi San Francisco must be included in the value of the goods imported into South Africa by Levi SA since such royalties are 'a condition of sale' by Levi SA and are therefore dutiable.

    3. Thirdly, that the certificates of origin issued by in Mauritius and Madagascar were invalidly issued and incorrectly used in respect of goods which were purchased from outside the SADC region - namely Singapore or Hong Kong or San Francisco. This dispute, as now appears in argument, is that the goods were not 'consigned' as contemplated within the SADC Treaty and Protocol. It is on either or these bases that SARS has determined that the preferential SADC tariff should not apply to such imported goods.

FIRST DISPUTE: BUYING COMMISSION

Background

16. The "transaction value" of any imported goods (on which value duty is paid) is "the price actually paid or payable for the goods when sold for export to the Republic" – as determined in terms of the 11 subsections of section 66 and subject to adjustments in terms of section 67 of the Act.

17. For purposes of determining the transaction value of imported goods, the Act requires that commission incurred by the buyer shall be added to the price actually paid for the goods. However 'buying commission' is not to be added to the price paid or payable and is therefore not involved in ascertaining the transaction value of the imported goods.[8]

18. 'Buying commission' is defined in section 65 of the Act as

> "any fee paid by an importer to the importer's agent for the service of representing the importer abroad in the purchase of the goods being valued".

19. It is common cause that the BAA between Levi APD and Levi SA provides for Levi SA to pay to Levi APD 'buying commission' on FOB value of all goods sourced on behalf of Levi SA – originally in at the rate of 7% and thereafter at the rate of 12%.

20. It is the compass of such commission which gives rise to the present dispute between the parties. SARS now maintains in argument [9] that the services provided by Levi APD and Levi GTC go well beyond what could constitute 'buying commission' while Levi SA contends that there is nothing to disturb their averment and evidence that the services performed by Levi APD/GTC fall within the parameters of a 'buyers commission'.

<u>The basis of the SARS determination and the case as pleaded</u>

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[888] Section 67(1) "In ascertaining the transaction value of any imported goods in terms of section 66(1) there shall be added to the price actually paid... for the goods:- (a)to the extent that they are incurred by the buyer but are not included in the price actually paid .... (i) any commission other than a buying commission:..."

[9] In the papers SARS averred that APD/GTC were the owners and thus the sellers of the goods and not acting as agents whereas in argument the latest version was that APD/GTC were partially paid a "buyers commission" and partially paid a sum on another undefined basis.

21. SARS originally took the view that the GSO (i.e. Levi APD and Levi GTC) was the principal party involved in the transactions and therefore was the 'reseller' of the goods to Levi SA. The SARS determination was made on the basis that SARS maintained that Levi APD and Levi GTC were the principals for whom the contract manufacturers manufactured. Accordingly, the GSO was determined to be the seller to Levi SA of the products and the 7% or 12% 'commission' was , according to SARS, a form of cost-recovery by the seller.

22. The determination made by SARS in this matter was made on the basis, as averred in the papers, that the monies paid by Levi SA to Levi APD and Levi GTC were monies paid to the real owner of the imported goods – namely APD and GTC - and that the transactions between Levi SA and Levi APD and GTC were those of a 'buy-sell' nature.

23. Accordingly, SARS contended that the additional amount of 12% charged by Levi APD and/or Levi GTC to Levi SA was a margin on the on-sale of the goods.

24. The Answering Affidavit of SARS was deposed to by Mr Allie, leader of the audit team, who subsequently gave evidence before this court. That AA confirmed that the determination made by SARS was on the basis that "Levi APD was not a buying agent but a supplier in its own right"[10] and that "Levi APD is not the buying agent for the applicant but it re-sells the imported goods to the applicant in its own right just like Levi GTC"[11]. Through examination of documents, interviews and information received , the AA states that SARS established certain facts which included that there were admissions that "Levi GTC buys the goods from the contract-manufactures falling within its region and resells them to the applicant"[12], that "we were satisfied that the buying agency agreement between the applicant and Levi APD was not implemented according to its tenor as between the parties. In fact, the same services that Levi APD was supposed to be

[10] Para 5.1
[11] Para 13.1
[12] Para 51

providing the applicant in terms of the written contract were performed by the applicant itself yet it still charged the so-called buying commission"[13], that "there is no need for the services of a buying agent in this system"[14] and concluded that "we were satisfied therefore that Levi APD is in fact not a buying agent as the applicant purchases the goods from Levi APD in the same way that it would purchase from Levi GTC"[15].

