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Is the foreign business establishment lagging behind new business models? *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] ZASCA 10

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I Introduction

Controlled foreign company (CFC) rules are anti-avoidance rules to ensure the taxation of profits diverted offshore by South African residents (Van der Zwan, 'Cross-border transactions' in Stiglingh (ed), *Silke: South African Income Tax* (LexisNexis 2023) 889). The rules are concerned with avoidance schemes and are not meant to deter real cross-border transactions (Van der Zwan, 'Cross-border transactions' in Stiglingh (ed), *Silke: South African Income Tax* (LexisNexis 2022) 871–872). In terms of the rules, profits of a non-resident company may also be liable for tax in South Africa at the hands of its resident shareholder/s if the company is considered to be a CFC of such resident shareholder/s (s 9D of the Income Tax Act 58 of 1962 (Act)). A company will be considered to be a CFC if it is a foreign company where more than 50 per cent of the total participation rights or voting rights in that company are directly or indirectly held or exercisable by one or more residents (except headquarter companies) or the financial results of that foreign company are reflected in the consolidated financial statements (prepared in terms of International Financial Reporting Standards 10) of a resident company (s 9D of the Act).

Not all income of the CFC will be attributable to the resident shareholder/s. Section 9D of the Act provides some exemptions which exclude the net income of a CFC or deem the income to be nil. This case note will only discuss the foreign business establishment (FBE) exemption. The FBE exemption has the effect that the income of a CFC that is attributable to an FBE is deemed as nil and thus not attributable to the resident shareholder/s (s 9D(9)*(b)* of the Act). Section 9D(1) of the Act defines an FBE as a fixed place of business through which it carries on the business of the CFC for at least one year. The fixed place of business must meet certain prescribed requirements such as constituting a physical structure such as an office, being suitably staffed and equipped, and having suitable facilities to conduct the business of the CFC.

The Supreme Court of Appeal (SCA) in *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] ZASCA 10 (*Coronation* case) had to determine whether the net income of Coronation Global Fund Managers (Ireland) Limited (CGFM), a company tax resident in Ireland, was attributable to its indirect South African shareholder, Coronation Investment Management SA (Pty) Ltd (CIMSA) or whether the income would fall within the ambit of the FBE exemption in terms of s 9D of the Act. The case also considered the imposition of understatement penalties in terms of s 222 of the Tax Administration Act 28 of 2011 (TAA), understatement penalties for provisional tax under para 20 of the Fourth Schedule to the Act, and interest in terms of s 89(2) of the Act. However, this case note will only discuss the CFC and FBE elements of the case.

The discussion considers whether the Court made the correct decision and provides an analysis of the implications of the decision as it might have devastating practical implications for South African residents with similar offshore operations. The case note starts by briefly setting out the facts of the case, followed by a summary and analysis of the judgment. This contribution submits that the FBE definition has not kept up with the pace of the new business models and excludes business models that could be legitimate businesses.

II The facts of the case

In 2012, CIMSA held 100 per cent of the issued share capital of a company tax resident in the Isle of Man, CFM. CFM in turn held 100 per cent of the issued share capital of CGFM (para 2). In terms of s 9D of the Act, CGFM is a CFC of CIMSA (para 9). CGFM had a licence from the Central Bank of Ireland as a management company in accordance with

the European Communities Regulations under Investment Services Directive 93/22/EEC 2125 (para 12) and it entailed investment management (para 40). The business of CGFM is 'to provide opportunities for clients to invest in South African and Irish domiciled collective investment funds' (para 12).

