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THE FOREIGN BUSINESS ESTABLISHMENT EXEMPTION AND OTHER ASPECTS OF SECTION 9D OF THE INCOME TAX ACT

RESEARCH REPORT

by

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Abstract

This research report considers a number of practical issues that arise in relation to the enforcement of section 9D of the Income Tax Act No. 58 of 1962 ("ITA") read together with complementary provisions of the Tax Administration Act No. 28 of 2011 ("TAA").

More particularly, this research report considers the following issues: the onus and burden of proof under section 9D; the scope of SARS' power under section 46 of the Tax Administration Act No. 28 of 2011 ("TAA") to request information in order to give effect to section 9D; the interlinking definitions in terms of section 9D; whether an outsourcing business model can constitute the primary or core operations of a CFC for the purposes of determining whether the CFC qualifies for the 'foreign business establishment' exemption under section 9D status; and, if the issue of whether a CFC correctly claimed an FBE status during the years of assessment be revisited by SARS, particularly in respect of years of assessment which have prescribed.

It is submitted as follows. Section 46 of the TAA provides SARS with the effective procedural powers to ensure compliance with section 9D. SARS is however required to provide the taxpayer with grounds for assessment with sufficient and reasonable detail in order to enable the taxpayer to understand the basis of and reason for such assessment and respond appropriately thereto. SARS is constrained by a three-year prescription period (from the date of an original assessment) for issuing additional assessments unless SARS can demonstrate that the taxpayer committed a fraud or misrepresentation which caused SARS failure to properly assess the taxpayer. The onus is on the taxpayer to show, on a preponderance of probability, that the decision/s of SARS in terms of section 9D against which it appeals is/are wrong. There is an arguable case for contending that

the active management of service providers and agents may constitute the primary operations for purposes of determining whether an FBE arises in relation to a CFC.

Keywords: Section 9D; Section 46; Retrospectivity; Controlled Foreign Company; Connected Person; Resident; Foreign Business Establishment; Primary business; Interpretation; Onus; Non-compliance; Sanctions Prescription

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INTRODUCTION

1. There are various mechanisms in terms of which the Income Tax Act No. 58 of 1962 (“ITA”) ensures that the net of tax liability is cast wide to ensure that foreign earned income is attributed to a controlling domestic entity and taxed locally. One such mechanism is section 9D.

2. It facilitates the imposition of tax on South African resident taxpayers who hold participation rights in controlled foreign companies (“CFCs”) as if the CFC was a resident in South Africa. In other words, it attributes the net income of the CFC to the South African resident for purposes of tax liability.

3. However, the attribution or imputation of a CFCs “net income” is subject to a number of exceptions that include those relating to the net income of a CFC that qualifies as a foreign business establishment (“FBE”) (“the FBE exemption”).

4. The South African Revenue Service ("SARS") increasingly initiates international tax reviews of South African registered companies and their overseas based affiliated or related companies. In a number of instances SARS alleges a contravention of section 9D. More specifically, it alleges that the South African resident taxpayer improperly claimed an FBE exemption in relation to its connected company based abroad and that the net income of such company falls to be included in the income of the South African resident taxpayer for the purposes of determining the resident’s tax liability.

5. Against this context, this research report addresses the following five related issues:

    5.1. is the mere assertion by SARS that a South African resident does not have an FBE or that its CFC does not qualify as an FBE sufficient to

place the burden of proof on either the resident or its CFC to exclude the operation of the section 9D exemption ("part 1");

5.2. what is the scope of SARS' power under section 46 of the Tax Administration Act No. 28 of 2011 ("TAA") to request information in order to give effect to section 9D ("part 2");

5.3. the interlinking definitions between a "foreign company", "resident" and "foreign business establishment" in terms of section 9D ("part 3");

5.4. can the act of management by CFC employees of third party service providers and agents constitute the primary or core operations of a CFC for the purposes of determining whether the CFC qualifies for FBE status ("part 4"); and

5.5. can the issue of whether a CFC correctly claimed an FBE status during the years of assessment be revisited by SARS, particularly in respect of years of assessment which have prescribed ("part 5").

6. The relevant legal provisions are set out below. Each of these issues is thereafter dealt with in turn.

SECTION 9D

7. Essential to each of the issues is the proper interpretation and application of section 9D of the ITA.

8. It is necessary to reproduce the relevant provisions of section 9D in some detail. Before doing so, some prefatory comments as to the aim and purpose of section 9D are appropriate.

9. Section 9D of the ITA was introduced in order to overcome a deferral problem. As described above, it facilitates the imposition of tax on South African resident

taxpayers who hold participation rights in CFCs. It does this by treating the CFC as if the CFC was a resident in South Africa.

10. However, the attribution or imputation of a CFCs "net income" to that of the South African resident is subject to a number of exceptions. One such exception concerns the net income of a CFC that qualifies as an FBE (i.e. the FBE exemption). If a CFC qualifies for the FBE exemption, the net income attributable to its activities will not be imputed to the South African resident taxpayer. In other words, when determining the net income of the CFC that qualifies as an FBE, such amounts are not taken into account in determining the South African resident's tax liability.

11. Certain diversionary rules, however, seek to exclude an FBE's income from exempt status to the extent that the income does not satisfy certain criteria because the legislature considers these to be diversionary and not arms-length transactions. These include:

    11.1. section 9D(9A)(*a*)(i), which deals with amounts derived from transactions relating to the disposal of goods by a CFC that is an FBE to a connected person (who is resident),

    11.2. section 9D(9A)(*a*)(iA), which deals with amounts derived from transactions relating to the sale of goods between a CFC (that is an FBE) and a person other than a connected person (who is resident), where the CFC initially purchased those goods (or any tangible intermediary inputs of such goods) from one or more connected persons (who is resident), and

11.3. section 9D(9A)(*a*)(ii), where, if a CFC renders services to a connected person (who is a resident) then the FBE exemption, subject to certain exceptions, would not apply.[1]

12. It is now appropriate to refer to the relevant provisions of section 9D in greater detail.

13. Subsection (2)(a)(i) thereof provides that –

> "*There shall be included in the income for the year of assessment of any resident … who directly or indirectly holds any participation rights in a controlled foreign company-*
>
> *(a) on the last day of the foreign tax year of that controlled foreign company which ends during that year of assessment, an amount equal to-*

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[1] Prior to 2011, section 9D contained three sets of rules that were known as the 'diversionary income rules'. The rules were as follows:

i) CFC inbound sales: if a CFC sold goods to a connected South African resident, then the foreign business establishment exclusion, subject to certain exemptions, would not apply;

ii) CFC outbound sales: if a CFC sold goods to a foreign person or a unconnected South African resident, but the goods were initially purchased from a connected South African resident, then the foreign business establishment exclusion would, subject to certain exemptions, not apply; and

iii) CFC connected services rule: if a CFC renders services to a connected South African then the foreign business establishment exclusion, subject to certain exemptions, would not apply.

In 2011, the CFC inbound sales rule was deleted from the Act as National Treasury believed at that stage that the transfer pricing rules contained in section 31 would be sufficient to deal with any sales made by a CFC to a connected South African resident. The CFC outbound sales rule was not deleted but its scope was narrowed, while the CFC connected services rule was retained.

However, in the Explanatory Memorandum to the Taxation Laws Amendment Bill of 2015, National Treasury states that the removal and narrowing of the diversionary income rules and the reliance on the transfer pricing provisions leaves the South African tax base vulnerable to base erosion practices. For this reason, the original diversionary income rules (in their pre-2011 form) have been reintroduced into the Act and 'will replace the provisions in section 9D(9A)(*a*)(i) and 9D(9A)(*b*)(i) and (ii), effective from 1 January 2016 in respect of foreign tax years of CFCs ending during years of assessment commencing or after 1 January 2016'.

(i) where that foreign company was a controlled foreign company for the entire foreign tax year, the proportional amount of the net income of that controlled foreign company determined for that foreign tax year, which bears to the total net income of that company during that foreign tax year, the same ratio as the percentage of the participation rights of that resident in relation to that company bears to the total participation rights in relation to that company on that last day;"

14. The definition of "*controlled foreign company*" referred to in subsection (2)(a)(i) is set out in subsection (1) as follows:

"'*controlled foreign company' means –*

(a) any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies: Provided that-

(i) no regard must be had to any voting rights in any foreign company-

(aa) which is a listed company; or

(bb) if the voting rights in that foreign company are exercisable indirectly through a listed company;

(ii) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and

(iii) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if-

(aa) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or

(bb) in the case of a scheme or arrangement contemplated in paragraph (e) (ii) of the definition of 'company' in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person-

(A) holds less than five per cent of the participation rights of that scheme or arrangement; and

(B) may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other; and

(b) any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident".

15. Subsection (2)(a)(i) must be read together with subsection (9)(b) which reads in relevant part as follows:

"*Subject to subsection (9A), in determining the net income of a controlled foreign company … there must not be taken into account any amount which -*

(a) …

(b) is attributable to any foreign business establishment of that controlled foreign company (whether or not as a result of the disposal or deemed disposal of any assets forming part of that foreign business establishment) and, in determining that amount and whether that amount is attributable to a foreign business establishment-

(i) that foreign business establishment must be treated as if that foreign business establishment were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the controlled foreign company of which the foreign business establishment is a foreign business establishment; and

(ii) that determination must be made as if the amount arose in the context of a transaction, operation, scheme, agreement or understanding that was entered into on the terms and conditions that would have existed had the parties to that transaction, operation, scheme, agreement or understanding been independent persons dealing at arm's length".

16. The definition of "*foreign business establishment*" referred to in subsection (9)(b) is set out in subsection (1) and reads in relevant part as follows:

"*'foreign business establishment', in relation to a controlled foreign company, means-*

(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;

[Para. (a) substituted by s. 12 (1) (a) of Act 17 of 2009.]

[Definition of 'foreign business establishment' inserted by s. 9 (1) (c) of Act 20 of 2006 and substituted by s. 9 (1) (b) of Act 8 of 2007.]"

17. Each of the five issues are now dealt with in turn.

PART 1: ONUS UNDER SECTION 9D

18. The TAA contains a number of important provisions and procedures which regulate the conduct of SARS in relation to the administration of the TAA. Similarly, there are important procedures and provisions which safeguard the rights of the taxpayer.

19. Some of the provisions of the TAA involve the exercise of discretionary powers by the Commissioner conferred upon him, and where such power is exercised, it constitutes administration action which is reviewable in terms of principles of

administrative law.[2]

20. Section 92 provides that "*[i]f at any time SARS is satisfied that an assessment does not reflect the correct application of a tax Act to the prejudice of SARS or the fiscus, SARS must make an additional assessment to correct the prejudice*." Section 95(1) of the TAA provides that SARS may make an additional assessment if the taxpayer submits information that is incorrect or inadequate.[3]

21. What is quite clear, however, is that the raising of an additional assessment must be based on proper grounds for believing that there is undeclared income or, as in the present contemplated instance, that the South African resident's CFC is no longer entitled to an FBE exemption.

22. In Commissioner, South African Revenue Service v Pretoria East Motors (Pty) Ltd[4] the SCA said the following:

> "*The raising of an additional assessment must be based on proper grounds for believing that, in the case of VAT, there has been an under declaration of supplies and hence of output tax, or an unjustified deduction of input tax. In the case of income tax, it must be based on proper grounds for believing that there is undeclared income or a claim for a deduction or allowance that is unjustified. It is only in this manner that SARS can engage the taxpayer in an administratively fair manner, as it is obliged to do. It is also the only basis upon which it can, as it*

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2 See Metcash Trading Ltd v Commissioner, SARS 2001 (1) SA 1109 (CC) at para 40.

3 Section 95(1) provides, in full, that –

"*SARS may make an original, additional, reduced or jeopardy assessment based in whole or in part on an estimate if the taxpayer-*

(a) fails to submit a return as required; or

(b) submits a return or information that is incorrect or inadequate."

4 2014 (5) SA 231 at para 11. See also South Atlantic Jazz Festival (Pty) Ltd v CSARS 2015 (6) SA 78 (WCC) at para 19.

must, provide grounds for raising the assessment to which the taxpayer must then respond by demonstrating that the assessment is wrong".

23. This is the proper test which will be applied in relation to the raising of any additional assessments where SARS believes that the CFC does not warrant an FBE.

24. Section 96(2)(a) requires SARS to provide the taxpayer against whom it is making an additional assessment with a statement of the grounds for the assessment. [5]

25. In order to comply with these provisions, the additional assessment would be required to indicate that:

    25.1. SARS is of the view that the South African resident did not have an FBE, and

    25.2. this view must be based on proper grounds in order to enable the South African resident and/or its CFC to engage properly with SARS;

    25.3. consequently in terms of section 9D(2)(b)(i) of the ITA there ought to have been included in the net income of the South African resident for each of the assessed years an amount equal to the net income of its CFC for those years.

26. However, even after the additional assessment has been raised, there are further procedural devices available to the South African resident and/or its CFC, as in accordance with Tax Court Rule 6(1) –

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[5] Section 96(2)(a) reads thus –

"*In addition to the information provided in terms of subsection (1) SARS must give the person assessed-*

(a) in the case of an assessment described in section 95 or an assessment that is not fully based on a return submitted by the taxpayer, a statement of the grounds for the assessment".