25. The upshot of the SARS case on the pleadings was that "Levi APD is not the applicant's buying agent but resells the goods to the applicant"[16]. On the one hand it was either "we were satisfied as auditors that at most ownership of the goods passed to Levi APD"[17] or that it was "Levi San Francisco [which] sells the finished goods to the applicant"[18].

26. However, the sworn averments set out in the SARS affidavit were undermined when Mr Allie himself gave evidence in the course of which he made a number of significant concessions.

27. Firstly, he acknowledged that he had no personal knowledge of the averment that Levi San Francisco was the seller of the finished goods to Levi SA in that "it was what were told during the audit". Allie conceded that he had no document to the effect that Levi San Francisco was a party to the agreement or that Levi San Francisco had made payments to the contract-manufacturers and that the audit team had not seen the documentation which actually indicated, quite to the contrary, that Levi San Francisco was not a party to the relevant agreement.

28. Secondly, in his evidence Allie indicated that the SARS team had taken the view at the time of the audit that delays in payment after importation meant that Levi APD had "sort

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[13] Para 65
[14] Para 66
[15] Para 67
[16] Para 67
[17] Para 148.2
[18] Para 97

of ownership of the goods"[19]. But Allie was unable to indicate any document to this effect. His affidavit had stated that it was denied that ownership and risk of the goods had never passed to Levi APD.[20] He then recalled that the goods were insured by Levi SA[21]. Notwithstanding that it was perfectly possible for Levi SA to insure goods belonging to someone else, it does , in the absence of any evidence to the contrary, mean that there was no challenge to the affidavits filed by Levi SA stating that ownership and risk passed from the contract manufacturers to Levi SA (and never to Levi APD) as also the evidence of Mr Nelson that Levi SA had insured the goods because it took ownership thereof.

29. At close of hearing of the evidence of Allie, Ettlin and Nelson, this court adjourned for further evidence to be taken as asked for by SARS in their interlocutory application and as ordered by Murphy J. Further evidence was not led and dates were arranged for argument.

30. At the hearing of argument, SARS abandoned this basis of their excise determination that Levi APD was not a buyer's agent and that either Levi APD or Levi San Francisco was the owner and a re-seller or seller to Levi SA.

The new basis for a SARS determination argument not set out in the pleadings but now tendered at the hearing

31. The argument now offered as the basis for the determination by SARS rests upon an apparently over enthusiastic set of activities performed by Levi APD which SARS contends fall outside a narrow definition of the services of a buyer's agent and what constitutes "buyers commission".

32. It was now conceded in argument that Levi APD may well have been the 'buying agent' for Levi SA and that therefore some portion of the percentages paid by Levi SA to Levi

[19] Page 134 of the transcript.
[20] Para 139.1 of the AA.
[21] Page 132 of the transcript.

APD would indeed constitute 'buyers commission'. However, some (unknown and undefined portion) did not fall within the parameters of a *bona fide* "buyers commission" since the services rendered by Levi APD exceeded the ambit of the definition and generally accepted practice and such portion was therefore something additional to and other than buyers commission. The capacity in which Levi APD might have been acting and the extent and basis of this portion of such payments were not suggested to this court by SARS.

33. The dispute now rests only on the parameters of the definition of "buying commission". SARS argued for narrow parameters to the meaning of 'buyers commission' submitting that the services allowed in section 65(9) as agent's fees encompass only those of representation, purchase and payment. Levi SA contend that the services performed do fit within a wider contemplation of such commission.

34. It is now appears that it is now common cause that some services were indeed performed by Levi APD for Levi SA (as an 'affiliate' within the Levi group) in it's capacity as a buyers agent. Those services are set out in the BAA of 2005 (page 124 of the pleadings)the 2005 Exhibit B (at page 130) and in a second amendment (at page 133).

35. Some 33 (thirty three) separate services to be performed by APD are identified therein. They include advice on development, sourcing, manufacturing and supply of proposed merchandise; advice on prices and sources of merchandise; provision of planning (including identification) of fashion trends and developments of merchandise and prices thereof; provision of development and implementation of fabric choices and review of prototypes to ensure mass production; provision of such merchandise prototypes and samples; oversight of quality testing procedures and liaison between product development and quality testing lab; management and provision of costing estimates; oversight and development of global sourcing strategies; preparation of detailed manufacturing specifications; publication and distribution of a detailed 'restricted substance list' pertaining to dangerous chemicals; publication and distribution of a