> 'In its business plan, attached to its licence application, CGFM presented an outsource business model where CGFM concentrates on being a "product provider". All non-core functions, such as investment, administration and custodial functions, are outsourced. The provision of investment management services and trading functions is outsourced to specialist investment managers, CAM in South Africa and CIL in the United Kingdom . . . CGFM has outsourced its distribution functions to CIL and CAM and its custodian functions to JP Morgan Bank (Ireland) Plc.' (para 13)

The Commissioner for the South African Revenue Service (SARS) did not dispute that CFGM met the FBE definition as they had offices and equipment in Dublin. Its dispute was that CGFM did not meet the economic substance requirements as its primary operations were not based in Ireland and thus 'the Dublin office was not suitably staffed with employees, not suitably equipped, nor did it have the facilities to conduct "the primary operations" of CGFM's business' (para 17). SARS assessed CIMSA's 2012 tax liability to include the net income of CGFM. CIMSA objected to this, and its objection was upheld by the Tax Court, which held that CGFM qualified as an FBE. Accordingly, SARS was required to issue a reduced tax assessment and was not entitled to claim understatement penalties in terms of s 222 of the TAA, understatement penalties for provisional tax under para 20 of the Fourth Schedule to the Act, and interest in terms of s 89*quat*(2) of the Act. SARS appealed the decision of the Tax Court to the SCA. The Court had to determine whether the income of CGFM should be imputed to CIMSA in terms of the CFC rules or whether CGFM satisfies the FBE exemption (para 3).

III The judgment of the case

The SCA held that:

> 'If the key operations of the business have been outsourced (here investment management), then the fixed place of business in Ireland lacks the staff and facilities to conduct those operations. If these operations are central to the business of CGFM, because they go to the very nature of what this business does, then CGFM does not conduct its primary operations in Ireland.' (para 52)
>
> 'The essential operations of the business must be conducted within the jurisdiction in respect of which exemption is sought. While there are

> undoubtedly many functions which a company may choose to legitimately outsource, it cannot outsource its primary business.' (para 54)

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On an examination of the CGFM business models, the SCA found that the primary operations of CGFM's business is that of fund management, which includes investment management, and that those operations were not conducted in Ireland. Accordingly, CGFM did not meet the requirements for an FBE exemption pursuant to s 9D(1) of the Act and, as a result, the net income of CGFM was imputable to CIMSA for the 2012 tax year in terms of s 9D(2) of the Act (paras 49, 52 and 55). The SCA upheld the appeal and replaced the order of the Tax Court with one directing the payment of the additional tax imposed in respect of the additional assessment and the interest imposed thereon in terms of s 89*quat*(2) of the Act (para 66). The court held that there was no underpayment and as such the understatement penalties and underestimation penalties should fail (paras 64 and 65). CIMSA has appealed the decision of the SCA to the Constitutional Court. At the time of writing this case note, the Constitution Court case had not yet been heard.

IV Analysis of the judgment

(a) Foreign business establishment definition

The FBE exemption applies where there is an FBE, and the income is attributable to such FBE. An FBE is defined in s 9D(1) of the Act as:

> '*(a)* A fixed place of business located in a country other than the Republic that is used or will continue to be used for the carrying on of the business of that controlled foreign company for a period of not less than one year, where—
>
> (i) that business is conducted through one or more offices, shops, factories, warehouses or other structures;
>
> (ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that controlled foreign company who conduct the primary operations of that business;
>
> (iii) that fixed place of business is suitably equipped for conducting the primary operations of that business;
>
> (iv) that fixed place of business has suitable facilities for conducting the primary operations of that business; and
>
> (v) that fixed place of business is located outside the Republic solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic:
>
> Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign

> company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company—
>
> *(aa)* if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;
>
> *(bb)* if that other company forms part of the same group of companies as the controlled foreign company; and
>
> *(cc)* to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company.'

From the definition of an FBE, it can be seen that a 'fixed place of business' that is or will continue to be used for the carrying on of the business of the CFC is a key component of the existence of an FBE. What constitutes a 'fixed place of business' is not defined in the Act. The same phrase is used in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention for defining a permanent establishment (PE) (s 1 of the Act read with article 5 of the 2017 OECD Model Tax Convention). In interpreting the 'fixed place of business' phrase in respect of the PE definition, para 1 of the OECD Model Tax Convention Commentary to article 5 provides that the following requirements should be met for there to be a fixed place of business:

(a) There must be a physical place of business such as an office or warehouse;

(b) The place of business must be fixed i.e., established at a physical place with some form of permanency; and

(c) The business of the enterprise must be carried on from such fixed place of business.

