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THE FOREIGN BUSINESS ESTABLISHMENT EXEMPTION IS NOT FOR OUTSOURCED SERVICES

SUMMARY

Controlled foreign company (CFC) provisions in the *Income Tax Act* provide for the imputation of the net income of a foreign company to its resident participants in proportion to their participation in the foreign company. However, income that is attributed to a foreign business establishment of the CFC is exempted from the imputation. In *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* [2023] ZASCA 10, a South African tax resident had a CFC in Ireland that outsourced some of its operations to third parties outside of Ireland. The resident sought to claim the foreign business establishment exemption in respect of all its CFC income. The South African Revenue Service disallowed the exemption in respect of all CFC income. The Tax Court allowed the exemption, and the Supreme Court of Appeal disallowed the exemption on the basis that the CFC outsourced its primary operations as contained in the CFC's operating license. This note concludes that the Supreme Court of Appeal erred in focusing on the operations that the CFC was licensed to conduct, as opposed to what it actually conducted. It also finds that the outsourcing of some of the operations should not disqualify the entire operations of the CFC from the exemption. It further canvasses the future of the exemption in light of the introduction of the global minimum tax.

1. INTRODUCTION

For a country to tax a person, a sufficient justifiable link needs to exist between the person and the country.[1] Ordinarily, in terms of South African law, persons are subject to tax in South Africa if they are resident in South

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1 Arnold & McIntyre 2002:15; Olivier & Honiball 2011:9-10.

Africa or on income that is sourced in South Africa.[2] These nexus rules are internationally applied, although they vary in the detail in various countries. One exception to this nexus rule is the controlled foreign company (CFC) regime that allows a country to tax income of foreign companies that are owned, or partially owned by residents of the country.

South Africa introduced controlled foreign company rules in 2002. An important facet of the CFC rule is to address the taxation of income earned by South African-owned foreign companies and other South African-owned foreign entities of a similar nature. Without CFC legislation, South African residents could avoid tax simply by shifting their income to foreign entities, and the tax on such income would be deferred, as the income earned by foreign entities would be taxed only once repatriated as a dividend. The failure to impose immediate tax is of great significance because taxpayers often delay repatriation for years or never repatriate funds at all.[3] CFC rules respond to the risk that taxpayers, with a controlling interest in a foreign subsidiary, can strip the tax base of their country of residence and, in some cases, other countries by shifting income into a CFC.[4]

The South African CFC regime broadly targets two sets of activities, namely mobile income that mainly includes income of a passive nature (even if indirectly arising from, or associated with a business operation) and diversionary income (income activities susceptible to transfer pricing).[5] Income attributable to a foreign business establishment is exempted from the CFC imputation rules.

This case note analyses the impact of the Supreme Court of Appeal case of *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (hereinafter referred to as "*Coronation*") on the foreign business establishment exemption, and its impact on the future of the exemption.

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2 See *Income Tax Act* 58/1962: sec. 1 definition of "gross income" read with the sec. 1 definition of "resident"; *Cohen v CIR* 1946 AD 174; *CIR v Kuttel* 1992 (3) SA 242 (A); Van der Merwe 2006:121-137; *AB LLC and BD Holdings LLC v CSARS* [2015] 77 SATC 349; Legwaila 2016:822-833.

3 National Treasury "National Treasury's Detailed Explanation to Section 9D of The Income Tax Act" 1, https://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf (accessed on 29 March 2023).

4 The OECD emphasises that without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation; see OECD "Inclusive framework on base erosion and profit shifting: Action 3 Controlled foreign company", https://www.oecd.org/tax/beps/beps-actions/action3/ (accessed on 19 April 2023).

5 Davis Tax Committee "Addressing base erosion and profit shifting in South Africa", Interim Report par. 4.2.2, https://www.taxcom.org.za/docs/New_Folder3/5%20BEPS%20Final%20Report%20-%20Action%203.pdf (accessed on 28 March 2023).