> "[a] *taxpayer who is aggrieved by an assessment may, prior to lodging an objection, request SARS to provide the reasons for the assessment required to enable the taxpayer to formulate an objection in the form and manner referred to in rule 7*".[6]

27. After the procedure set out above has been exhausted, the South African resident is entitled to object to the assessment in terms of section 104 of the TAA.[7]

28. In terms of sections 106(1) to (4) of the TAA read together with Tax Court Rule 9, SARS must thereafter:

    28.1. consider any such objection;

    28.2. deliver a notice informing the South African resident of its decision in relation to the objection; and

    28.3. state the basis for its decision.

29. The issue of whether the South African resident can through its CFC benefit from an FBE will thereafter be crystalised in the tax court through the filing of the parties' respective statements as set out in the Tax Court Rules 31 to 34.

30. The onus of proof in a hearing before the tax court is set out in section 102 of

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[6] The sufficiency of such reasons was dealt with by the Gauteng Tax Court (in ITC No 1811 68 SATC 193 at pp 200-202) where Jajbhay J held that the accepted test, cited with approval by the Supreme Court of Appeal (in Minister of Environmental Affairs and Tourism v Phambili Fisheries 2003 (6) SA 407 (SCA) at para 40, per Schutz JA), required SARS to explain its decision in a way which will enable a taxpayer to say, in effect:

> "*even though I may not agree with it, I now understand why the decision went against me. I am now in a position to decide whether that decision has involved an unwarranted finding of fact, or an error of law, which is worth challenging*".

[7] Tax Court Rule 7(2)(a) stipulates that the taxpayer must "*specify the grounds of the objection in detail*". The taxpayer's detailed grounds of objection would be required simply to set out that the CFC does indeed have an FBE for exactly the opposite reasons given by SARS in its reasons, and contend therefore that the CFC's net income should not be included in the net income of the taxpayer.

the TAA which reads as follows:

> *"(1) A taxpayer bears the burden of proving-*
>
> *(a) that an amount, transaction, event or item is exempt or otherwise not taxable;*
>
> *(b) that an amount or item is deductible or may be set-off;*
>
> *(c) the rate of tax applicable to a transaction, event, item or class of taxpayer;*
>
> *(d) that an amount qualifies as a reduction of tax payable;*
>
> *(e) that a valuation is correct; or*
>
> *(f) whether a 'decision' that is subject to objection and appeal under a tax Act, is incorrect*."

31. Therefore, where an appeal is prosecuted against a decision/s of SARS in accordance with the above-described procedure, such appeal is to be approached on the basis that the onus is on the taxpayer to show, on the preponderance of probability, that the decision/s of SARS against which it appeals is/are wrong.[8]

32. It is important to stress that the nature of the appeal before the Tax Court is not an appeal in the ordinary sense. The Tax Court is a court of revision and in essence the matter before the Tax Court is a rehearing of the whole matter, so that both parties (that is the taxpayer and SARS) are at liberty to lead evidence

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[8] See Pretoria East Motors case *supra* at 235E-F.

in relation to the disputed issues.[9]

33. If the issue of whether a CFC has an FBE in terms of section 9D of the ITA for the years of assessment is dealt with in accordance with the prescribed procedural framework in the TAA and Tax Court Rules, it will:

33.1. give rise to relatively minimal obligations on the respective parties to substantiate their contentions at various stages of the procedural route, and

33.2. ultimately come before the tax court by way of an appeal against SARS' decision to the effect that the South African resident and/or the CFC had not established an FBE where:

33.2.1. in terms of section 102 of the TAA the burden of proof would fall upon the South African resident to demonstrate that it's CFC had established an FBE;

33.2.2. the South African resident could "*only discharge the onus by showing, on a balance of probabilities*" [10] that its CFC had an FBE;

33.2.3. if the tax court finds that the requirements for an FBE were not satisfied on a balance of probabilities, the South African resident will not have discharged the onus and the appeal will be unsuccessful and the assessment raised by SARS will stand.

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9 See Pretoria East Motors case *supra* at 233E-G.

10 CSARS v Capstone 556 (Pty) Ltd (20844/2014) [2016] ZASCA 2 (9 Feb 2016) at para 22.

PART 2: POWER OF SARS TO REQUEST INFORMATION

34. The ability of the Commissioner to effectively enforce section 9D turns largely on his ability to request information from the taxpayer. Only in this manner will SARS be able to ensure proper compliance with the provisions of section 9D.

35. Section 46 of the TAA provides SARS with the procedural powers to request information to ensure that provisions such as section 9D are effectively enforced. In that regard, at least the following four aspects arise:

    35.1. First, can section 46 of the TAA be applied retrospectively to years of assessment that pre-date the commencement of the section?

    35.2. Second, what are the jurisdictional requirements that must be satisfied in order for a valid section 46 request for information to be made by SARS?

    35.3. Third, what consequences follow if SARS fails to comply with the requirements for issuing a section 46 notice?

    35.4. Fourth, what are the sanctions against the taxpayer for its non-compliance with a section 46 request?

36. Each of these aspects is dealt with below under this header. Before that, however, the wording of section 46 is considered.

Section 46 of the TAA

37. The TAA came into force in 2012. Section 46 of the TAA has been amended from time to time. Assessments are issued by SARS in relation to preceding years. Therefore, the version of section 46 that applied during the years relating to any assessment might well differ materially from the version of section 46 that is in force at time when SARS issues the assessment.

38. Of necessity, this research report focuses only on the current version of section 46 which reads as follows:

> "***Request for relevant material***
>
> *(1) SARS may, for the purposes of the administration of a tax Act in relation to a taxpayer, whether identified by name or otherwise objectively identifiable, require the taxpayer or another person to, within a reasonable period, submit relevant material (whether orally or in writing) that SARS requires.*
>
> *(2) A senior SARS official may require relevant material in terms of subsection (1)-*
>
> *(a) in respect of taxpayers in an objectively identifiable class of taxpayers; or*
>
> *(b) held or kept by a connected person, as referred to in paragraph (d) (i) of the definition of 'connected person' in the Income Tax Act, in relation to the taxpayer, located outside the Republic.*
>
> *[Sub-s. (2) substituted by s. 42 (a) of Act 23 of 2015.]*
>
> *(3) A request by SARS for relevant material from a person other than the taxpayer is limited to material maintained or kept or that should reasonably be maintained or kept by the person in respect of the taxpayer.*
>
> *[Sub-s. (3) substituted by s. 50 (a) of Act 21 of 2012 and by s. 42 (a) of Act 23 of 2015.]*
>
> *(4) A person or taxpayer receiving from SARS a request for relevant material under this section must submit the relevant material to SARS at the place, in the format (which must be reasonably accessible to the person or taxpayer) and-*
>
> *(a) within the time specified in the request; or*
>
> *(b) if the material is held by a connected person referred to in*

subsection (2) (b), within 90 days from the date of the request, which request must set out the consequences referred to in subsection (9) of failing to do so.

[Sub-s. (4) substituted by s. 46 of Act 44 of 2014 and by s. 42 (a) of Act 23 of 2015.]

(5) If reasonable grounds for an extension are submitted by the person or taxpayer, SARS may extend the period within which the relevant material must be submitted.

[Sub-s. (5) substituted by s. 50 (b) of Act 21 of 2012 and by s. 42 (a) of Act 23 of 2015.]

(6) Relevant material required by SARS under this section must be referred to in the request with reasonable specificity.

(7) A senior SARS official may direct that relevant material-

(a) be provided under oath or solemn declaration; or

(b) if required for purposes of a criminal investigation, be provided under oath or solemn declaration and, if necessary, in accordance with the requirements of section 212 or 236 of the Criminal Procedure Act, 1977 (Act 51 of 1977).

[Sub-s. (7) substituted by s. 38 of Act 39 of 2013.]

(8) A senior SARS official may request relevant material that a person has available for purposes of revenue estimation.

(9) If a taxpayer fails to provide material referred to in subsection (2) (b), the material may not be produced by the taxpayer in any subsequent proceedings, unless a competent court directs otherwise on the basis of circumstances outside the control of the taxpayer and any connected person referred to in paragraph (d) (i) of the definition of 'connected person' in the Income Tax Act, in relation to the taxpayer.

[Sub-s. (9) added by s. 42 (b) of Act 23 of 2015.]"

Retrospective application of section 46?

39. The first issue which arises is whether or not the current version of section 46 is capable of restrospective application. Put differently, can SARS can rely on section 46(2)(b), assuming that it did not exist at all, or did not exist in its current version, during the years of assessment.

40. Section 46 is a procedural mechanism as opposed to substantive in nature. That might arguably suggest that it does have retrospective effect. However, in the final analysis, whether a statute has a retrospective effect cannot safely be decided by classifying the statute as procedural or substantive. It appears that the proper approach "*is not to decide what label to apply to it, procedural or otherwise, but to see whether the statute, if applied retrospectively to a particular type of case, would impair existing rights and obligations*".[11]

41. To put it differently: there is a presumption against the retrospective operation of any amending Act; and retrospectivity is defined as the taking-away or impairing of vested rights under existing laws.[12]

42. The question of the retrospective application of section 46 must be considered having regard to the above legal principles. Assuming SARS now issues assessments against a taxpayer in respect of years in which an earlier version of section 46 was in force, which is the correct version of section 46 to be applied: the current version or the earlier version?

43. Section 46 does not impair or denude a taxpayer of pre-existing/vested rights. It cannot be said that a taxpayer would have a particular right to defend or deal

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[11] Yew Bon Tew v Kenderaan Bus Mara [1983] 1 AC 553 (PC) ([1983] 2 All ER 833) at 839d-f per Lord Brightman, cited with approval in Minister of Public Works v Haffejee NO 1996 (3) SA 745 (A) at 752C-G, in Euromarine International of Mauren v The Ship Berg and Others 1986 (2) SA 700 (A) at 710E-H, and in Transnet Ltd v Ngcezula 1995 (3) SA 538 (A) at 549G-I.

[12] See Unitrans Passenger (Pty) Ltd t/a Greyhound Coach Lines v Chairman, National Transport Commission, and Others; Transnet Ltd (Autonet Division) v Chairman, National Transport Commission, and Others 1999 (4) SA 1 (SCA) at para 12.

with income tax issues only according to the procedure which existed during the years of assessment.[13] It thus follows that section 46 is procedural in nature, does not take-away or impair vested rights, and is therefore an exception to the presumption against retrospectivity. In other words, section 46 arguably does have retrospective application.

Jurisdictional requirements for a valid section 46 notice

44. In order to determine the jurisdictional requirements for a valid section 46 notice, it is necessary to interpret the ambit and scope of section 46.

45. Both sections 46(2)(b) and 46(4)(b) of the TAA refer to a "*connected person*".[14] In terms of the ITA a "*connected person*" is defined to mean *inter alia* –

> "*…*
>
> *(d) in relation to a company-*
>
> *(i) any other company that would be part of the same group of companies as that company if the expression 'at least 70 per cent of the equity shares in' in paragraphs (a) and (b) of the definition of 'group of companies' in this section were replaced by the expression 'more than 50 per cent of the equity shares or voting rights in';*
>
> *[Sub-para. (i) substituted by s. 3 (1) (b) of Act 20 of 2006, by s. 3 (1) (b) of Act 8 of 2007, by s. 7 (1) (a) of Act 24 of 2011 and by s. 4 (1) (h) of Act 31 of 2013.]*
>
> *(ii) and (iii) .....*
>
> *[Sub-paras. (ii) and (iii) deleted by s. 3 (1) (c) of Act 20 of 2006.]*

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13 See Poswa v President of the Republic of South Africa and Others 2015 (2) SA 127 (GJ); Minister of Public Works v Haffejee N.O. 1996 (3) SA 745 (A) and the cases referred to. Although it has been said in these cases that it is sometimes misleading to determine retrospectivity by reference to procedure only.

14 Both these terms are comprehensively defined in the ITA.

(iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of-

(aa) the equity shares in the company; or

(bb) the voting rights in the company;

[Sub-para. (iv) substituted by s. 2 (1) (a) of Act 21 of 1994, by s. 2 (1) (b) of Act 28 of 1997 and by s. 6 (1) (e) of Act 7 of 2010 and amended by s. 4 (1) (i) of Act 31 of 2013.]"

46. To ascertain the definition of "*connected person*" for purposes of para (d)(i) of the ITA Act therefore also has to have regard to the definition of "*group of companies*" in the ITA Act which means –

"*two or more companies in which one company (hereinafter referred to as the 'controlling group company') directly or indirectly holds shares in at least one other company (hereinafter referred to as the 'controlled group company'), to the extent that–*

(a) at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and

[Para. (a) substituted by s. 7 (1) (w) of Act 24 of 2011.]

(b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company;

[Definition of 'group of companies' inserted by s 6 (1) (k) of Act 74 of 2002 and substituted by s. 3 (1) (h) of Act 32 of 2005.]"

47. It appears, therefore, that the notion of a connected company is sufficiently wide to allow for SARS to employ the mechanism of section 46 against a CFC

on account of its connected status to the domestic taxpayer. In other words, SARS can request information held or kept by a CFC located outside the Republic in relation to the taxpayer, to the extent that the CFC is a 'connected person' (as broadly defined) to that taxpayer.

48. Section 46 therefore operates in the following manner:

48.1. For the purposes of carrying out its duties and for the purpose of the administration of the TAA in relation to a taxpayer, SARS may request the taxpayer or any other person (in the Republic) to submit relevant material that SARS requires. Importantly, SARS is entitled to request relevant material in relation to a taxpayer from both the taxpayer or any person. The limitation to the power is that the material required must be relevant;

48.2. SARS can also request relevant material held or kept by a connected person located outside the Republic. This power is conferred upon SARS in terms of section 46(2)(b). This sub-section is not the model of clarity and it is not clear whether it is the relevant material or connected person which is located outside the Republic. However, applying the ordinary rules of interpretation and syntax,[15] the section applies to the person who holds or keeps the relevant material and who is a connected person located outside the Republic;[16]

48.3. Upon receiving that request for relevant material, the taxpayer or person must submit the relevant material to SARS and if the material is held by a connected person,[17] the material must be provided within

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15 It seems that the entitlement to request the relevant material relates to relevant material held or kept by a connected person, even though that person is located outside the Republic.