Section 232 of the Constitution of the Republic of South Africa, 1996 provides that customary international law is law in South Africa unless it is inconsistent with the Constitution or other South African legislation. The section also states that when interpreting any legislation, the courts must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law. The court in *CIR v Downing* (1975 (4) SA 518 (A) 524) held that South Africa should consider interpretation guidelines on concepts used in the OECD Model Tax Convention. Based on s 232 and the *CIR v Downing* case, the interpretation of 'fixed place of business' could be used to interpret the

phrase in the FBE definition. Using the OECD MTC Commentary on 'fixed place of business' as an aid to interpret the 'fixed place of business' as contained in the CFC rules, it can be argued that for an FBE to exist the company must have some physical presence in a country outside of South Africa.

The FBE definition also includes the possibility of outsourcing, provided the outsourcing is to a company in the same group of companies as the CFC and it is tax resident in the same country as the CFC (s 9D(1) of the Act). Although outsourcing is permissible, it would be contrary to the FBE definition for all activities of a business establishment to be outsourced to third-party suppliers: 'The personnel, equipment, and facilities for the critical primary operations of a business cannot be outsourced' (para 42). In the *Coronation* case:

> 'SARS submits that the FBE definition requires each of the requirements set out in s 9D(1)*(a)*(i) to (v) to be present in a fixed place of business in order for a controlled foreign company to qualify as a FBE. If not, the business is not entitled to a tax exemption under s 9D(1)*(a)*. While it is permissible for a controlled foreign company to outsource locational permanence and economic substance, it must then comply with the proviso set out in s 9D, and each of the discreet requirements in the subsections *(aa)*, *(bb)* and *(cc)* of the proviso have to be met. Whether CGFM qualifies as an FBE, notwithstanding the outsourcing of these primary functions, must be answered with reference to the proviso.' (para 18)

CGFM's outsourcing business structure did not meet the FBE proviso in that the outsourced operations of the business were regarded as its primary operations and were outsourced to companies resident outside Ireland. Thus, on the application of the law to the facts, the SCA made the correct judgment in law. This decision has significant consequences for South African tax residents with offshore businesses that deploy outsourced business models because such businesses may not qualify for the FBE exemption if the proviso is not complied with. This will have the consequence that, save for any other exemption being applicable, the income derived by such businesses will be imputed to the South African tax resident in proportion to their shareholding in such business. The CFC legislation that contains the FBE concept rules was introduced in South African legislation in 1997 (and expanded on in 2001). This was a time before a lot of today's business models like Facebook and Uber were in operation. Accordingly, National Treasury had not envisioned such business models at the time of enacting the rules (Kraamwinkel & Grimm, (November 2018) *Without Prejudice* available at https://www.without prejudice.co.za/free/article/6281/view (accessed on 24 September 2022)).

Below, the discussion considers what the aim of the FBE definition is and whether the concept is not lagging behind new business models like digital business and the use of outsourcing business models.

(b) New business models

The aims of the FBE definition include advancing the international competitiveness of South African offshore companies, avoiding the eroding of the South African tax base to low or no tax jurisdictions, and '[limiting] a situation where an exemption is obtained over earnings in a low tax jurisdiction when the primary operations for the business are not conducted there' (para 53; see also Van der Zwan, (LexisNexis 2022) 871–872). The FBE exemption was created to protect income from legitimate businesses falling within the ambit of the CFC anti-avoidance provisions (Olivier & Honiball, *International Tax: A South African Perspective* (Siberink 2011) 447; see also Oguttu, 'The challenges that e-commerce poses to international tax laws: Controlled foreign company legislation from a South African perspective (part 1)' (2008) 20 *SA Merc LJ* 361). The

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business models that the legislature envisioned were the brick-and-mortar business models that must have a physical presence in a jurisdiction to operate from and in such jurisdiction. Under the brick-and-mortar business models, businesses operated in a jurisdiction by being physically present in a jurisdiction. Outsourcing of business functions and operations would be more of an exception than the norm.