2. THE LAW

CFC provisions are broad and extensive and, for that reason, the background given in this note relates only to the law as it directly impacts on the case or the analysis thereof. Sec. 9D of the *Income Tax Act*[6] includes, in the income of a resident, the net income of a CFC, in which the resident directly or indirectly holds participation rights. A CFC is any foreign company[7] where over 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or over 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons who are residents.[8]

Participation rights in relation to a foreign company is the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company. However, in the case where no person has such a participation right in the foreign company or no such rights can be determined for any person, participation rights in the CFC is the right to exercise any voting rights in that company.[9]

There are specific exclusions for listed companies: CFCs whose participation rights are held by other CFCs and collective investment schemes.[10] If a company is a CFC, its net income is included in the income of residents that hold participation rights in it in proportion to their rights in the CFC. The income included is the net income of the CFC for the foreign tax year that ends during the resident's tax year.[11] The net income of a CFC, in respect of a foreign tax year, is an amount equal to the taxable income of that company determined in accordance with the provisions of the *Act* as if that CFC had been a taxpayer and as if that company had been a resident for purposes of the definition of gross income.[12]

6 *Income Tax Act* 58/1962. Please note that references to "the *Act*" or to sections refer to the *Income Tax Act* or sections of the said *Act*, unless specifically stated or the context indicates otherwise.

7 Foreign company is defined in sec. 1 of the *Act* as a company that is not a resident.

8 Definition of 'controlled foreign company' in sec. 9D of the *Act*. Headquarter companies are totally excluded from the application of sec. 9D, to the effect that, if a headquarter company holds participation rights in a foreign company, its holding is excluded from the calculation of the 50 per cent holding that is required for a foreign company to be a CFC. And if the foreign company is a CFC regardless of the participation rights of the headquarter company the net income of the CFC would not be imputed to the headquarter company.

9 See sec. 9D(1) definition of "participation rights".

10 See proviso to the definition of "controlled foreign company" in sec. 9D of the *Act*.

11 Sec. 9D(9)(2)(a)(i) of the *Act*.

12 Definition of "net income" in sec. 9D(1) of the *Act*.

3. FOREIGN BUSINESS ESTABLISHMENT EXEMPTION

Sec. 9D(9) of the *Act* excludes, in the determination of the net income of a CFC, any income that is attributable to a foreign business establishment (FBE) of the CFC. It is important to note that the presence of an FBE is only the first requirement in a two-step test, which must be met in order for a CFC to exclude the income of the CFC on the basis of the FBE exemption. The second step is to determine whether the specific amount is attributable to the FBE of that CFC.[13]

An FBE is defined as follows:[14]

> "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.

I hasten to emphasise that all the requirements contained in (i) to (v) of the above definition need to be satisfied for a CFC to have an FBE, as they are connected with the conjunction "and". To determine whether there is a fixed place of business, a CFC may take into account the utilisation of structures, employees, equipment, and facilities of any other company subject to the following three conditions:

13 ENS Africa "Foreign business establishments", https://www.saica.co.za/integritax/2016/2546._Foreign_business_establishments.htm (accessed on 23 March 2023).

14 Definition of "foreign business establishment" in sec. 9D(1) of the *Act*.

a. The company whose structures, employees, equipment, and facilities are used must be subject to tax in the country in which the fixed place of business of the CFC is located by virtue of residence, place of effective management or other criteria of a similar nature.[15]

b. The company whose structures, employees, equipment, and facilities are used must form part of the same group of companies as the CFC.[16]

c. The structures, employees, equipment, and facilities can only be taken into account to the extent that they are located in the same country as the fixed place of business of the CFC.[17]

In determining the amount that should not be taken into account in determining the net income of the FBE and whether that amount is attributable to the FBE, a two-step process is followed.[18] First, the FBE is treated as if that FBE 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 CFC, of which the FBE is an FBE.[19] Secondly, that determination is 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.[20]

4. THE CASE OF *CORONATION*

4.1 Facts

The taxpayer was Coronation Investment Management SA (Pty) Ltd (CIMSA), a company that was tax resident in South Africa. It was a member of the Coronation Group of companies. CIMSA was a 90 per cent subsidiary of Coronation Fund Managers Limited, and the holding company of Coronation Management Company and Coronation Asset Management (Pty) Ltd (CAM), which were both registered for tax in South Africa. CIMSA was also the 100 per cent holding company of CFM (Isle of Man) Ltd that was tax resident in Isle of Man. CFM (Isle of Man) Ltd was the 100 per cent owner of Coronation Global Fund Managers (Ireland) Limited (CGFM) that was tax resident in Ireland and Coronation International Ltd (CIL) that was tax resident in the United Kingdom.