'master supply agreement' setting out the terms of engagement to which suppliers and manufacturers must adhere; entering into agreements on behalf of Levi SA for the manufacture and supply of products; provision of supply chain planning associated with mass production; identification of manufacturers who can meet the requirements of Levi SA; solicitation of offers from manufacturers to provide merchandise; review of pricing to ensure globally competitive prices; assistance to Levi SA representatives in visits to suppliers; assistance to Levi SA in preparation of purchase contracts; selection of third party suppliers and manufacturers including evaluation of process and methods and working conditions placement of orders; informing suppliers that Levi SA is the principal on whose behalf Levi APD is the agent; notification of details of suppliers; monitoring the status of all orders until delivery; ensuring that manufacturers adhere to Levi APD global sourcing guidelines; inspection of finished goods; arrangement and supervision of consolidation of shipments; arrangement of shipments to each port of entry; representation of Levi SA in any claims; use of best efforts to ensure merchandise qualifies for duty-free treatment; procurement and provision of all documentation; general administrative services; advance payment for merchandise on behalf of Levi SA.

36. According to the witness Ettlin, Vice President of Finance for the Levi global supply chain organization (formerly and sometimes known as the global sourcing organization/ global trading company) , those functions entail "development of product, sourcing of product, testing and quality, development and production of samples, selection of vendors, supplying goods to various markets "[22]. Ettlin referred to these services provided to affiliates as including "to basically source and develop product on behalf of the affiliates".[23] The witness referred to the work done on "product development" where Levi "sits down with the designers, look at the garments, what type of garments, what trends are happening," as also "standardization" and "supply planning" both of which drove a more standardized process to help Levi leverage the scale to drive efficiencies.

[22] Summary of evidence on page 7of transcript.
[23] Page 14 of transcript.

37. All these services were done by the GSO through Levi APD for the benefit of the 'affiliates' and little ambit remained to be done by the local affiliates. This was confirmed by the witnesses Ettlin and Nelson, finance director of Levi SA.

38. Ettlin also elaborated on the documentation pertaining to the "mark up" which included management services, marketing, human resources, distribution, logistics and which are different services to those envisaged within the buyers commission and not included within that commission but subject to a "mark up" on cost.

39. Ettlin was adamant that all services for which provision was made were actually performed by Levi APD as buying agent and fell within the parameters for which the 'buying commission' was paid. This evidence was not challenged under cross examination.

Conclusion

40. My first concern is that the basis upon which SARS made it's determination and issued it's demand is not the one upon which this court is required to determine the dispute before me. The SARS case as set out in the pleadings is not the dispute which I am now asked by SARS to determine. That case was firmly stated to be that "Levi APD did not render any services of a buying agent to the applicant"[24]. Yet now the existence and performance of some of the services of a buying agent deserving of buying commission from Levi SA are conceded by SARS to Levi APD. I accept I must be mindful of that old adage that 'the court does not exist for the pleadings but the pleadings for the court' but I am equally mindful that firstly, the basis for the SARS determination on the 'buying commission' has been abandoned, secondly, that this new argument which emerged on the day of argument was never pleaded, thirdly, that Levi SA had no opportunity to deal therewith in the pleadings (their replying affidavit) nor to elect to call witnesses on a number of issues, fourth, that there has been no quantification by SARS on this new point.

[24] Para 147.2 of the AA.

41. In short, this was neither the basis upon which SARS made the determination which forms the subject matter of this appeal nor was it the case which the taxpayer came to meet. The powers of SARS are such that a court must be careful not to grant unto such a State entity greater latitude (to make errors or chop and change it's mind or take the taxpayer unawares) than is either prudent or consonant with principles of fair procedure and justice.

42. My second concern is that the submissions of SARS are to the effect that, if there is any portion of the so-called 'buyers commission' which is not, in fact, 'buyers commission' then the invoices are incorrect and that no "buyers commission" is then allowable. In this regard, SARS relied upon an onus resting upon Levi SA. But this begs the point of the procedures followed by SARS. SARS relied upon one basis for making it's determination and then affirmed this basis on oath in it's answering affidavit. Once it's own evidence was shown to be unsustainable and that other evidence displaced it's own version, it now seeks to rely upon anther supposition upon which Levi SA has had no opportunity to present evidence – either in it's founding or replying affidavit or by way of expert or other evidence. The prejudice to Levi SA is obvious. The applicant/appellant was given no notice of and has not had the opportunity to deal with this new version.

43. My third concern is the meaning to be given to the ambit of a "buyers commission". I have already quoted the relevant portion of section 65 which provides that such commission is ""any fee paid by an importer to the importer's agent for the service of representing the importer abroad in the purchase of the goods being valued". The vital phrase is "the service of representing the importer ... in the purchase of the goods". I can see no reason to exclude any of the 33 services set out in Exhibit B from the services to be legitimately incorporated within the overall service and overarching phrase of "service of representing in the purchase". Each and every service can, as far as I can see, be ascribed to the continuum of purchase of goods. There is no evidence to the contrary

and that continuum is supported in the evidence of the Levi SA employees who gave evidence.