However, with new business models such as digital businesses, businesses no longer need to be 'physically' present in a jurisdiction but can operate digitally or virtually anywhere in the world (Olivier & Honiball, (Siberink 2011) 447; see also Oguttu, (2008) 20 *SA Merc LJ* 361). It is possible for a business to carry on economic activity without the need for personnel present and certain physical structures (Harpaz, 'Taxation of the digital economy: Adapting a twentieth-century tax system to a twenty-first century economy' (2021) 46 *The Yale Journal of International Law* 58). Certain tasks that were previously performed by local personnel can now be performed remotely by automated equipment across borders. (Sengwane, 'Controlled Foreign Companies' Rules and the Digital Economy' (2023) 26 *PELJ* 4). Digitalisation makes it possible for a business to carry on economic activity without the need for a multitude of offices, staff, equipment, and other resources. Outsourcing of business functions is no longer an exceptional concept with new business models: 'Outsourcing is a commercial reality' (*Coronation* case para 41).

On the rigid application of the FBE rules, many 'new' business models such as digital companies may not qualify for the exemption — albeit being real businesses — merely because they are not based on the old brick-and-mortar model. The FBE criteria do not consider new business models that could be legitimate businesses alas operating virtually. In their current form, the FBE concept rules do not embrace digitalisation and its consequences for business models. Therefore, although the SCA decision correctly applied the current principles in the *Coronation* case, it should be highlighted that the FBE definition and rules are outdated and have not kept pace with new business models such as digital businesses. The purpose of the CFC rules was not to include businesses with real substance within the ambit of the rules. It is possible for a real digital business to exist without the physical presence requirements contained in the FBE definition. The legislature should consider expanding the FBE concept rules to also include within their ambit genuine businesses in operation despite not meeting physical substance requirements. I recommend that the FBE exemption should be based on the economic activity of an entity in a jurisdiction rather than its physical presence in determining whether a real business with substance exists in a foreign jurisdiction. Income derived from genuine digital businesses with economic substance should be exempted from the application of the rules.

New business models such as digital businesses exacerbate base erosion and profit shifting (OECD (2015), Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report 16), and can be used as vehicles to avoid or evade taxes. This is because of the key features of digital companies such as heavy reliance on intangibles and the anonymity of the Internet, which can easily be manipulated, making it possible for a business to reduce or avoid a taxable presence in certain jurisdictions (OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 — 2015 Final Report 16). However, there can be and in fact there are legitimate digital businesses that should not be ring-fenced merely because they are digital. Digital and traditional business models should not receive different tax treatment as this can go against the tax principles of neutrality and equity. The legislature needs to embrace and accept new business models. The CFC rules can still apply to protect the tax base against erosion; however, the FBE exemption should be broad enough to also encompass new business models that are not shams. Country-by-country (CbC) reporting could be a useful tool to incorporate into the CFC legislation. CbC is an OECD BEPS Action 13 minimum standard that requires multinational

enterprises (MNEs) to report annually key information on their activities and income in each tax jurisdiction in which they operate or conduct business (see OECD, Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 — 2015 Final Report). Another useful tool would be to require South African MNEs to disclose public country-by-country reporting on tax that conforms with the Global Reporting Initiative (GRI) 207. The GRI 207 is a global standard for tax transparency that supports the public disclosure of a company's business activities and tax payments on a country-by-country basis (GRI 207 Tax 2019 GRI Standard 2019 available at https://www.globalreporting.org/standards/media/2482/gri-207-tax-2019.pdf accessed on 6 July 2023). This reporting includes the reporting of an MNE's financial, economic, and tax-related information for each jurisdiction where the MNE operates. Such reporting will assist in determining economic substance in a country.

V Conclusion and recommendation

In conclusion, the SCA in the *Coronation* case had to decide if CGFM's income is attributable to an FBE considering its outsourcing business model or whether its income should be imputed to its South African shareholder, CIMSA. The Court, in applying the CFC and FBE principles, correctly held that the business activities of CGFM did not qualify for the FBE and, accordingly, its income is imputable to CIMSA. I argue that the CFC and FBE rules are outdated in that they have not kept pace with new business models and hold fast to principles developed with brick-and-mortar business models in mind. I suggest that the FBE exemption should be expanded to include new business models that are real businesses and not a sham, despite not having the current required physical or economic level of substance in a foreign jurisdiction.

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