16 It does not really matter whether the words "*located outside the Republic*" qualify both the location of the relevant material or the connected person because the taxpayer would nevertheless be obliged to take reasonable steps to furnish or make available that information to SARS.

17 Referred to in sub-section (2)(b).

ninety days from the date of the request, which request must set out the consequences referred to in sub-section (9) of failing to do so.[18]

49. It seems implicit from a reading of sections 46(4)(a) and (b) that the request is required to specify that the information must be furnished within ninety days of the date of the request and that the request must also set out the consequences referred to in sub-section (9) of failing to do so.

50. Sub-section 46(9) provides that if the taxpayer fails to provide the material referred to in sub-section (2)(b), then the material may not be produced by the taxpayer and any subsequent proceedings, unless a competent court directs otherwise on the basis of circumstances outside the control of the taxpayer, and any connected person referred to in paragraph (d)(i) of the definition of "*connected person*" in the Income Tax Act in relation to the taxpayer.

51. In summary, therefore, section 46 properly interpreted, requires SARS to give proper notice to the taxpayer, specifying the relevant material which it requires and which is held or kept by a connected person located outside the Republic, that material is to be furnished within ninety days from the request and the request further must set out the consequences which flow from a failure to comply with the SARS's request. Section 46(9) contains a sanction for failure to comply with the request.

The effect of SARS failing to comply with the requirements of section 46

52. SARS would generally request information relating to the CFC (located abroad) from the domestic taxpayer on account of the fact that such information pertains to the domestic taxpayer in the context of section 9D.

53. In such context, what is the effect of a failure by SARS to comply with the requirements of section 46? Historically, the question turned on whether the

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[18] Section 46(4)(b).

requirement in the statutory provision was classified as 'mandatory' or 'peremptory' on the one hand, or 'directory' on the other hand, the former needing strict compliance on pain of non-validity, and the latter only substantial compliance or even non-compliance.[19]

54. More recently our courts have eschewed this mechanical formal approach and recast the issue as one of statutory interpretation: the question thus formulated is whether what SARS did constituted compliance with the statutory provisions viewed in the light of their purpose; a narrowly textual and legalistic approach is to be avoided.[20]

55. Much turns on the facts of each particular case. In the context of section 46, it seems that at least in relation to the failure by SARS to advise the taxpayer of the consequences of the failure to provide the relevant material requested, there is room for the contention that the purpose of sub-section 46(4)(b) was not met and that failure to comply therewith renders the notice a nullity.[21]

56. When viewed in the context of the statute and enactment as a whole and having regard to the aim and scope of the statute and in particular section 46, it seems that there is room for the contention that the failure to notify the taxpayer of the consequences of a failure to comply with the requirements of section 46(2)(b), would render the notice void. The matter is however not free of doubt.

57. In relation to a failure to specify the ninety-day period, the position is even less clear. In any event, in relation to both these potential 'defects' in the section 46 notice, the point of a defective notice, if take, would be dilatory because SARS

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19 Hoexter *Administrative Law in South Africa* 2 ed (Juta & Co Ltd, Cape Town 2012) at 48 – 50 and 292 – 5.

20 ACDP v Electoral Commission 2006 (3) SA 305 (CC) (2006 (5) BCLR 579; [2006] ZACC 1) at para 25**;** Allpay Cons Inv Holdings (Pty) Ltd v CEO, SA Social Security Agency 2014 (1) SA 604 (CC) (2014 (1) BCLR 1; [2013] ZACC 42) at para 30; Sphandile Trading Enterprise (Pty) Ltd v Hwibidu Security Services CC 2014 (3) SA 231 (GJ) at para 13.

21 See Standard Bank of South Africa Ltd v Fob and Others 2003 (2) SA 692 (LC) at 696, paras 5 and 6

could quite easily rectify the defects in the notice.

Sanctions against the taxpayer for non-compliance with section 46

58. Section 234 of the TAA provides for criminal offences which arise from non-compliance with Tax Acts. It is quoted in full–

> "*A person who wilfully and without just cause-*
>
> *(a) fails or neglects to register or notify SARS of a change in registered particulars as required in Chapter 3;*
>
> *(b) fails or neglects to appoint a representative taxpayer or notify SARS of the appointment or change of a representative taxpayer as required under section 153 or 249;*
>
> *(c) fails or neglects to register as a tax practitioner as required under section 240;*
>
> *(d) fails or neglects to submit a return or document to SARS or issue a document to a person as required under a tax Act;*
>
> *(e) fails or neglects to retain records as required under this Act;*
>
> *(f) submits a false certificate or statement under Chapter 4;*
>
> *(g) issues an erroneous, incomplete or false document required to be issued under a tax Act to another person;*
>
> *[Para. (g) substituted by s. 77 (a) of Act 21 of 2012]*
>
> *(h) refuses or neglects to-*
>
> *(i) furnish, produce or make available any information, document or thing, excluding information requested under section 46 (8);*
>
> *(ii) reply to or answer truly and fully any questions put to the person by a SARS official;*

(iii) take an oath or make a solemn declaration; or

(iv) attend and give evidence,

as and when required in terms of this Act;

(i) fails to comply with a directive or instruction issued by SARS to the person under a tax Act;

(j) fails or neglects to disclose to SARS any material facts which should have been disclosed under this Act or to notify SARS of anything which the person is required to so notify SARS under a tax Act;

(k) obstructs or hinders a SARS official in the discharge of the official's duties;

(l) refuses to give assistance required under section 49 (1);

(m) holds himself or herself out as a SARS official engaged in carrying out the provisions of this Act;

(n) fails or neglects to comply with the provisions of sections 179 to 182, if that person was given notice by SARS to transfer the assets or pay the amounts to SARS as referred to in those sections;

(o) dissipates that person's assets or assists another person to dissipate that other person's assets in order to impede the collection of any taxes, penalties or interest; or

(p) fails or neglects to withhold and pay to SARS an amount of tax as and when required under a tax Act,

[Para. (p) added by s. 77 (b) of Act 21 of 2012]

is guilty of an offence and, upon conviction, is subject to a fine or to imprisonment for a period not exceeding two years."

59. A question which arises for consideration is whether or not the sanction

contained in section 46(9) is the exclusive sanction in relation to a taxpayer who refuses to comply with a request in terms of section 46(2)(b) or whether in addition, the taxpayer would be liable for possible criminal prosecution in terms of section 234.

60. Section 234 provides that upon conviction the stipulated offences are punishable by a fine or imprisonment for a period not exceeding two years, but a conviction for those criminal offences can only arise if firstly there was willful non-compliance with the tax Acts and secondly there was no just cause for such non-compliance.

61. It is an offence in terms of section 234(d) if a person "*fails or neglects to submit a document to SARS as required under the Tax Act*". In terms of section 234(h)(i) it is an offence if that person "*refuses or neglects to furnish, produce or make available any information, document or thing excluding information requested under section 46(8)*".

62. It is also an offence in terms of section 234(i) for a person who "*fails to comply with a directive or instruction issued by SARS to a person under a Tax Act*". However, although section 46 in its own terms contains a built-in sanction for failure to comply with section 46(2)(b), it arguably does not provide an exclusive sanction. It may be that the taxpayer is in proceedings before the Income Tax Court and is precluded from utilising the material requested by SARS. The sanction of the taxpayer not being able to use the material used by SARS in the Income Tax Court may be more illusory than real because the information requested by SARS may be for its assistance and inimical to the interests of the taxpayer. So the failure to produce the relevant material may assist the taxpayer and not SARS, and would therefore provide insufficient redress to SARS.

63. In any event, there appears to be nothing in the statute, properly interpreted,[22]

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[22] Read in its context as a whole. See Natal Joint Municipal Pension Fund v Endumeni

which leads to the inference that the legislature intended the sanction in section 46(9) to operate as an exclusive sanction to the exclusion of criminal sanctions.[23]

64. The preferable view, more consonant with the purpose of the relevant provisions, is that the remedy in section 46(9) is not exhaustive and there is room for the contention that failure to comply therewith may well lead to a criminal sanction provided that there was willful non-compliance with the request and there was no just cause for such non-compliance. Bearing in mind that the taxpayer and the connected person have separate legal personalities, they often might be regulated by different legal jurisdictions, and in many instances they are relatively far from being co-extensive in their interests and equity holdings, the most effective way to avoid criminal liability would be for the taxpayer to make a reasonable attempt to obtain the information sought by SARS, for example, by requesting it from the connected person. If such information was then not forthcoming for whatever reason, the taxpayer cannot be said to be in willful non-compliance and/or would have a just cause for not providing it, thereby avoiding any potential criminal liability.

Municipality 2012 (4) SA 593 (SCA) at paras 17-19; Cool Ideas 1186 CC v Hubbard 2014 (4) SA 474 (CC) (2014 (8) BCLR 869 [2014] ZACC 16 at para 28; DA v ANC 2015 (2) SA 232 (CC) (2015 (3) BCLR 298; [2015] ZACC 1) at para 136.

[23] It is always a vexed question in the field of contract that where a penalty or criminal sanction is imposed, without indicating that a contract is void, to determine whether the legislature was content with the penalty as sufficient sanction without intending the contract to be void. See Swart v Smuts 1971 (1) SA 819 at 831. Conversely, a prohibition without a criminal sanction may indicate that the contract contravening the prohibition is void. See Simplex (Pty) Ltd v Van Der Merwe 1996 (1) SA 111 (W) at 113C-E.

Arguably the inclusion of section 46(9) in section 234 might lead to the conclusion that only non-compliance with that section would lead to a criminal sanction. Such reasoning would rely on the presumption of interpretation *expressio unius inclusio est exclusio alterius*: the express inclusion of one thing and the non-inclusion of another (of the same genus or type) implies that the legislature intended that the provision should not cover the thing that was not included (Centre for the Study of Violence and Reconciliation v the President for the Republic of South Africa 2009 JDR 0380 (GNP) at 25). However, the presumption has been held "*not to be final, but only a prima facie indicator of meaning and therefore no hard and fast rule*" (Du Plessis Re-interpretation of statutes (2002) at 238. See also Dawood, Shalabi, Thomas v Minister of Home Affairs 2000 (1) SA 997 (C), at 1020E-G and 1022F).

There is no hard and fast rule as is the case in relation to the statute in *casu*. Each case must be judged on its own facts

PART 3: DEFINITIONS – FOREIGN COMPANY, RESIDENT, POEM

65. Section 9D(1) of the ITA defines "*foreign company*" as meaning *inter alia* "*foreign company, as defined in section 1*". Section 1 of the ITA defines *'foreign company'* as meaning "*any company which is not a resident*".

66. Section 1 of the ITA defines "*resident*" as meaning *inter alia* "*person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic*". This is consonant with section 9D(1) of the ITA, where the definition of "*country of residence*" means, "*in relation to a foreign company, the country where that company has its place of effective management*".

67. Therefore, if it is found that a company has its place of effective management in South Africa, it generally cannot be said to be "*resident*" in another country, it cannot be said to be a "*foreign company*", and it cannot be said to be a CFC. In such an instance, the questions of: i) the company's "*country of residence*" as a foreign company, and ii) whether or not that company benefits from an FBE under section 9D of the ITA, consequently do not arise.

PART 4: OUTSOURCING AND FBE

68. The resolution of this issue involves a proper interpretation and application of the definition of the phrase "*primary operations*", as it occurs in the definition of "*FBE*" in section 9D of the ITA. Put differently, the issue is whether or not the active management of service providers and agents (if these activities are outsourced) can constitute "*primary operations*" for the purposes of determining whether a CFC qualifies as an FBE for the purposes of section 9D of the ITA. [24]

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[24] It is noteworthy that a tax expert comments on this very issue in the context of section 9D of the ITA as follows:

> "*[I]t is astonishing how frequently the search for the Holy Grail of a [F]BE leads to the question to what extent a [F]BE may be constituted by outsourced operations. It seems*

69. In Natal Joint Municipal Pension Fund v Endumeni Municipality[25] the current state of our law in regard to the interpretation of documents, including tax legislation, was summarised as follows:

> "*Over the last century there have been significant developments in the law relating to the interpretation of documents, both in this country and in others that follow similar rules to our own. It is unnecessary to add unduly to the burden of annotations by trawling through the case law on the construction of documents in order to trace those developments. The relevant authorities are collected and summarised in Bastian Financial Services (Pty) Ltd v General Hendrik Schoeman Primary School. The present state of the law can be expressed as follows: Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results*

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that South African corporates have still not kicked the habit of wanting offshore profits but no, or as little as possible, an offshore establishment of their own!" (David Clegg "Business establishments" (2004) 18 Tax Planning 60 at 60-1).

[25] Natal Joint Municipal Pension Fund v Endumeni Municipality 2012 (4) SA 593 (SCA) at para 18 (footnotes omitted), per Wallis JA (Mthiyane AP, Lewis JA, Shongwe JA and Pillay JA concurring). This decision was cited with approval in a separate concurring judgment of Cameron J (Froneman J and Jafta J concurring) in National Credit Regulator v Opperman and Others 2013 (2) SA 1 (CC) (2013 (2) BCLR 170 para 96 fn 105. See also See also Bothma-Batho Transport (Edms) Bpk v S Bothma & Seun Transport (Edms) Bpk 2014 (2) SA 494 (SCA) at paras 10 - 12.

or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. To do so in regard to a statute or statutory instrument is to cross the divide between interpretation and legislation; in a contractual context it is to make a contract for the parties other than the one they in fact made. The inevitable point of departure is the language of the provision itself, read in context and having regard to the purpose of the provision and the background to the preparation and production of the document."