44. Fourth, (insofar as this court is no expert on the topic) I have regard to the Explanatory Note 2.1 dealing with paragraph 1(a)(i) of Article 8of GATT attached to SARS own answering affidavit which provides that

> " a buying agent is person who acts for the account of a buyer, rendering hi services in connection with finding suppliers, informing the seller of the desires of the importer, collecting samples, inspecting goods and, in some cases, arranging the insurance, transport, storage and delivery of the goods."

While the 33 services for which provision is made by Exhibit B to the BAA entered into by Levi SA are more detailed and explicit as to each and every stage of the buying process, the above Explanatory Note both indicates that section 65 is not to be so narrowly construed as argued for by SARS counsel and that those 33 services could indeed fall within the services contemplated by this Note.

45. Fifth, I have alluded above to the fact that this court is not an expert on what is and is not to be encompassed within the work of a buyer's agent and the commission resulting therefrom. SARS argued that some of the Levi APD services are not those of "typical" or "bona fide" buyers agents. But no evidence was led on this point. The taxpayer appellant was not forewarned in either the reasons given for the determination and demand or in the pleadings that this issue was the crux of this aspect of the dispute. The taxpayer had no opportunity to ask for leave to lead expert evidence and SARS did not do so. In the result, what are and are not "typical" services are left up in the air and this court can make no determination thereon save by having regard to the language of the Act, the GATT Explanatory Note, the evidence in both documents and from witnesses.

46. Sixth, insofar as counsel for SARS was dubious about some of these services (i.e those pertaining to child labour or environmental practices) falling within buying concerns and services, he may have failed to have regard to the significance attached internationally

in relation to such issues and the impact which failure to comply with fair labour practices and environmental and other health hazards has on business reputation.

47. Seventh, SARS challenged the witness Ettlin and submitted that the nature of some of the activities performed by the GSO (such as setting up a permanent GSO structure, trademark protection and enhancement and reputation management, IT development) and charged to the affiliates such as Levi SA exceed the duties of a *bona fide* or proper buying agent . But the evidence of Ettlin dealt with the increase in the work of the GSO and of buying agents and what was and what was not allocated to the work of buyers agents and included within "buying commission" (which percentage had now increased from 7% to 12%) and what was not so included but covered by a 'mark up' paid in addition to the "buying commission".

48. In the result I can only but find that the appeal of the taxpayer, Levi SA must succeed on this point of the "buyers commission".

SECOND DISPUTE: ROYALTIES

Background

49. It is common cause that Levi SA pays royalties to the trademark owner and licensor of the Levi brand - Levi San Francisco. It appears not to be in dispute that the royalty is paid on both locally manufactured and imported goods – only once such goods have been sold. If they are not sold they do not attract any royalty (my underlining).

50. SARS has determined that such royalties or license fees must be included in the value of goods imported by Levi SA in terms of section 67(1)(c) of the Act.

51. The subsection provides that, in ascertaining the transaction value of any imported goods, there shall be added to the transaction value

"royalties and licence fees in respect of the imported goods... and for the right to distribute and resell the goods, due by the buyer, directly or indirectly, as a condition of sale for export to the Republic...."

52. The issue is thus whether or not the royalties and licence fees are due by Levi SA "as a condition of sale" for their export to South Africa.

The argument

53. According to SARS, the Trade Licence Agreement, (the 'TLA') between Levi San Francisco and Levi SA contains an inherent obligation to pay royalties. SARS relies upon both Commentary on the relevant paragraphs of the GATT as well as Advisory Opinion of the Technical Committee of the Customs Valuation, AO 4.15, issued in April 2013. SARS also relies upon the agreement of the witness Ettlin with a set of propositions put to him . SARS maintains that all these accord with the commercial substance of the transaction in the present case. Accordingly, it was submitted that the royalties payable by Levi SA to Levi San Francisco were a condition of sale of the imported products.

54. I do not understand the facts before myself or the propositions placed before Mr Ettlin to necessarily lead to the conclusion contended by SARS.

1. SARS proceeded on the basis that " the imports through Levi APD are in substance purchases from the GSO as a re-seller – and not the sale from the contract manufacturer - is the sale that must be used to determine the value of the goods".[25] But, by the beginning and certainly by the end of argument, SARS had abandoned this point that the GSO (and thus also Levi APD) was the seller or the re-seller.
2. Further, what was put to Ettlin was a postulation of the effect of a cancellation of the TLA on the ability of Levi SA to "purchase Levi Strauss marked, trademarked

[25] Heads of Argument para 66.

goods, and distribute them in South Africa" and "without the licence and without the permission you cannot purchase or manufacture and distribute in South Africa" (my underlining). To which postulations Ettlin replied in the affirmative in respect of the ability of Levi SA to both 'purchase' and 'manufacture' and 'distribute' the goods which is certainly not conclusive agreement with the royalties being a condition "of sale" for export to South Africa.