15 Par. (*aa*) of the proviso to sec. 9D(1) definition of "foreign business establishment".
16 Par. (*bb*) of the proviso to sec. 9D(1) definition of "foreign business establishment".
17 Par. (*cc*) of the proviso to sec. 9D(1) definition of "foreign business establishment".
18 Sec. 9D(9)(b) of the *Act*.
19 Sec. 9D(9)(b)(i) of the *Act*.
20 Sec. 9D(9)(b)(ii) of the *Act*.

From the above structure, it is clear that CFM (Isle of Man) Ltd was a CFC of CIMSA through CIMSA's direct holding of CFM (Isle of Man) Ltd. CGFM and CIL were also CFCs of CIMSA by virtue of CIMSA's 100 per cent indirect holding through CFM (Isle of Man) Ltd. The court was called upon to decide whether the activities of CGFM in Ireland qualify CIMSA for the FBE exemption. Of particular significance is that CGFM had adopted an outsource business model. The basis of the outsource business was that CGFM was in the business of fund management and it outsourced investment management functions to CAM and CIL. CGFM received fee income for the outsourced services.

It was common course that CGFM had a fixed place of business located in a country other than the Republic that is used or would continue to be used for the carrying on of the business of CGFM for a period of not less than one year in terms of par. (i) of the definition of FBE. It was also common course that the 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 in terms of par. (v) of the definition of FBE.[21] To be able to rely on the FBE exemption, CIMSA needed to prove that CGFM also satisfied the requirements of subparas. (ii)-(vi) of par. (a) of the definition of FBE. These, in the main, require that the place be suitably staffed, suitably equipped, and have suitable facilities to conduct the primary operations of that business.

CIMSA sought to claim the FBE exemption in respect of income of CGFM. The South African Revenue Service (SARS), on the other hand, denied the applicability of the FBE on the basis that CGFM did not undertake operations in Ireland sufficient to create an FBE because such operations were outsourced. The issue was, therefore, whether investment management was a primary operation of a fund management business as required in paras. (ii)-(vi) of par. (a) of the definition of FBE.

4.2 The Tax Court decision

The Tax Court made a distinction between investment management and fund management. It held that fund management is multifaceted and requires various activities, including the securing of the correct licenses; ensuring compliance with statutory, regulatory, and other laws; making broad decisions about where to invest, and deciding the amounts and when to distribute

21 On this issue, the Tax Court relied on CGFM's Transfer Pricing Report, which stated that CGFM was responsible for the overall management of the Irish Funds, including but not limited to the investment management function. The Tax Court found that the reason for creating CGFM was to generate opportunities for its investors which it could not provide in South Africa. The tax court was satisfied that CGFM had economic substance and does not merely exist on paper, and on the basis that its conduct did not amount to housing its activities in a foreign company to avoid tax in the home country on the income it produced. *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10:par. 23.

profits to investors.[22] By contrast, the court held that investment management is more one dimensional and that the actual discretionary decisions of investment managers play a relatively minor role in the overall picture of fund management.[23] Applying the income of CGFM to the distinction between fund management and investment management, the court found that the fee (or at least part thereof) arose, or was paid by clients for the management of the fund.[24] That is to say that the management of the fund was a *sine qua non* of the payment of the fee.

The court accepted that the assets under management consist of money which investors invest in collective investment schemes. According to the Tax Court, CGFM's fee income was based on the quantum of assets under management. Fees were raised on the amounts invested by individuals and apportioned to various role players. CGFM retained a portion and paid the balance to CIMSA.[25] The court stated that the relevant basis of calculating the fees is on the globular amount under management. The evidence before the Tax Court was that the fee was based on the capital contributed by the investors which occurs before any investment management takes place. Even if raising fees were the primary conduct of the company, this would still not be as a result of investment management. According to the Tax Court, fees were received by CGFM as a result of the creation and managing of a fund. "'Investors' money comprises the assets under management. The fees are not based on the profitability of the investments carried out by each individual person playing a role in the process of investment managing."[26]

While the Tax Court agreed with SARS that investment performance does have some impact on the quantum of the fee, the Tax Court also agreed with CIMSA that, while investment performance is an important part of the overall fund management business, its relative contribution to the fund management fee is limited. The confidence that investors place in the fund manager *per se* in placing its assets with the fund manager gives rise to the fee, rather than the investment management activity.[27]

The Tax Court held that, without the execution of the management function by CGFM, none of the other functions could lawfully take place. Without the existence of a license to conduct the business of making investments into the CIS, the court reasoned, CGFM would not be able to conduct business and there would be no other functions of investment management, administration,