70. When interpreting the phrase "*primary operations*", as it occurs in paragraph (a) of the FBE definition in section 9D(1) of the ITA, the exercise must take place:

70.1. having regard to the ordinary grammatical and literal meaning of the words employed;

70.2. having regard to the context of paragraph (a) of the definition of FBE and in the broader context of section 9D;

70.3. having regard to the purpose of section 9D read together with the purpose of the exception carved out in subsection (9)(b) of the ITA; and

70.4. with a view to achieving a reasonable, sensible and businesslike interpretation.

71. The genesis of section 9D, the context in which it was introduced into the ITA and its purpose, are revealed when one has regard to the Explanatory Memorandum on the Income Tax Bill, 1997.[26] It is recorded there that –

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[26] At page 3, available on the SARS website:
http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-1997-02%20-%20%20Explanatory%20Memorandum%20Income%20Tax%20Bill%201997.pdf (accessed

"*The Katz Commission in its Fifth Report considered the question of whether tax should be imposed on the income of a resident regardless of the source of the income (the residence or world-wide basis) or on the income at source regardless of residence (the 'source' basis). As the recommendations of the Commission have far-reaching implications, which require further consideration and analysis, it is proposed to introduce certain interim measures during the shorter term. This is of particular importance in the light of the announcement by the Minister of Finance in his Budget Speech with regard to the relaxation of exchange controls from 1 July 1997. In order to protect the South African tax base the following measures in relation to the taxation of investment income are proposed in two new sections, that is sections 9C and 9D, to be introduced in the principal Act* [the ITA]." This culminated in the introduction of section 9D into the ITA by section 9 (1) of Act 28 of 1997.

72. Section 9D of the ITA is essentially an anti-avoidance provision. It is aimed at preventing South African residents from excluding certain taxable income from the South African taxing jurisdiction through investment in CFCs. Section 9D was thus introduced as a mechanism to protect the South African tax base. It subjects residents to tax on their income accumulated in the name of a qualifying legal entity, the CFC. In appropriate circumstances, a CFC's income will be allocated to residents. This accords with one of the key purposes of the ITA described in its preamble, namely "*to provide for the recovery of taxes on persons*".

73. Over the years, significant changes have been wrought to section 9D. However, when one tracks the various amendments to section 9D, it appears that it's broad underlying purpose has not changed.

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on 12 February 2018).

74. The policy underpinning section 9D is that it strikes a balance between competitiveness and international tax neutrality. It does so in the following manner.

74.1. In terms of section 9D a CFC generates current taxable income for its South African resident shareholder who holds a participation right in the CFC if that CFC generates diversionary income or mobile income or passive income. In this manner section 9D ensures the domestic tax base is not eroded, and retains international tax neutrality.

74.1.1. Diversionary income involves income that is associated with transfer pricing avoidance. It flows from tax schemes that are artificially shifting income offshore. It includes income described in section 9D(9A)(a)(i) and (ii).[27] These provisions target tax avoidance. They are aimed at precluding South African taxpayers from entering into transactions which divert income which ought to be taxable in South Africa to a jurisdiction with a more beneficial taxing regime.[28]

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27 These provisions are cited from the law as it stands presently merely in order to broadly set out the scheme of section 9D of the ITA and illustrate how it supports the underlying purpose and policy objective. The wording of these particular subsections may well have been slightly different at the inception of section 9D.

28 Section 9D of the ITA is a powerful tool in SARS' arsenal. To a certain extent, it complements the transfer pricing provisions in section 31 of the ITA. Some commentators have gone as far as contending that CFC rules (such as those in section 9D of the ITA) are the "*backstops*" to transfer pricing rules (see, for example, Fleming, J. Clifton Jr., Peroni, Robert J. and Shay, Stephen E., "Worse than Exemption" 59 Emory L.J. 79 (2009) at p 105, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1536731; accessed on 8 February 2018). However, CFC rules and transfer pricing rules are not entirely co-extensive. There are at least two key differences.

First, transfer pricing rules in section 31 focus primarily on payments between related parties. They therefore do not remove the need for the CFC rules in section 9D. This is because the application of the CFC rules is generally more mechanical and more targeted than transfer pricing rules. And more significantly, many CFC rules under section 9D automatically attribute certain categories of income that is more likely to be geographically mobile and therefore easy to shift into a low-tax foreign jurisdiction, regardless of whether the income was earned from a related party. As stated by the OECD:

"*CFC rules may target the same income as transfer pricing rules in some situations, but it*

74.1.2. Passive income is self-explanatory. It includes, for example, royalites, dividends or interest earned and other income described in sections 9D(9A)(a)(iii) to (vii) of the ITA. [29]

74.1.3. Mobile income is income from a shell business which merely maintains a post office address or website and which has no real non-tax reason for existing. Such shell businesses are without economic substance. Section 9D includes such income in its net in the following manner. If the requirements of paragraph (a) of the definition of an FBE under section 9D(1)(a) are not met, then the FBE exemption under section 9D(9)(b) is not triggered and such income falls within the net of sections 9D(2) and 9D(2A) and is included in the taxable income of the CFC's shareholder who is resident in South Africa.

74.2. However, the legislature also recognizes that CFCs are often used for legitimate business purposes. Therefore active income of CFCs are exempt in terms of section 9D(9) in order to ensure that foreign

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is unlikely that either CFC rules or transfer pricing rules in practice eliminate the need for the other set of rules. Instead, while CFC rules may capture some income that is not captured by transfer pricing rules (and vice versa), neither set of rules fully captures the income that the other set of rules intends to capture."

(OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project p 14 paras 8-9), OECD Publishing, Paris (available at http://dx.doi.org/10.1787/9789264241152-en; accessed on 28 January 2018).

Secondly, because transfer pricing will attack simulated transactions which take advantage of low tax jurisdictions without sufficient attention being given to the substance of the agreements, transfer pricing auditing processes are time consuming and skilled-labour intensive and, by their nature, often take years to finalise. Therefore, relying solely on transfer pricing leaves the South African tax base vulnerable to profit shifting. In contrast, section 9D is relatively more effective and efficient, and therefore has an important role to play for SARS.

29 These provisions from the law are cited as they are presently found merely in order to broadly set out the scheme of section 9D of the ITA and illustrate how it supports the underlying purpose and policy objective. The wording of these particular subsections may well have been slightly different in preceding years.

businesses remain competitive[30] with local businesses in the foreign country from a tax point of view.

74.2.1. This active income includes income attributable to a foreign business that meets the requirements described in paragraph (a) of the definition of FBE read together with section 9D(9)(b), provided that such income is not diversionary or passive income as set out in section 9D(9A). The requirements of paragraph (a) of the definition of FBE are met essentially if the business is truly active, has some physical nexus to its foreign country of residence and is used for *bona fide* non-tax business purposes.[31] A CFC engaged in active foreign business in such circumstances does not generate income which must be included for the purposes of South African income tax.

74.2.2. The active income also includes income attributable to a foreign business that meets the requirements described in each of the paragraphs (b) to (g) of the definition of FBE read with section 9D(9)(b), provided that such income is not diversionary or passive income as set out in section 9D(9A). These FBE exemptions concern foreign businesses dealing with the extraction of natural resources, construction sites, farming, and international transport. They are not directly relevant to the present matter.

See para C1 at p 8 of the National Treasury's detailed explanation to section 9D of the Income Tax Act (June 2002). It is available at:

http://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf; accessed on 13 February 2018).

31 AJ Cockfield "Balancing National Interests in the Taxation of Electronic Commerce Business Profits" (1999) 74 Tulane Law Review 133 at 144-148 deals generally with the permanent establishment test and emphasises that it is premised on a physical connection.

75. It seems that the definition of foreign business establishment, as contained in 9D(a), is of wide amplitude and does not define or limit the sphere of operation of the business of the foreign business establishment, which is the case in sections 9(b) to (g). This has an important bearing on the issue.

76. Generally the foreign business establishment requirement provides that there should be a place of business, with an office, shop, factory, warehouse or other structure which is used or continued to be used by the CFC whereby the business of the CFC is carried on. However, the place of business should be suitably staffed with onsite managerial and operational employees of that CFC and which management, and employees are required to render services on a full-time basis and be suitably equipped with proper facilities for the purposes of conducting the primary operations of the business(es).

77. It is important to stress that in relation to this definition, there is no definition of what business is to be carried out by the CFC or what constitutes the primary operations of that business. The emphasis appears to be that the place of business, which is located in the foreign jurisdiction, should be suitably staffed with onsite managerial and operational employees who render services on a full-time basis and have suitably equipped and proper facilities to conduct the primary operations of the business.

78. The words "*primary operations*" do not have a prescribed meaning, either in the ITA or TAA, nor is the expression a term of art. The ordinary or dictionary meaning can be accorded to the phrase and means "*main functions*", "*core functions*" or "*principal activities*".[32] So, applying the ordinary cannons of construction and the proper interpretation of the section under consideration, there seems to be nothing in the wording of section 9D which precludes the active management of a service provider/s and agent from constituting the

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[32] De Beers Industrial Diamonds Division (Pty) Ltd v Ishizuka 1980 (2) SA 191 (TPD). Dictionary meanings do not govern but afford a useful guide to interpretation but again must yield to the contextual approach.

"*primary operations*" or "*main functions*" or "*principal activities*" of a CFC as qualifying as a foreign business establishment.

79. But does this accord with the above purpose of section 9D? Arguably yes. As demonstrated above, one of the aims of section 9D is to ensure that *inter alia* mobile income and certain stipulated diversionary and passive income of CFCs falls within the net of taxable income of a resident.

    79.1. Where a business is merely a so-called black-box entity with a registered name, a postbox and/or an email address, and all its functions are outsourced, the almost irresistible inference arises that this mobile income is being moved abroad as part of an avoidance scheme. It is this device that the legislature has set its face against by inserting paragraph (a) of the definition of FBE in section 9D(1). The requirements of paragraph (a) of the definition of an FBE would not be met because in such circumstances the business would not have physical structures, would not be suitably staffed with managerial and operational employees who conduct that business, would not have suitable facilities for conducting that business, and would not be used for *bona fide* non-tax business purposes.

    79.2. However, what of the business that has, as its primary operations, the active management of service providers and agents? How does this measure against the purpose of section 9D and the definition of an FBE? In such instance, although outsourcing even extensive outsourcing is present, it cannot be said that the CFC is a shell or subterfuge or that its corporate entity has been used for ulterior or improper motive. The business will have substance and provided there is a proper characterisation of its business and business activities, there is nothing untoward or controversial in its existence. Also, presumably, it will be at arm's length from its South African parent company. Therefore, the active management of the outsourcing,

coupled with the requisite supporting facilities, equipment, employees and physical structures which satisfy the requirements of paragraph (a) of the definition of an FBE, including that it is being used for a *bona fide* non-tax business purposes, will render that business an FBE. The question is essentially one of fact.

80. A further argument in favour of construing the active management of service providers and agents as constituting the "*primary operations*" of a company is the following.

80.1. The scheme of section 9D and its underlying purpose make it plain that the legislature has sought to bring *inter alia* mobile income and certain stipulated diversionary and passive income of CFCs within the scope of taxable income of a resident.

80.2. Where the requirements of an FBE are met, the legislature has provided that such income does not fall within the scope of section 9D (unless it falls within one of the stipulated exceptions in section 9D(9A)).

80.3. If a business, whose primary operations are constituted by the active management of service providers, satisfies the requirements of paragraph (a) of the definition of an FBE, but the legislature nevertheless sought to have its income fall within the scope of section 9D, the legislature would have expressly made provision for that in precisely the same manner as it has, for example, in relation to other exceptions set out in section 9D(9A). To put the converse, the legislature's failure to expressly exclude from the net of section 9D the income of a business whose primary operation is the active management of third party service providers and agents (as the legislature has in other instances), suggests that a business with such

primary operations should qualify for FBE status if the relevant requirements of paragraph (a) thereof are met.

80.4. There is nothing in this approach which is subversive or inimical to the definition of foreign business establishment as it occurs in the definition of (a). The business, as contemplated in that section, is of wide amplitude and does not expressly or impliedly exclude the business of outsourcing.

81. It is unclear whether much assistance can be drawn from comparative law[33] in dealing with this issue.

81.1. Admittedly it is a common feature of CFC rules (such as section 9D of the ITA) that they result in a state taxing its residents on income attributable to their participation in certain foreign entities.[34] This is internationally recognised as a legitimate instrument to protect a country's domestic tax base.[35]

81.2. But despite this broad common objective, it is a notorious fact that this type of CFC legislation varies considerably among countries.[36]

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33 See, for example, Deloitte's *The Guide to Controlled Foreign Company Regimes* (updated as of January 2014) which surveys the regimes for 65 countries (available at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-guide-to-cfc-regimes-210214.pdf; accessed on 1 February 2018).

34 See OECD Commentaries on the Articles of the Model Tax Convention at p 70 para 23 (available at http://www.oecd.org/berlin/publikationen/43324465.pdf; accessed on 10 February 2018).