55. SARS argument proceeds on the basis that by reason of importation there must have been a purchase and by reason of the purchase there must be a sale. SARS argued that the facts in *CSARS v Delta Motor Corporation (Pty) ltd 2002 JDR 0727 (SCA) ('Delta Motors)* were different to those in the present case and that the approach to follow is that to be found in the New Zealand authorities *Addidas New Zealand v Collector of Customs (Northern Region) [1999] 1 NZLR 558 (CA) , Collector of Custom s v Avon Cosmetics Ltd [1999] NZ 256 and Chief Executive of New Zealand Customs Service v Nike New Zealand Ltd [2003] NZCA 218; [2004] 1 NZLR 238 (CA).* It was submitted that this approach is submitted would be in conformity with the "sensible or businesslike" meaning commended in *National Joint Municipal Pension Fund v Endumeni Municipality 2012 (4) SA 593 (SCA)*

56. The appellant taxpayer has countered that the TLA is clear that that royalties accrue only at point of sale and not on importation and that no royalties are payable on goods which are not sold. This too, was the evidence of the witnesses Ettlin and Nelson. Furthermore, royalties are also payable on the sale of locally manufactured Levi branded products (constituting some 40% of goods sold by Levi SA) which is further proof that it is **sale** and not importation which attracts royalties (my highlinghting).

Conclusion

57. Firstly, I note that there is, of course, no provision that royalties are a condition of sale in the contract under consideration. SARS has neither pleaded nor argued for any such

tacit condition. There is, of course, clause 3.3.(b) which explicitly provides that royalties payable to Levi San Francisco shall "under no circumstances... be considered a condition of (1) purchase of any product ... (2) import of any product.... (3) sale of any product..." I am mindful that parties may insert any clause they may wish in a contract to proclaim that red is blue or the earth is flat in order to achieve certain commercial benefits. But, that this clause is a "ruse" (as was argued by SARS) was not put to the witnesses Ettlin or Nelson. I am, however, reluctant to rely on insertion of this clause to proclaim a state of affairs or legal conclusion which should be determined upon facts and not self-interest.

58. Secondly, the reliance by SARS upon *Endumeni supra* to encourage this court to adopt a sensible and businesslike application of section 67(1)(c) does not strictly accord with that which was said by Wallis JA in paragraph 18 of that judgment. Consideration must be given to the language in the light of the ordinary rules of grammar and syntax as well as context and purpose. Where more than one meaning is possible, then each possibility must be weighed in the light of all factors. It is only then that "a sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document". The court cautioned judges against the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. In the present case, there is no ambiguity in meaning which could tempt me to follow my own views as to what may or may not constitute a sensible or businesslike approach.

59. Third, while there is merit in having regard to international authorities (such as the Canadian, New Zealand and other authorities to which I was referred) as also international opinion (such as GATT), I must first seek guidance from South African courts and especially our higher courts. In *Delta supra* the court held that the EST charges/royalties were not payable "as a condition of sale" because there was nothing in the agreement of sale for export which made such EST charges/royalties payable as a condition of sale. It was found, per Howie JA for the full court, that it was the sale of

the Opel vehicle assembled by the taxpayer which "triggered" liability for the royalty[26]. The facts were not the same as in *Samcor Manufacturing (Pty)Ltd v the Commissioner for the South African Revenue Service 22655/98* where payment of a royalty was required for each set of imported parts whereas in *Delta supra* "payment of a royalty is required in respect of each vehicle sold"[27]. Ultimately, the finding by the court in Delta supra was stated [in paragraph 25] to be that

> "the sale of kits to the respondent is regulated by the supply agreement. Nothing in that agreement makes the charges now in dispute payable as a condition of sale. .... [28] The EST charges are consequently not payable "as a condition of sale".

60. Fourth, in the decision in *Samcor v Commissioner for the SA Revenue Services 2002 (JDR 0234 (SCA)* the court, (without making reference to the case of *Canada (Deputy Minister of National Revenue) v Mattel Canada Inc [2001] 2 SCR 100*) gave *obiter* support to the argument that the words found in subsection 67(1)(c) do not qualify the words "as a condition of sale" but rather the words "due by the buyer" and that one should enquire whether the buyer would have to undertake to pay the royalties before the seller would have to sell the imported goods.

61. I do not propose to incorporate the Canadian approach into South African law. I do however bear in mind the importance of the clear wording of "condition of sale" which does indeed, in our law of contract, result in consideration given to repercussions upon breach by either party. In *Mattel Canada supra* the court took the approach that royalties are not dutiable unless the seller is entitled to repudiate the sale for export or refuse to sell to a purchaser who was in default with royalty payments. It was existing (as opposed to new and independent) obligations from which the exporter must be

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[26] Para 8 of the judgment.
[27] Para 24 of the judgment.
[28] The court found that engineering and styling charges and also tooling charges arose from other documents not dealing with royalties.

entitled to renege. Accordingly, the qualification "directly or indirectly" applied to payment and not the "condition of sale".[29]

62. In the present case, the various contract manufacturers in Mauritius or Madagascar who are the exporters do not have any right to renege from their existing obligations with Levi SA should Levi SA fail to make payment of royalties to Levi San Francisco. Similarly Levi SA cannot cancel orders with the contract manufacturers because it will not pay Levi San Francisco. Payment of the royalties do not, of course, benefit the exporters who are the contract manufacturers but only Levi San Francisco.

63. Fifth, as I have already indicated, the royalties become due and payable upon sale and this bears no relation to the issue of importation. But the relevant section qualifies the 'condition of sale' as being related to 'export of goods to the Republic' or, differently put, it is 'export to the Republic' which is qualified by 'the condition of sale'. In either event, it has been made clear (and is apparently common cause) that the royalty by Levi SA is paid as a result of a sale and not as a result of export to the Republic. The subsection does not therefore pertain to the facts in this case.

64. For these reasons I can only conclude that the royalties payable by Levi SA to Levi San Francisco in respect of goods sold by the contract manufacturers to Levi SA and which royalties are payable on and at point of sale by Levi SA are not a "condition of sale" as envisaged in subsection 67(1) (c) of the Act and therefore are not to be added to the value of the transactions. The appeal accordingly succeeds on this point.

THIRD DISPUTE: SADC ORIGIN

Background

[29] See also *Reebok Canada v Canada (Deputy Minister of National Revenue) 2002 FCA 133.*

65. SARS has determined that the goods imported by Levi SA into the Republic do not qualify for preferential rates in terms of Annex 1 to the Protocol on Trade in the Southern African Development Community Region ('SADC Trade Protocol'). The basis of that decision is essentially that the trade relationship is not with the contract manufacturers in Mauritius or Madagascar (which are part of the SADC region) but with Hong Kong (Levi GTC) and Singapore (Levi APD). Argument was strongly directed towards the absence of trade benefits for the SADC region as a result of the Levi group structure.

66. The facts of the SADC operations are, in the main, common cause. It is the understanding of some of those facts (such as invoices) and then interpretation and application of the SADC Protocol which has given rise to this dispute.

67. It is common cause that Levi SA has imported into the Republic and into Sub Saharan Africa goods which are wholly or partially produced by contract manufacturers in Madagascar and/or Mauritius. It is also common cause that those contract manufacturers submit invoices to Levi SA which are the basis upon which the necessary certificates of origin in terms of the SADC Protocol are based. It is also common cause that the contract manufacturers looked to Levi GTC and Levi APD for payment in terms of the Levi GSO and treasury functions already described.

The SADC Protocol

68. Rule 2 of Annex 1 to the SADC Protocol provides for preferential rates on import of goods where such goods originate in a Member State. Goods are accepted as having originated in a Member Sate

> " if they are consigned directly from a Member State to a consignee in another Member State".

69. SARS has relied upon two main submissions with regard to reading of the Protocol which it maintains justify the SARS determination. Firstly, the purpose of and the context within which the Protocol must be read indicates that the consignment

necessarily involves more than just delivery but also a trading relationship between Member States and this does not exist between the contract manufacturers and Levi SA. Secondly, the triangular nature of the trade between the contract manufacturers, Levi SA and either Levi APD (Singapore)/Levi GTC (Hong Kong) not only negates the purpose of the Protocol itself but means that the true commercial invoices are to be found between Levi APD/ Levi GTC and Levi SA and not between the contract manufacturers and Levi SA with the result that the certificates of origin are invalid.

70. The first submission deals with interpretation of the wording "consigned directly from a Member State to a consignee in a Member State."

1. SARS submits that the term "consigned directly" requires both 'consignment' and 'trade' to have taken place and that 'consignment" necessarily incorporates "trade" transactions. For this submission, SARS relies upon a meaning extracted from the Oxford English Dictionary.