Cf BJ Arnold "Comparative Perspective on the U.S. Controlled Foreign Corporation Rules" (2012) 65 Tax L. Rev. 473 at 473-474:

> "*Readers should be skeptical about drawing conclusions from any comparison of discrete aspects of countries' tax systems. Pieces of a tax system can be properly assessed only in the context of the system as a whole. That said, CFC rules are more suitable for comparative analysis than many other types of rules because in all countries CFC rules have the same fundamental purpose and structure*".

35 See OECD Commentaries on the Articles of the Model Tax Convention at p 70 para 23.

36 See OECD Commentaries on the Articles of the Model Tax Convention at p 70 para 23.

82. Similarly, it is unclear whether, and how much, assistance can be drawn from international law.

82.1. The meaning of "*primary operations*" as used in the definition of paragraph (a) of the FBE definition in the context of section 9D of the ITA is mainly a matter of interpretation of domestic legislation in accordance with the interpretive parameters described above.

82.2. However, section 233 of the Constitution of the Republic of South Africa states that in interpreting legislation "*every court must prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law"*.

83. To the extent that international law has any role to play in the interpretation of section 9D, I set out below recent developments at the OECD[37] and decisions of the Court of Justice of the European Union ("the Court of Justice").[38]

More recently, in an in-depth report dealing with the strengthening of CFC legislation that was published on 5 October 2015, the OECD has recognized the need for flexibility to ensure countries can design CFC rules that are consistent with their domestic policies and indicates that countries "*are free to choose their rules for defining CFC income*".

(See OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, p 43 para 73, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (available at http://dx.doi.org/10.1787/9789264241152-en; accessed on 28 January 2018).

37 The OECD is a forum where governments collaborate to address the economic, social and environmental challenges of globalisation. The OECD provides a setting where governments can compare policy experiencesfind solutions to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union also takes part in the work of the OECD. See: http://www.oecd.org

The OECD Commentary on the application and interpretation of the Model Tax Convention has become widely accepted. It is generally followed by countries which use the OECD Model Tax Convention as a basis for drawing and interpreting their international tax treaties and even for their domestic tax laws.

84. On 3 April 2015, the OECD released a draft report on the strengthening of CFC rules, and invited comment.[39] That report described *inter alia* the various legislative approaches used to define CFC income, including a categorisation test[40] and an establishment test.[41] On 5 May 2015 the OECD published the first part of the comments it received in response.[42] Several comments received cautioned against the drawing of any overly-narrow establishment test; they pointed to the need for CFC legislation, and an establishment test in particular, to be flexible enough to accommodate commercial outsourcing arrangements. The following comment by Deloitte summed up the point:

> "*Although it is clear that the employees and establishment analysis approach [which is the approach followed in paragraph (b) of the definition of FBE in section 9D of the ITA] requires less fact intensive analysis compared to a viable independent entity analysis or substantial contribution analysis, we consider this approach to be too narrow. It does not take account of commercial outsourcing arrangements which in*

South Africa is not an OECD member country. The Commentary is not legally binding. But South African courts have recognized and had regard to OECD reports and commentary in both tax cases and non-tax cases (see, for example, Helen Suzman Foundation v President of the RSA 2015 (2) SA 1 (CC) at para 40 (per the majority judgment of Mogoeng CJ), Secretary for Inland Revenue v Downing 1975 (4) SA 518 (A) at 525, Glenister v President of the RSA 2011 (3) SA 347 (CC) at paras 187-189 of the majority decision per Moseneke DCJ and Cameron J, Krok and Another v Commissioner, South African Revenue Service 2015 (6) SA 317 (SCA) at paras 37-38; Commissioner, South African Revenue Service v Tradehold Ltd 2013 (4) SA 184 (SCA) at para 18). This is unsurprising in light of section 233 of the Constitution of the Republic of South Africa.

38 The Court of Justice of the European Court of Justice (CJEU, sometimes referred to as the European Court of Justice or 'ECJ'), is officially known as the Court of Justice (French: *Cour de Justice*). It is the highest court in the European Union in matters of European Union law. As a part of the judicial machinery of the European Union it is tasked with interpreting EU law and ensuring its equal application across all EU member states.

See, generally: http://europa.eu/about-eu/institutions-bodies/court-justice/index_en.htm

39 See: http://www.oecd.org/tax/aggressive/discussion-draft-beps-action-3-strengthening-CFC-rules.pdf; accessed on 8 February 2018.

40 Such as that employed in section 9D(9A) of the ITA.

41 Such as that contained in paragraph (a) of the definition of FBE in section 9D(1) of the ITA.

42 Comments received on public discussion draft – BEPS Action 3: Strengthening CFC Rules, 5 May 2015 Part 1 (available at: http://www.oecd.org/tax/aggressive/public-comments-beps-action-3-strengthening-cfc-rules-part1.pdf; accessed on 12 February 2018).

certain industries are typical even in the case of core functions. For example in the pharmaceutical industry it is not uncommon for research and development activities to be outsourced for commercial reasons, despite being a crucial element of the life cycle of that industry. In addition, the exclusion of activities that are outsourced by the CFC to another group company within the same jurisdiction would not seem to further the policy objectives of a CFC regime. For example in the insurance industry in the UK it is common for regulatory purposes to have staff employed by a group service company working for more than one regulated insurer. Such group service companies are also common in the banking industry. If the substance test was applied on an entity basis, rather than on a group basis, this may lead to a substance threshold not being met." [43]

85. This demonstrates the commercial reality of outsourcing arrangements. If the words "*primary operations*" in the definition of an FBE in the context of the CFC rules in section 9D are to be given a commercially sensible or businesslike meaning, a court might arguably be prevailed upon to have regard to the commercial realities regarding outsourcing, such as those set out in Deloitte's response to the OECD report on CFC rules.[44]

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[43] Deloitte response at pp 229-238 esp at p 234 question 9, appearing in "Comments received on public discussion draft – BEPS Action 3: Strengthening CFC Rules, 5 May 2015 Part 1" (available at: http://www.oecd.org/tax/aggressive/public-comments-beps-action-3-strengthening-cfc-rules-part1.pdf; accessed on 13 February 2018).

[44] At p 53 thereof, available on the SARS website:

http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2006-01%20-%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202006.pdf (accessed on 13 February 2018). See Westinghouse Brake and Equipment (Pty) Ltd v Bilger Engineering (Pty) Ltd 1986 (2) SA 555 (A) at 562B-563A, cited with approval in Minister of Health NO v New Clicks SA (Pty) Ltd (TAC as Amici Curiae) 2006 (2) SA 311 (CC) at para 201 and in CSARS v Bosch 2015 (2) SA 174 (SCA) at para 18.

See also, for example, J Roin "Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment" (2008) 61 Tax L. Rev. 169 at 205 where the author notes, in the context of a paper dealing with base erosion and profit sharing, that we are "*[i]n an era where outsourcing and leasing of employees is common*." The author points out further at 206 that there is no effective mechanism for dealing with outsourcing.

86. It is not irrelevant, in this context, that when the definition of "*business establishment*" was deleted and the definition of FBE was introduced in 2006, the reason for such change set out in the accompanying Explanatory Memorandum on the Income Tax Bill, 2006 was that *"[t]he current definition of business establishment is too rigid, making it difficult for South African companies that are conducting genuine non-tax business activities*".[45] This suggests that the purpose of the introduction of the current FBE definition was to render more open and flexible the business establishment test in a bid to allow "*genuine non-tax business activities*" to be excluded from the net of section 9D.[46] A business comprising the active management of third party service providers would arguably constitute such a "*genuine non-tax business activit[y]*" which the change in legislation sought to embrace.

87. On 5 October 2015, the OECD released its final report on the strengthening of CFC rules.[47] The final report did not specifically address this criticism of establishment tests that are too narrowly drawn. Nor did it in any other way deal with the issue of outsourcing. However, the final report did note the following in relation to a "substance analysis" for determining whether income falls within the net of CFC rules:

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45 At p 53 thereof, available on the SARS website:

http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2006-01%20-%20Explanatory%20Memorandum%20Revenue%20Laws%20Amendment%20Bill%202006.pdf (accessed on 12 February 2018).

In CSARS v Bosch 2015 (2) SA 174 (SCA) at para 18 the Supreme Court of Appeal held in the context of interpreting the ITA that:

> "*the explanatory memorandum accompanying the amending legislation when it was placed before parliament… not only identifies the purpose of the amendment, but is also a permissible guide to parliament's understanding of the existing section*".

46 It appears that despite this amendment, the current CFC provisions in section 9D, based upon the idea of a physical presence or location, are still subject to considerable criticism to the effect that they are out of touch with commercial reality with the advent of e-commerce. In this regard, see AW Oguttu "The challenges that ecommerce poses to international tax laws: 'controlled foreign company' legislation from a South African perspective (Part I)" 2008 (20) SA Merc LJ 347-371 esp at pp 367-367.

47 See OECD (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (available at http://dx.doi.org/10.1787/9789264241152-en; accessed on 28 January 2018). ("OECD final report").

"*A substance analysis looks to whether the CFC engaged in substantial activities in determining what income is CFC income. Many existing CFC rules apply a substance analysis of some sort, and many Member States of the European Union combine a categorical approach with a carve-out for genuine economic activities. Substance analyses can use a variety of proxies to determine whether the CFC's income was separated from the underlying substance, including people, premises, assets, and risks. Regardless of which proxies they consider, substance analyses are generally asking the same fundamental question, which is whether the CFC had the ability to earn the income itself. Substance analyses could be combined with the categorical or excess profits analysis, and most existing substance analyses apply alongside more mechanical rules and are not stand-alone rules. Although such rules add to the complexity of CFC rules, they may be more able to accurately identify and quantify shifted income*."[48]

…

"[T]*here are many different ways that a jurisdiction could design a substance analysis that is consistent with the jurisdiction's policy objectives.*

…

A third option would consider whether the CFC had the necessary business premises and establishment in the CFC jurisdiction to actually earn the income and whether the CFC had the necessary number of employees with the requisite skills in the CFC jurisdiction to undertake the majority of the CFC's core functions. If applied as a threshold test, this would attribute all the income of a CFC that did not have the necessary people and premises (or exclude all the income of a CFC

[48] See OECD final report (2015) at p 47 para 81.

that did have the necessary people and premises). If applied as a proportionate test, this would treat as CFC income all the income that the CFC did not have the people and premises to earn"[49] (my emphasis).

88. This excerpt from the OECD final report is arguably relevant to an interpretation of section 9D(1) of the ITA because it emphasizes the objective of the substance analysis contained in paragraph (a) of the FBE definition, namely to ensure that the CFC had the ability to earn the income itself.

88.1. This accords with the additional[50] purpose of paragraph (a) of the definition of FBE which was introduced in 2009. The accompanying Explanatory Memorandum on the Income Tax Bill, 2009 made it clear that "*[t]he foreign business establishment definition will be clarified and tightened to ensure that the foreign business establishment relied upon is economically meaningful*" [51] (my emphasis).

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49 See OECD final report (2015) at p 48 para 85, where the South African example of paragraph (b) of the definition of an FBE in section 9D of the ITA was cited in the footnote as an example of this 'third option' giving effect to this 'substance analysis'.

Although it is not clear, under the FBE exemption in section 9D there does not appear to be any proportionality test. Instead, there appears to be only a threshold test. This arguably creates an all or nothing approach. In other words, either the requirements are not met and an FBE does not arise in which event its income is attributed to the resident, or the requirements are met and an FBE does arise in which event its income is not attributed (subject to the exceptions in section 9D(9A)).

On a preliminary view, despite the phraseology of "*any amount which is attributable to any foreign business establishment*" in section 9D(9)(b), there does not appear to be scope for contending that only *a proportion* of the CFC's foreign business establishment income is attributable.

However, this is merely a preliminary view, the question has not been considered, and it is expressly excluded from the purview of the research report.

50 As set out above, the first purpose, upon the introduction of the definition of FBE in 2006 was to render the business establishment definition in section 9D of the ITA more open and flexible so as to ensure that "*genuine non-tax business activities*" did not fall within the net of section 9D. The 2009 amendment to the FBE definition was aimed at ensuring that such "genuine non-tax business activity" had to be "economically meaningful".

51 At p 74 thereof, available on the SARS website:

http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2009-01%20-

88.2. This suggests furthermore that whatever the primary operations of the CFCs business is, if the requirements of the FBE definition are met in relation to those primary operations (thereby demonstrating economic substance), that will suffice. In other words, although the point of departure would be to identify the primary operations, that ought to be relatively uncontroversial. The real focal point would be on the other requirements for an FBE in relation to such primary operations; these would be subjected to careful analysis and scrutiny. Therefore, if the primary operations of a business were identified as the active management of outsourced service providers and agents, the other requirements in relation to such primary purpose would have to be carefully established in order to find an FBE. There is some academic support for this analysis of section 9D: [52]

> "*Now some degree of outsourcing is likely to take place in almost any business activity, so to what extent **is** this possible without destroying [F]BE status?*
>
> *…*
>
> *The critical elements of relevance to the outsourcing question are the requirement that a [F]BE be 'suitably equipped with on-site operational management, employees . . .'.*
>
> *Clearly, the principal activity of the [F]BE needs to be identified. It is then necessary to determine the minimum extent to which on-site management and employees are necessary to undertake*

%20Explanatory%20Memorandum%20Taxation%20Laws%20Amendment%20Bill%202009.pdf (accessed on 12 February 2018).

52 David Clegg "Business establishments" (2004) 18 Tax Planning 60 at 61. Although the learned author was dealing with the definition of 'business establishment' which was found in the ITA at that time, he later affirmed these views after the definition of FBE was inserted in 2006 (see David Clegg "Business establishments: outsourcing obstacle" (2006) 20 Tax Planning 133).

that activity. Possibly the easiest example is the situation of a property-owning and letting organisation. An organisation of this nature typically outsources much of its work – in particular building maintenance and, frequently, collections of rentals – leaving relatively little for its own management and employees to do.