2. Furthermore, SARS relies upon a contextual reading of the relevant Treaty and Protocol and Rules issued thereunder to argue that delivery without trade benefits is inimical to the objectives of the Treaty and Protocol. SARS reminded the court that:
    i. Article 5(1)(a) of the Consolidated Text of the Treaty of the Southern African Development Community ('the SADC Treaty') sets out that one of the objectives of SADC is to "promote sustainable and equitable economic growth and socio-economic development" (and also ensure poverty alleviation, enhance the standard and quality of life of the people of Southern Africa and support the social disadvantaged through regional integration).
    ii. Article 2 of the Protocol states the objective is to "liberalise intra-regional trade in goods and services on the basis of fair, mutually equitable and beneficial trade arrangements".

3. SARS submits that it is insufficient for goods to be produced and shipped from a consignee in one Member State to a consignee in another Member State. Not only must there be satisfaction of the physical elements but there must also be a direct trade between Member States so as to satisfy the economic and commercial requirements inherent in the Protocol. Accordingly, so argues SARS, there cannot be an interposing or intervening sale or transaction such as is involved with Levi APD or GTC.

4. Using hypothetical calculations of the transactions involved, SARS submitted that it was an abuse of the Protocol to seek preferential rates where contract manufacturers submitted invoices to and were paid from Hong Kong or Singapore and speculated on lowered profit margins by reason thereof.

71. Secondly, SARS referred this court to various of the invoices. It was argued that since payment was to be made by or though the GSO, payment therefore emanated from outside SA to the manufacturers. It was further argued that the true commercial invoices were therefore those of Levi GTC or Levi APD to Levi SA. It was thus concluded that the manufacturers invoices and the certificates of origin upon which they were based are not true commercial invoices and therefore invalid.

Conclusion

72. Notwithstanding an impassioned plea for this court to have regard to the intended "sustained and equitable economic benefits" intended for SADC economies, the abuse occasioned by allowed the intervention of external businesses who enter into trade arrangements which are for their own benefit and which thus cause damage to SADC countries, I am not persuaded that the contextual interpretation sought by SARS is persuasive.

73. Firstly, SARS seeks to incorporate by implication the requirement of "trade" into the wording "consign" used in the Protocol. That implication is sought to be found in the context of the purpose and wording of the SADC Treaty itself. However, notwithstanding the desirability of 'trade' between SADC members and the apparent benefits therefrom as set out in the Treaty, I find it relevant that neither the formulators thereof nor signatories thereto saw fit to use other than the word "consign" in the Protocol which is the foundation of the present dispute.

74. This court cannot read words into the Protocol by implication merely because one feels they ought or should have been so incorporated. Implication of words should only be done where such implication is a necessary one in the sense that "without it effect cannot be given to the statute as it stands"[30] and, in the present instance, effect can be given to the Protocol as it stands even though SARS may be unhappy with the result of the wording of the Protocol and the actual practice of the taxpayer.

75. There is no definition in the Protocol of the word 'consign' but "consignment" is defined as "products which are sent simultaneously from one exporter to one consignee or covered by a single transport document covering their shipment from the exporter to the consignee ,or in the absence of such a document, by a single invoice." Clearly, the Protocol sought to focus on movement of goods from one entity to another. The emphasis is not on trade and the transfer of funds and the financial benefits resulting therefrom.

76. The word "consign" is defined in the OED. It means "to hand over formally", "to deliver", "to deliver or transmit [goods] for sale or custody; usually implying their transit by ship, railway or other public carrier", to deliver", "to make over as possession, to deliver formally". Clearly, the word selected by the formulators of Rule 2 to Annex 1 has, as it's focus, mode of movement or transfer and not financial arrangements.

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[30] *Rennie NO v Gordon and Noather NNO 1988 (1) SA 1 AD at 22E*

77. Secondly, I am mindful of and appreciate the import of the SADC Treaty and Protocol but it is inappropriate for this court to rewrite the wording of the very provision to which all SADC Member States assented and to which, as consigners or consignees, they committed themselves merely because it may be that the wording may now appear to SARS to frustrate the purpose of the Treaty or Protocol.

78. In following the approach to judicial interpretation of instruments set out in *Endumeni supra*, I am unable to find lack of clarity or ambiguity which would entitle me to use different meaning or wording than that which appears in Rule 2. In addition, it is not for this court to determine that the laudable objectives of the Treaty and Protocol have not been wholly, partially or satisfactorily achieved and so exclude arrangements which comply with the actual wording utilized by those who formulated those instruments – i.e. the physical requirements of production and of direct consignment. It is not for this court to create a new definition for the word "consign" under the guise of contextual interpretation in order to create my own view of what might be (what I consider) would be harmonization of the objectives of the SADC Rules of Origin with the actual provisions of the Protocol.