It seems to me, however, that at the very least the organisation must employ an individual with sufficient experience in the business concerned to be able to 'hire, chastise and fire' the outsource subcontractors without reference to higher authority. Indeed, if that is not the situation and the person with that managerial experience and authority sits in, say, Cape Town, then it is more than likely that the effective management and hence residence of the entity is in South Africa!

But I do not think that the terms of the definition are prescriptive in the sense that an organisation necessarily needs both a manager and at least one employee – there will be some organisations (and the property-owning organisation may be an example) where a single suitably-qualified or experienced individual can perform all the required tasks without the need for, for example, the secretarial assistance of another employee.

What is suitable equipment both in terms of hardware and manpower must, therefore, depend upon practice and custom in the industry concerned. But in structuring a business establishment, it is better to err on the side of conservatism and retain as much of the activities in-house as possible.

Informal discussions with the office of the Commissioner suggests that outsourcing will be frowned upon. A heavily outsourced operation may need to defend its position in court.

From the above, it would seem that the outsourcing of business operations by a [F]BE must be acceptable to some extent, depending somewhat upon industry custom, although SARS appears to be unhappy with the concept" (my emphasis).

89. In Cadbury Schweppes[53] the Court of Justice considered the compatibility of Member State CFC rules with the EU treaty freedoms. The Court of Justice held *inter alia* that:

89.1. CFC rules (and other tax rules) that apply to cross-border transactions and that are justified by the prevention of tax avoidance must specifically and restrictively target "*wholly artificial arrangements*" which do not evidence "*any genuine economic activity*" such as a "'*letterbox' or 'front' subsidiary*" which is intended to escape national tax normally payable; [54]

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53 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue Case C-196/04

(available at http://curia.europa.eu/juris/liste.jsf?language=en&num=C-196/04#; accessed on 27 January 2018).

54 Cadbury Schweppes case above at paras 68, and 72-74. See L Faulhaber " Sovereignty, Integration and Tax Avoidance in the European Union: Striking the Proper Balance" (2010) 48 Colum. J. Transnat'l L. 177 at 194 who notes that:

> *"[T]he court [the ECJ] has replaced the balancing test inherent in the principle of proportionality with the requirement that a Member State's anti-avoidance measure may limit freedom of movement if it applies only to wholly artificial arrangements*".

In Itelcar – Automóveis de Aluguer Lda. v. Fazenda Pública Case C-282/12 (3 October 2013) at para 34, the Court of Justice made it clear that a national measure restricting the fundamental EU freedoms may be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory.

89.2. "*the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement*"; [55]

89.3. "*[t]he resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine*"; [56] and

89.4. in the absence of objective evidence that shows the existence of a wholly artificial arrangement, the CFC's income should not fall within the net of the CFC rules even in circumstances where the intention of the resident company to obtain a reduction in its tax liability was central to the reasons for incorporating the CFC.[57]

90. The above excerpts from the Court of Justice are also potentially relevant in light of the wording of paragraph (a) of the definition of an FBE in section 9D(1) of the ITA which requires (at sub-paragraph (v)) that the FBE's fixed place of business outside the Republic must not be "*solely or mainly for a purpose other than the postponement or reduction of any tax imposed by any sphere of government in the Republic*".

91. This fits in with the relevant section of the ITA which strongly implies that the reduction of tax payable by the parent company in South Africa conceivably could be one of the purposes of establishing the CFC (but cannot be the main

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55 Cadbury Schweppes case above at para 69.

56 Cadbury Schweppes case above at para 70.

57 Cadbury Schweppes case above at paras 68, and 72-74. A detailed analysis of this decision is provided in A Lyden-Horn "Note and comment: Cadbury Schweppes: a critical look at the future and futility of UK controlled foreign company legislation" (2008) 22 Temp. Int'l & Comp. L.J. 191.

or sole purpose) and this would not rule out an FBE exemption. Therefore, where the CFC is established for sound commercial reasons and where the sole or main purpose is not the postponement or reduction of tax imposed by any sphere of government in the Republic, and where the other jurisdictional requirements of the definition are satisfied, the FBE definition would be met and the FBE exemption would be available. There will always be some measure of outsourcing in relation to any business enterprise, irrespective of its primary operations.[58] The degree to which a business engages in outsourcing does not appear to be the crucial issue in the interpretation of section 9D and the FBE definition in subsection (1).[59] Instead, the more important enquiry, irrespective of the degree of outsourcing, is whether, once the primary operations of the business is identified, the other requirements in relation to such primary operations (set out in paragraph (a) of the FBE definition) are satisfied.

92. In conclusion on this "*in principle*" question: on a proper interpretation of section 9D, there is an arguable case for contending that the active management of service providers and agents may constitute the primary operations for purposes of determining whether an FBE arises in relation to a CFC. It appears that at least one commentator has expressed similar sentiment, confirming that, in his view, a business which is entirely outsourced can attract the status of an FBE as described in paragraph (a) of that definition provided that the other requirements going to physical establishment are met:[60]

> "[A]*s I pointed out in my earlier article, some functions of even the most real and substantial business imaginable are always outsourced. For example, the owner of an office block or factory is most unlikely to employ his own window-washing team – he will almost inevitably outsource that function and in fact, the distinction (if there is one)*

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58 See David Clegg "Business establishments" (2004) 18 Tax Planning 60 at 61.

59 *Cf* David Clegg "Business establishments" (2004) 18 Tax Planning 60 at 61.

60 See David Clegg "Business establishments: outsourcing obstacle" (2006) 20 Tax Planning 133.

between 'outsourcing' and the hiring of a service provider (for example, a bank, lawyer, building contractor or car hiter) is more a matter of perception and industry practice than of substance. If, in a particular industry, most businesses use in-house personnel for function A but some use service providers, it would be called 'outsourcing' – but if the whole industry uses service providers, it is referred to as using 'contractors' or 'consulting a lawyer', for example.

So it was that I reached the conclusion in my earlier article, namely, that, while the provisions of the 'business establishment' definition required at least one senior person to be employed with the knowledge, experience and authority to 'hire, chastise and fire' other employees or service providers, there was really no reason why a business establishment should not outsource virtually all its actual operating activities – although this would be limited to an extent by the requirement that the establishment be 'suitably equipped' and hence industry practice in relation to outsourcing would be of some relevance in judging whether that requirement had been fulfilled.

…

"The new definition of a 'foreign business establishment' provides that the term means …

…

So, is outsourcing still permitted? In my view the answer has to be yes. … It seems to me that he (sic) term 'suitably staffed' is intended to recognise that the primary operations of the busienss need not be fully staffed by employees and to that extent, the amended provisions are little different to their predecessor" (my emphasis).

93. It might well transpire that SARS issues audits in respect of years where a double taxation agreement exists between the Government of the Republic of South Africa and another foreign government.[61] This research report expresses no view on whether there is any conflict between any of the CFC rules contained in section 9D of the ITA and the provisions of any such double taxation treaty in relevant years and, if so, how such conflicts could be resolved. Such issues do not fall within the purview of this research report. [62]

PART 5: PRESCRIPTION

94. Assuming that it is contended that a CFC did not have an FBE status during the years of assessment, can this issue be revisited by SARS, particularly in respect of years of assessment which have prescribed? This raises two sub-issues, namely:

    94.1. whether SARS can revisit those years where the assessments have prescribed; and

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61 Examples in point are as follows.

The double taxation agreement between the Government of South Africa and the Government of Mauritius was concluded on 5 July 1996. It was replaced by a new double taxation agreement in 2015. The 1996 double taxation agreement is available at:

http://www.sars.gov.za/AllDocs/LegalDoclib/Agreements/LAPD-IntA-DTA-2012-09%20-%20DTA%20Mauritius%20GG%2018111.pdf; accessed on 6 February 2018).

Dubai, as part of the United Arab Emirates, did not have a double taxation treaty with South Arica for until 2015. It appears from news reports, however, that the Governments of the United Arab Emirates and Republic of South Africa signed an agreement for the avoidance of double taxation in November 2015 (see: http://www.wam.ae/en/news/emirates/1395288454013.html; accessed on 14 February 2018). It is unclear whether this agreement has been ratified and therefore enforceable.

62 However, it appears that the possibility of impediments may arise. See, for example, AW Oguttu "Resolving the conflict between 'controlled foreign company' legislation and tax treaties: a South African perspective" (2009) XLII CILSA 73-114.

Contra paragraph IC at p 2 of the National Treasury's detailed explanation to section 9D of the Income Tax Act (June 2002) wherein the unequivocal assertion is made that the CFC provisions do not conflict with any double taxation agreements or treaties. It is available at:

http://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf; accessed on 12 February 2018).

94.2. if the answer is in the affirmative, which regime applies – the ITA or the TAA?

95. We commence with the relevant sections in the TAA.

96. Section 92 of the TAA deals with additional assessments and provides that –

> "*[i]f <u>at any time</u> SARS is satisfied that an assessment does not reflect the correct application of a tax Act to the prejudice of SARS or the fiscus, SARS must make an additional assessment to correct the prejudice*" (emphasis added).

97. Section 95(1) of the TAA provides that SARS may make an additional assessment if the taxpayer submits information that is incorrect or inadequate.[63]

98. Sections 92 and 95 are subject to section 99 of the TAA which deals with the "*period of limitations for issuance of assessments*". The relevant portion reads as follows -

> *"(1) An assessment may not be made in terms of this Chapter-*
>
> *(a) three years after the date of assessment of an original assessment by SARS;*
>
> *…*
>
> *[Sub-s. (1) amended by s. 51 (a) of Act 23 of 2015]*

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63 Section 95(1) provides, in full, that –

"*SARS may make an original, additional, reduced or jeopardy assessment based in whole or in part on an estimate if the taxpayer-*

(a) fails to submit a return as required; or

(b) submits a return or information that is incorrect or inadequate."

(2) Subsection (1) does not apply to the extent that-

(a) in the case of assessment by SARS, the fact that the full amount of tax chargeable was not assessed, was due to-

(i) fraud;

(ii) misrepresentation; or

(iii) non-disclosure of material facts;

…;

(3) The Commissioner may, by prior notice of at least 30 days to the taxpayer, extend a period under subsection (1) or an extended period under this section, before the expiry thereof, by a period approximate to a delay arising from:

(a) failure by a taxpayer to provide all the relevant material requested within the period under section 46 (1) or the extended period under section 46 (5); or

(b) resolving an information entitlement dispute, including legal proceedings.

[Sub-s. (3) added by s. 51 (c) of Act 23 of 2015]

(4) The Commissioner may, by prior notice of at least 60 days to the taxpayer, extend a period under subsection (1), before the expiry thereof, by three years in the case of an assessment by SARS or two years in the case of self-assessment, where an audit or investigation under Chapter 5 relates to-

(i) the application of the doctrine of substance over form;

(ii) the application of Part IIA of Chapter III of the Income Tax Act, section 73 of the Value-Added Tax Act or any other general anti-avoidance provision under a tax Act;

(iii) the taxation of hybrid entities or hybrid instruments; or

(iv) section 31 of the Income Tax Act.

[Sub-s. (4) added by s. 51 (c) of Act 23 of 2015]"

99. The TAA came into force on 1 October 2012,[64] subject to a few stipulated exceptions. Prior to that, an approximately equivalent but differently worded provision, section 79 of the ITA, applied. It provided in relevant part as follows:

"***Additional assessments***

(1) If at any time the Commissioner is satisfied—

(a) that any amount which was subject to tax and should have been assessed to tax under this Act has not been assessed to tax; or

(b) that any amount of tax which was chargeable and should have been assessed under this Act has not been assessed; or

(c) …,

[64] In terms of Annexure A to Proclamation 51 in *Government Gazette* 35687.

he shall raise an assessment or assessments in respect of the said amount or amounts … : Provided that the Commissioner shall not raise an assessment under this subsection—

(i) after the expiration of three years from the date of the assessment (if any) in terms of which any amount which should have been assessed to tax under such assessment was not so assessed or in terms of which the amount of tax assessed was less than the amount of such tax which was properly chargeable, unless—

(aa) the Commissioner is satisfied that the fact that the amount which should have been assessed to tax was not so assessed or the fact that the full amount of tax chargeable was not assessed, was due to fraud or misrepresentation or non-disclosure of material facts; or

(bb) the Commissioner and the taxpayer agree otherwise prior to the expiry of that three year period; …"

100. Quite clearly the Commissioner is entitled, both in terms of section 99 of the TAA and in terms of section 79 of the ITA, to issue additional assessments after the expiration of a period of three years from the date of assessment if the amount which should have been assessed to tax was not so assessed as a result of fraud, misrepresentation or non-disclosure of material facts.[65]

101. In dealing with the issue of which regime applies (the ITA or the TAA), three questions are addressed. They are the following.

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[65] There are some differences in the wording of sections 99 of the TAA and 79 of the ITA, which are highlighted below. But for present purposes they are not relevant for the discussion which follows immediately.

101.1. First, does section 99 of the TAA apply or does section 79 of the ITA apply or do both provisions apply? It seems that section 99 of the TAA is the operative section.

101.2. Secondly, does the reference to misrepresentation and non-disclosure in section 99(2)(a) include innocent and negligent misrepresentation, and innocent and negligent non-disclosure? It seems that any misrepresentation or non-disclosure suffices.