79. Thirdly, insofar as SARS has postulated hypothetical arithmetical calculations of the costs of manufacturing for the SADC contract manufacturers and hypothetical financial reduction in profits for the SADC contract manufacturers where commissions are involved, such postulations remain only hypothetical. This court cannot thumbsuck the actual or potential profits of these contract-manufacturers and the advantages or disadvantages to their employees or their Member States based on hypothetical argument in court.

80. It is for the Member States to determine whether or not they (each or in concert) are satisfied that the current wording of Rule 2 of Annex 1 to the Protocol adequately or sufficiently promotes "sustainable and equitable economic growth and socio-economic

development" and also ensures poverty alleviation, enhancement of the standard and quality of life of the people of Southern Africa and supports the social disadvantaged through regional integration.

81. Fourthly, from the invoices and documentation it would appear that, notwithstanding interpolation of Levi APD or Levi GTC within the financial arrangements (in that invoices are sent by contract-manufacturers to APD or GTC and paid by them, while APD or GTC send invoices for commission to Levi SA which pays them), the SADC contract-manufacturers are paid in full and no benefits are diverted from the financial endeavours of the SADC contract-manufacturers to Levi APD of Levi GTC.

82. Fifth, I note that the original determination made by SARS on commissions was made on the basis that Levi APD or Levi GTC or Levi San Francisco were the 'owners' of the goods and not Levi SA. But it has now been conceded by SARS that none of Levi APD or Levi GTC or Levi San Francisco were the owners, that they were not re-sellers and that Levi APD and Levi GTC were buying agents and that services were provided to and for the benefit of Levi SA either in Hong Kong or Singapore. On that basis, the argument for the lack of benefits within the SADC community (when the full payment made to the contract-manufacturers is considered) is even less persuasive.

83. Insofar as the SARS argument is to the effect that the economic benefits accrued to Levi APD in Singpore and Levi GTC in Hong Kong and not to the contract-manufacturers in the SADC region, there is nothing to support this contention. From the documentation, there is no evidence that SADC contract-manufacturers have their profit margins or any financial reward diverted from them or from within SADC region by reason of the existence of the Hong Kong or Singapore treasury functions.

84. In the result, it is my view that the applicant should succeed on this ground.

ORDER

85. In the result, orders are made that:

1. The Applicants appeal against the Respondent's determinations made on 25 March 2014 are upheld.

2. The aforesaid determinations made by Respondent on 25 March 2014 are set aside:
   2.1 .That Levi Strauss Asia Pacific Division (Pte) Ltd ('Levi APD') is not a buying agent of the Applicant and that consequently the buying commissions paid by the Applicant on goods sourced by Levi APD should have been included in the value of those goods for duty purposes upon their importation;
   2.2.That the royalties/licence fees paid by the Applicant to Levi Strauss & Co are to be included in the value for duty purposes of the goods imported by the Applicant upon their importation; and
   2.3.That South African Development Community Certificates of Origin were invalidly used in respect of goods imported by the Applicant from SADC manufacturers/suppliers contracted by Levi APD or Levi Strauss Global Trading Company Ltd ('Levi GTC') resulting in the Applicant incorrectly claiming preferential duty rates.

3. That the said determinations be substituted by determinations to the following effect:
   3.1. That Levi APD is a buying agent of the Applicant and that the buying commission paid by the Applicant on goods sourced by Levi APD is not to be included in the value of those goods for duty purposes upon their importation:
   3.2. That the royalties/licence fees paid by the Applicant to Levi Strauss & Co are to be excluded from the value for duty purposes of the goods imported by the Applicant; and

3.3. That Southern African Development Community Certificates of Origin were validly used in respect of goods imported by the Applicant based in South Africa from SADC manufacturers/suppliers contracted by Levi APD or Levi GTC and that preferential duty rates are . applicable to the importation of such goods.

4. That the demand accompanying the above determinations be withdrawn.

5. That the Respondent shall pay the costs of this application, including the costs of two counsel, such costs to include those attendant upon the interlocutory application heard before Murphy J which resulted in the judgment of Murphy J of 2 May 2017.

DATED AT JOHANNESBURG THIS 15TH DAY OF FEBRUARY 2019

pp BHOOLA A.J

SATCHWELL J

Dates of Hearing: 19,20,21 February 2018; 22 November 2018.

For Applicant:
Attorneys Shepstone & Wylie
JP Vorster SC
E Muller

For Respondent:
The State Attorney
CE Puckrin SC
NK Nxumalo