101.3. Thirdly, in the absence of any jurisdictional fact such as "*to the satisfaction of the Commissioner*" that obtained under section 79 of the ITA, is SARS required under section 99 of the TAA first to satisfy itself: i) that there was fraud, or misrepresentation, or material non-disclosure, and ii) that this was causally related to the full amount of the tax chargeable not being assessed, before SARS can issue an assessment that goes beyond the three years described in section 99(1)(a)? It seems that what is required is a causal connection between the fraud, misrepresentation and non-disclosure, and the failure to assess.

102. Each of these questions are addressed in detail below.

Does section 99 of the TAA or section 79 of the ITA apply, or both?

103. Section 99(1)(a) provides that "[a]*n assessment may not be made in terms of this Chapter … three years after the date of assessment of an original assessment by SARS*".

104. The TAA became operative on 1 October 2012 ("*the effective date*"). The three-year period of limitation for the issue of further and additional assessments must be determined by reference to the date of issue of the original assessment, and section 99 applies from the effective date. This

statement is uncontentious, but the precise meaning is unclear. There are at least two possible scenarios:

104.1. In the first instance it could mean that section 99 of the TAA applies only when SARS issues an additional assessment after 1 October 2012, irrespective of whether the original assessment was issued prior to that date or thereafter (provided that the additional assessment is issued no later than three years after the date of the original assessment). On this approach:

104.1.1. the effective date is linked to the date of the issue of the additional assessment;

104.1.2. section 99 can then be said to have a retrospective effect because it potentially applies to the original assessments (and events which have already occurred) in relation to years that preceded the effective date (up to a maximum period of three years, unless there is fraud, misrepresentation or non-disclosure); and

104.1.3. only section 99 applies because (the repealed) section 79 of the ITA is effectively rendered nugatory with no scope for its application;[66]

("the retrospective interpretation")

104.2. Alternatively, and in the second instance, it could mean that section 99 of the TAA applies only in relation to an original assessment that was issued after 1 October 2012, provided SARS issues an additional assessment within three years thereof. On this approach:

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66 The original assessment could well have been made under section 79.

104.2.1. the effective date is linked to the date of issue of the original assessment; and

104.2.2. section 99 has no retrospective application at all, it only applies prospectively to original (and, logically, additional) assessments that are issued after the effective date. [67]

("the prospective interpretation").

105. The question arises as to which interpretation applies: the retrospective or the prospective interpretation? In considering this question, the point of departure is the issue of retrospectivity and the rule of law. Thereafter the difference between strong and weak retrospectivity is considered.

106. The rule of law is a foundational pillar of South Africa's constitutional democracy.[68] In Pharmaceutical Manufacturers Assoc of SA: In re *Ex parte* President of the RSA Chaskalson P quoted with approval[69] the following exposition of the rule of law:

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67 Section 79 of (the repealed) ITA would still have a role to play: it would apply in relation to years in respect of which the original assessments were issued prior to the effective date (and in relation to which additional assessments are now being sought to be issued). This situation might arise, for example, where there has been an original assessment under section 79 of the ITA before the operation of the TAA, but in respect of which SARS is entitled to issue additional assessments in terms of section 99 of the TAA after the effective date.

68 Section 1 of the Constitution provides in relevant part that –

> *"[t]he Republic of South Africa is one, sovereign, democratic state founded on the following values:*
>
> *(a) …*
>
> *(b) …*
>
> *(c) supremacy of the constitution and the rule of law*" (emphasis added).

Section 2 of the Constitution provides that the "*Constitution is the supreme law of the Republic; law or conduct inconsistent with it is invalid.*"

Read together, these two constitutional provisions form the edifice of the rule of law which governs the exercise of all public power.

69 2000 (2) SA 674 (CC) (2000 (3) BCLR 241) at para 39.

> "(T)*he standards applied by the courts in judicial review must ultimately be justified by constitutional principles, which govern the proper exercise of public power in any democracy. This is so irrespective of whether the principles are set out in a formal, written document. The sovereignty or supremacy of Parliament is one such principle, which accords primacy to laws enacted by the elected Legislature. The rule of law is another such principle of the greatest importance. It acts as a constraint upon the exercise of all power. The scope of the rule of law is broad. It has managed to justify - albeit not always explicitly - a great deal of the specific content of judicial review, such as the requirements that laws as enacted by Parliament be faithfully executed by officials; that orders of court should be obeyed; that individuals wishing to enforce the law should have reasonable access to the courts; that no person should be condemned unheard, and that power should not be arbitrarily exercised. In addition, the rule of law embraces some internal qualities of all public law: that it should be certain, that is ascertainable in advance so as to be predictable and not retrospective in its operation; and that it be applied equally, without unjustifiable differentiation*"[70] (emphasis added).

107. The Constitutional Court has affirmed the above characteristics of the rule of law.[71] The decision of that court in Veldman v The DPP: (WLD)[72] is particularly instructive. The question before the Constitutional Court was whether the retrospective application of legislation by the trial court was in any way

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70 De Smith, Woolf & Jowell *Judicial Review of Administrative Action 5ed* at 14-15.

71 See, *inter alia*: Pharmaceutical Manufacturers Assoc of SA: In re Ex p President of the RSA 2000 (2) SA 674 (CC) (2000 (3) BCLR 241) per Chaskalson P at para 40; Dawood v Minister of Home Affairs; Shalabi v Minister of Home Affairs; Thomas v Minister of Home Affairs 2000 (3) SA 936 (CC) (2000 (8) BCLR 837) per O'Regan J at para 47; and President of the RSA v Hugo 1997 (4) SA 1 (CC) (1997 (1) SACR 567; 1997 (6) BCLR 708) per Mokgoro J at para 102.

72 2007 (3) SA 210 (CC) at para 26. See also the more recent decision of the Constitutional Court in Masiya v DPP, Pretoria (Centre for Applied Legal Studies, Amici Curiae) 2007 (5) SA 30 (CC) at para 55.

unconstitutional. Mokgoro J, writing for the majority of the Constitutional Court,[73] held that –

> "*[g]enerally, legislation is not to be interpreted to extinguish existing rights and obligations. This is so unless the statute provides otherwise or its language clearly shows such a meaning. That legislation will affect only future matters and not take away existing rights is basic to notions of fairness and justice which are integral to the rule of law, a foundational principle of our Constitution. Also central to the rule of law is the principle of legality which requires that law must be certain, clear, and stable. Legislative enactments are intended to 'give fair warning of their effect and permit individuals to rely on their meaning until explicitly changed*'" [74] (underlining added).

108. Having described the touchstone of fairness used by our courts to assess retrospective legislation, the meaning of retrospectivity is now considered; more particularly, the question of whether section 99 of the TAA is "retroactive" or "retrospective" is engaged.

109. The terminology is sometimes confusing and it is not always easy to discern what is meant by the language employed. Generally, the term or expression "retroactive" is used to denote retrospectivity in the strong sense whilst the expression or term "retrospective" is used to denote retrospectivity in the weaker sense. Both these concepts were lucidly described by the SCA in National Director of Public Prosecutions v Carolus and Others,[75] at pp 1138-1139, paras 33-35 where the following was stated:

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[73] Moseneke DCJ, Sachs J, Skweyiya J and Van der Westhuizen J concurred in the judgment of Mokgoro J.

[74] At para 26.

[75] 2000 (1) SA 1127 (SCA).

“”[33] In the Transnet case supra at 7B-D, it was pointed out that a distinction is made in the case law between ‘”true” retrospectivity (ie where an Act provides that from a past date the new law shall be deemed to have been in operation) and cases where the question is merely whether a new statute or an amendment of a statute interferes with or is applicable to existing rights’. Reference was then made to a number of decisions of this Court, starting with Shewan Tomes & Co Ltd v Commissioner of Customs and Excise 1955 (4) SA 305 (A) at 311. ‘True’ retrospectivity was described (at 7E) as being ‘strong’, whilst the adjective ‘weaker’ was applied to retrospectivity in the second sense as it is used in our case law.

[34] In Benner v Canada (Secretary of State) (1997) 42 CRR (2d) 1 (SCC), a decision of the Supreme Court of Canada, Iacobucci J referred (at 17) to the fact that the terms ‘retroactivity’ and ‘retrospectivity’ can be confusing and he quoted with approval definitions of the two terms given by the well known Canadian writer on the interpretation of statutes, Elmer A Driedger, in an article in (1978) 56 Canadian Bar Review 264 at 268-9 as follows: ‘A retroactive statute is one that operates as of a time prior to its enactment. A retrospective statute is one that operates for the future only. It is prospective, but it imposes new results in respect of a past event. A retroactive statute operates backwards. A retrospective statute operates forwards, but it looks backwards in that it attaches new consequences for the future to an event that took place before the statute was enacted. A retroactive statute changes the law from what it was; a retrospective statute changes the law from what it otherwise would be with respect to a prior event.’

[35] In terms of this terminology the expression ‘retroactivity’ is used for retrospectivity in the ‘strong’ sense while the express ‘retrospectivity’ is reserved for what is described as retrospectivity in the ‘weaker’ sense.

[36] It appears clearly from the many cases on the point, both in our law and in overseas jurisdictions, that the basis of the presumption against retrospectivity (in the strong and weak senses) is what Stevens J described, when giving the opinion of the United States Supreme Court in Landgraf v USI Film Products et al. 511 US 244 (1994) at 265 as 'elementary considerations of fairness [which] dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly.'"

110. To similar effect is the judgment of Malan JA in Mankayi v Anglogold Ashanti[76] where the following was stated:

> "*It is clear that COIDA is not a retrospective statute in the strong sense, i.e retrospective 'where an Act provides that from a past date the new law shall be deemed to have been in operation'. This is not the issue. The question to be posed is, rather, whether s.35 of COIDA was intended to interfere prospectively with rights that existed on the day it came into force. It seems to me that COIDA is a statute that operates forwards but looks backwards in that it attaches consequences for the future to an event that took place before the statute was enacted.*"

111. Having regard to the touchstone of fairness in assessing retrospective legislation, and the difference between strong retrospectivity ("retroactive") and weak retrospectivity ("retrospective"), it appears that the retrospective interpretation rather than the prospective interpretation is the better one for at least the following reasons:

    111.1. first, it seems that section 99 operates retrospectively in the weaker sense, and not retroactively. In other words, it is forward looking (in that it regulates additional assessments issued after enactment of section 99), but might operate to a limited extent with reference to

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[76] 2010 (5) SA 137 (SCA) at para 47.

conduct that may have occurred before the enactment of section 99 of the TAA (i.e. the issue of original assessments pre-October 2012);

111.2. second, the focal point and content of both section 79 of the ITA and section 99 of the TAA is in relation to additional assessments, and not original assessments. The retrospective interpretation maintains that focal point;

111.3. third, this retrospective interpretation does not impair or extinguish any existing or vested rights and obligations and consequently it cannot be said to occasion any unfairness to a taxpayer:

111.3.1. any additional assessments that were raised prior to the effective date were raised and are dealt with in accordance with section 79 of the ITA and remain unaffected by section 99 of the TAA,

111.3.2. therefore, to the extent that section 79 of the ITA can be said to have vested any rights and/or obligations it did so only in relation to additional assessments, and these rights and/or obligations were not in any way impaired or extinguished by section 99 of the TAA,

111.4. fourth, the retrospective interpretation ensures that all further audits are consistently treated and are subjected to the same constraints of section 99 of the TAA irrespective of whether the original assessment (issued 3 years previously) was issued prior to or after the effective date.

Are innocent and negligent misrepresentation and non-disclosure included in section 99(2)(a)?

112. SARS might contend that an FBE status was granted in circumstances where there was a misrepresentation or non-disclosure of material facts.

113. Section 99 does not qualify such misrepresentation or non-disclosure as innocent or negligent or fraudulent. Accordingly, on an ordinary grammatical reading any misrepresentation or non-disclosure, including an innocent or negligent one, will fall within its purview. This also accords with one of the purposes of the section, which is to enable SARS to collect taxes that are properly payable by the taxpayer.[77]

114. Furthermore this interpretation is reinforced by the wording employed in section 99(2)(a) which lists the following three possible reasons for SARS going beyond the three year limitation for raising additional assessments, namely fraud, misrepresentation and non-disclosure of material facts.

    114.1. The word 'fraud' in this context includes fraudulent misrepresentation and fraudulent non-disclosure.

    114.2. The clear wording suggests that the legislature intended to impose lesser thresholds (than fraud) which SARS has to meet in order to raise additional assessments beyond the three-year period.

115. This interpretation is also supported by the context of section 99.

    115.1. Section 99(2)(b) expressly sets out fraud, "*intentional or negligent misrepresentation*" and "*intentional or negligent non-disclosure of*

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77 Comm, SARS v Brummeria Renaissance (Pty) Ltd and Others 2007 (6) SA 601 (SCA) at para 26.

material facts" as grounds for SARS overriding the three-year limitation period prescribed in section 99(1) in the case of self-assessment.

115.2. The difference in wording demonstrates the clear intention of the legislature.

116. Finally, any doubt as to the true intention of the legislature is dispelled by the decision in ITC 1518[78] where it was held in relation to the similarly worded section 79 of the ITA, that it is irrelevant that the non-disclosure of material facts was unintentional.

Is there an evidential and causal threshold required under section 99 of the TAA?

117. In SIR v Trow[79] the Appellate Division held that before the Commissioner can rely on section 79 of the ITA, he had to show:

117.1. a causal connection between, on the one hand, the fraud, misrepresentation or non-disclosure of material facts and, on the other hand, the failure of SARS to assess tax, and

117.2. there was some evidence that the Commissioner satisfied himself in this regard.[80]

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78 (1989) 54 SATC 113 at p 137.

79 1981 (4) SA 821 (A) at 825.

80 In the Trow case the Appellate Division referred with approval to Natal Estates Ltd v SIR 1975 (4) SA 177 (A) at 208 where it was held that in relation to section 79 of the ITA, the Commissioner had to be satisfied that fraud, misrepresentation and/or material non-disclosure had taken place and that the Commissioner could not raise an additional assessment unless he properly informed the taxpayer of that fact that he was satisfied, and of the basis of his satisfaction.

However, no matter the subjective framing of the provision, there would now have to be reasonable grounds for the Commissioner's satisfaction. Our law no longer accepts the subjective satisfaction of a decision-maker as compliance with legislative prescripts – however permissively the relevant provisions are framed. The Constitutional Court declared

118. Although this line of case law dealt with former versions of section 79 which expressly included the jurisdictional fact that the Commissioner must be so satisfied, these dicta are still relevant and applicable to a proper interpretation of section 99 of the TAA (where such a jurisdictional fact of the Commissioner's "satisfaction" is absent). Similar if not identical threshold considerations would apply in interpreting and applying section 99 of the TAA. Even though section 99 is not identically worded to section 79 of the ITA, it does not follow that it is to be applied in any different manner[81] or in a manner which would create

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as much in Walele v City of Cape Town and Others 2008 (6) SA 129 (CC) at para 60 where it held that this: "*is no longer the position in our law. More is now required if the decision-maker's opinion is challenged on the basis that the subjective precondition did not exist. The decision-maker must now show that the subjective opinion it relied on for exercising power was based on reasonable grounds.*"

The High Court noted in Free Market Foundation v Minister of Labour and Others 2016 (4) SA 496 (GP) at para 91 that the effect of the pronouncement in *Walele* is "*to make all jurisdictional facts objectively justiciable, whatever their wording*".

81 In Metcash Trading Limited v Commissioner for the South African Revenue Service and Another 2001 (1) BCLR 1 (CC) at para 44 a unanimous Constitutional Court, per Kriegler J, held that –

> "*[a]lthough those cases [cited earlier in the judgment] concerned income tax and the Income Tax Act, not specifically VAT and the Act, there is no reason to doubt the applicability of the jurisdictional principle in the present – analogous – context. Indeed, it is evident from a comparison of the sections that the drafters of the Act borrowed freely from the Income Tax Act, the terminology of which is frequently echoed*."

But the position is not free from dispute.

In Smith v CIR 1964 (1) SA 324 (A) a point in issue was the interpretation of the phrase "*which has the effect of avoiding . . . liability for any tax . . . on income*" in s 90 of Act 31 of 1941 as substituted by s 17 of Act 78 of 1959. On the basis of the decision in Ex parte Minister of Justice: In re R v Bolon 1941 AD 345 at 359 counsel argued that it must be presumed that the legislature, in repeating substantially the same words, must have intended them to mean the same. Steyn CJ rejected the argument, saying that a comparison of s 90 as enacted in 1941, and the section in its then current form disclosed obvious and significant differences.

Similarly, when Australia abandoned certain provisions in the Income Tax Assessment Act of 2006 and replaced it with new provisions of that Act, the High Court (in FCT v Spotless Services Ltd (1996) 186 CLR 404 at 414, 96 ATC 5205, quoting a phrase used in Ex parte Professional Engineers' Association (1959) 107 CLR 208 at 276) warned that:

> "*Part IVA is to be construed and applied according to its terms, not under the influence of 'muffled echoes of old arguments' concerning other legislation.*"

The Constitutional Court decision in Metcash (above) is more relevant and reflective of contemporary views regarding legal interpretation. Indeed, it is unrealistic to expect that the provisions of the TAA such as section 99 can be interpreted *de novo* and free of the "*muffled echoes*" of the broadly equivalent repealed provisions of the ITA given that many identical terms and phrases and markedly similar provisions of the latter statute have been incorporated into the TAA.

uncertainty for the taxpayer or in a manner contrary to the purport of the TAA. The reasons for this are as follows:

118.1. First, a taxpayer would be unable to meaningfully and properly respond to any additional assessment in the absence of knowledge as to the reason it has been raised. A bald assertion by SARS to the effect that the taxpayer acted fraudulently or committed a misrepresentation or material non-disclosure would not suffice.[82] There must be some sort of minimal evidential basis before[83] the Commissioner can issue the additional assessment.

118.2. Secondly, if the position were otherwise, the following consequences, both inequitable and plainly not contemplated by the legislature, would arise. SARS would be entitled to issue additional assessments where the three-year period (contemplated by both sections 99 of the TAA and 79 of the ITA) had already elapsed, without any evidence that the taxpayer had acted either fraudulently or was guilty of a misrepresentation or non-disclosure ("the impugned conduct"). In addition, SARS would be entitled to demand general information from the taxpayer relating to any period extending beyond the three year

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82 In Natal Estates v Secretary for Inland Revenue 1975 (4) SA 177 (AD) at 208 D-G, the then Appellate Division made it clear that any allegation by revenue of fraud against the taxpayer was most serious (the court described it as "*a grave and ugly imputation*") which heightened the degree of disclosure required to be made to the taxpayer.

83 *Contra* ITC 1425 1985) 49 SATC 157 (C) at 162, where the taxpayer argued that the Commissioner must arrive at his satisfaction *before* he issues an additional assessment. Grosskopf J rejected this contention, holding that the Commissioner is still in compliance with s 79(1) where his satisfaction regarding fraud, misrepresentation or non-disclosure of material facts is reached only *after* an additional assessment has already been issued. The court instead held that in terms of section 79(1), as it then read, the Commissioner must be 'satisfied' as required by the said qualification at any time before attempting to enforce the relevant additional assessment This finding was not regarded by Grosskopf J as being inconsistent with the above Appellate Division decision in Natal Estates Ltd v SIR).

That decision can be distinguished at least on the basis that it was determined in a pre-constitutional era, prior to the application of the Constitution with its emphasis on the principles of administrative justice against which the exercise of all public power has to be tested.

prescriptive period[84] with a view to determining whether or not the impugned conduct had taken place, or whether there was any causal link between the impugned conduct on the one hand and the failure on the part of SARS to assess the full tax chargeable without any limitation of the period under review on the other hand.[85]

118.3. In other words, without this limitation and without requiring SARS to be satisfied on a reasonable evidentiary basis that the impugned conduct has taken place and that there is a causal link between the failure to assess and the impugned conduct, there is room for abuse and well-established principles of finality, fairness to the taxpayer and public interest considerations are eroded.

118.4. Thirdly, the objection procedure described above (dealt with in the second issue) requires that information be disclosed to a taxpayer on request. Furthermore, the common law principles of natural justice and legality,[86] quite apart from the provisions of the Promotion of Administrative Justice Act 3 of 2000 ("PAJA"),[87] require that such notice

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84 In ITC 1691 (62 SATC 504) at 507 (Zimbabwe Special Court) in a similarly worded provision it was noted that the legislature gives the Commissioner a period of grace to correct the mistakes of his officials, and that period is three years: what is not discovered within that period cannot be remedied, unless of course it was induced by fraud, misrepresentation or wilful non-disclosure of facts.

85 For the purposes of carrying out its duties and for the purpose of the administration of the TAA in relation to a taxpayer, SARS may request the taxpayer or any other person to submit relevant material that SARS requires in terms of *inter alia* section 46 of the TAA.

86 These common law principles imposes a duty on a functionary who exercises a public power to provide reasons for its act or decision. See, for example: Wessels v Minister of Justice and Constitutional Development 2010 (1) SA 128 (GNP) at 141I–J.

87 Section 5(2) of the PAJA explicitly provides that a person whose rights have been materially and adversely affected by administrative action is entitled to be given written adequate reasons for the action. What are "adequate" reasons, has been dealt with above in this research report (see: Minister of Environmental Affairs and Tourism v Phambili Fisheries 2003 (6) SA 407 (SCA) at para 40, per Schutz JA).

Where an administrator fails to provide reasons for administrative action taken by him, a statutory presumption is triggered in terms of s 5(3) of PAJA which provides that:

"*If an administrator fails to furnish adequate reasons for an administrative action, it must, subject to subsection (4) and in the absence of proof to the contrary, be presumed in any*

and reasons be given to a taxpayer when SARS is exercising its quintessentially public power. Therefore, no formal reading-in of words or obligations to section 99 of the TAA is required. This is because, in accordance with such statutory and common law obligations, in order for SARS to assess outside the three-year period:

118.4.1. there must be a *prima facie* evidential basis for SARS' to form the view that:

118.4.1.1. the foundational event/s of fraud and/or misrepresentation and/or non-disclosure of material facts have occurred, and

118.4.1.2. such event/s are causally linked to its failure to assess the full amount of tax chargeable; and

118.4.2. SARS must have communicated such basis to the taxpayer in reasonably sufficient detail in order to enable a taxpayer to understand the decision taken and to take whatever steps deemed appropriate in response thereto.

CONCLUSION

119. The views in this research report may be summarized as follows.

120. The ability of the Commissioner to enforce section 9D turns largely on his ability

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proceedings for judicial review that the administrative action was taken without good reason."

It is noted that the definition of "*administrative action*" under PAJA requires that such action has "*a direct, external legal effect*". Only a final decision (including a proposed final decision) by SARS will fulfill these criteria (*cf* Currie, I and Klaaren, J, *The Promotion of Administrative Justice Act Benchbook* (2001) at 82, para 2.34. No proceedings in terms of PAJA can be brought in anticipation of a final decision. Therefore, for example, where SARS raises queries with a taxpayer regarding his tax return, with a view to issuing an additional assessment, those queries do not trigger any right on the part of the taxpayer to invoke PAJA to forestall the issuing of the additional assessment.

to effectively request information from the taxpayer. Section 46 of the TAA provides SARS with the requisite procedural powers to request information to ensure that *inter alia* section 9D is effectively enforced.

120.1. Section 46 of the TAA can be applied retrospectively to years of assessment that pre-date the commencement of the section.

120.2. Section 46 requires SARS to give proper notice to the taxpayer, specifying the relevant material which it requires and which is held or kept by a connected person located outside the Republic, that material is to be furnished within ninety days from the request and the request further must set out the consequences which flow from a failure to comply with the SARS's request.

120.3. A failure by SARS to comply with the requirements of section 46 in any of the above respects does not necessarily result in a section 46 notice being a nullity. Much turns on the facts of each case, and whether the aspect of non-compliance defeats the aim and scope of the particular provision of section 46.[88] In any event, in at least some respects a defective notice would have only a dilatory effect because SARS could quite easily rectify the defects in the notice.

120.4. Section 46(9) provides that if the taxpayer fails to provide the material, then the material may not be produced by the taxpayer in any subsequent proceedings, unless a competent court directs otherwise on the basis of circumstances outside the control of the taxpayer. The remedy in section 46(9) is not exhaustive. There is room for the contention that failure to comply with section 46 may well lead to a criminal sanction provided that there was willful non-compliance with the request and there was no just cause for such non-compliance.

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88 See Standard Bank of South Africa Ltd v Fob and Others 2003 (2) SA 692 (LC) at 696, paras 5 and 6.

121. If it is found that a company has its place of effective management in South Africa, it generally cannot be said to be "*resident*" in another country, it cannot be said to be a "*foreign company*", and it cannot be said to be a CFC. In such an instance, the questions of: i) the company's "*country of residence*" as a foreign company, and ii) whether or not that company benefits from an FBE under section 9D of the ITA, consequently do not arise.

122. SARS exercises a discretion in making an additional assessment. The exercise of such discretionary power constitutes administrative action that is subject to the constraints set out in the common law, enshrined in PAJA (which itself gives effect to the constitutional right to just administrative action), and encapsulated in the Tax Court Rules.

123. Accordingly, the raising of an additional assessment must be based on proper grounds for believing that there is undeclared income or, as in the present case, that a CFC is no longer entitled to an FBE exemption. SARS must provide the taxpayer with grounds for assessment with sufficient and reasonable detail in order to enable the taxpayer to understand the basis of and reason for such assessment and respond appropriately thereto.

124. Any appeal before the tax court is to be approached on the basis that the onus is on the taxpayer to show, on a preponderance of probability, that the decisions of SARS against which it appeals are wrong.

125. There is an arguable case for contending that the active management of service providers and agents may constitute the primary operations for purposes of determining whether an FBE arises in relation to a CFC.

126. Should it be found that a CFC did not have an FBE in respect of previous years of assessment:

    126.1. SARS could issue an additional assessment in terms of section 92 read

with section 99 of the TAA provided that the additional assessment is issued no later than three years after the date of the original assessment (and irrespective of whether the original assessment was issued prior to or after 1 October 2012);

126.2. SARS could issue an additional assessment in terms of section 92 read with section 99 of the TAA beyond the three-year period described above in circumstances where:

126.2.1. there is a reasonable evidential basis for SARS' view that:

126.2.1.1. the taxpayer committed a fraud and/or misrepresentation and/or non-disclosure of material facts (including a negligent or innocent misrepresentation and a negligent or innocent material non-disclosure), and

126.2.1.2. such fraud and/or misrepresentation and/or non-disclosure of material facts is causally linked to SARS's failure to assess the full amount of tax chargeable; and

126.2.2. SARS has communicated such basis (and the causal link) to the taxpayer in reasonably sufficient detail in order to enable the taxpayer to understand the decision taken and to take whatever steps deemed appropriate in response thereto.

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Tax Administration Act No. 28 of 2011

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