22 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 22.
23 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 22.
24 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 24.
25 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 24.
26 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 24.
27 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 24.

custody or distribution, because CGFM was not an investment management company. It was a fund management – it was a licensed fund management company. Its license stated that it was licensed to conduct collective portfolio management. One of the functions that are carried out by a fund management company is investment management. In this instance, that function was outsourced on contract to others. On this basis, the Tax Court was satisfied that the management function performed by CGFM was the primary operation of the business of CGFM and, therefore, CGFM satisfied the requirements of an FBE in Ireland[28]

4.3 The Supreme Court of Appeal decision

The Supreme Court of Appeal (SCA) thoroughly examined the nature of the business that CGFM's license approved.[29] The court concluded that the license was limited to collective investment management. The court held that the fact that CGFM was licensed to perform collective investment management was inconsistent with CIMSA's assertion that it was not licensed to perform any investment management. The court also concluded that investment management was integral to CGFM's license as an authorised management company.[30]

The court also examined the terms of the license granted to CGFM which stated that the functions included in activity of a collective portfolio management are investment management; administration; legal and management accounting services, and marketing.[31] It then examined the regulation that made provision for outsourcing or delegating functions. Among other things, this regulation referred to the core function of investment management. From that, the court made two observations. The first was that collective portfolio management, which CGFM has been authorised to conduct, includes investment management, administration, and marketing. The second observation was that the regulations indicate that the purpose of delegation is to enhance the efficiency of the company's business. It does not detract from the business of the company, nor is it possible for delegation to alter that business. It merely entailed supervision of the core business which, in terms of the regulation, was recognised as investment management. On this basis, the court concluded that CGFM's license entailed investment management.

28 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 25.

29 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 27.

30 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 29.

31 The license, which was headed 'Authorisation of a UCITS Management Company', provided for authorisation by the Irish Financial Services Regulatory Authority of CGFM as a management company in accordance with the provisions of the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2003 as amended (see *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 27).

With regards to the primary operations of CGFM, the court referred to the Memorandum of Association and noted that the objects of CGFM include the following clauses:

- "provide for such undertakings investment management services including but not limited to financial advisory services, administration services, marketing services, placement services, brokerage services, agency services and all other services of a financial nature and generally to deal in units of the undertakings managed by the Company."
- "To carry on the business of investment and financial management including venture and development capital investment, corporate treasury management, fund management and fund administration for individuals, investment schemes or undertakings…"
- "…the Company may provide fund administration, investment advisory or management services to any fund manager appointed to an investment scheme or undertaking other than a Collective Investment Undertaking."
- In holding that CGFM could not outsource a function that it did not possess in the first place, the court reasoned that an agent cannot perform a function which does not form part of the business of the principal.[32] The court continued that[33]

> [i]f the key operations of the business have been outsourced (here, investment management), then the fixed place of business in Ireland lacks the staff and facilities to conduct those operations. If these operations are central to the business of CGFM, because they go to the very nature of what this business does, then CGFM does not conduct its primary operations in Ireland. Without the investment management operations, can it be said to conduct its primary operations in Ireland? The answer must be, 'no'.

In its final judgment, the court emphasised that its decision is based on the particular facts of the case, stating that "*[o]n these particular facts*, I conclude that the primary operations of CGFM's business (and, therefore, the business of the controlled foreign company as defined) is that of fund management which includes investment management" (emphasis added).[34] The court proceeded that, because these operations were not conducted in Ireland, CGFM did not meet the requirements for an FBE exemption in terms of sec. 9D(1). As a result, the net income of CGFM was imputed to CIMSA for the 2012 tax year in terms of sec. 9D(2).[35]

32 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 50.
33 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 52.
34 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 55.
35 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 55.

5. ANALYSIS

5.1 Functions performed

In the ordinary course of business, fund managers are responsible for the financial and operational management of their funds. This is a very broad responsibility encompassing all aspects of fund management. These responsibilities include fund oversight, establishment of internal controls at the departmental level, transaction review, and financial responsibility.[36] In *Coronation*, the court disregarded these ordinary course activities, but opted to examine the specific terms and conditions of the agreements entered into by the parties, the founding statements of the parties as well as the details of the licenses under which the parties operated, in order to determine what the primary operations of CGFM were. It is, therefore, imperative at this stage to note that the case was decided based on the specific and unique facts of the case crafted in the documents referred to and the activities undertaken by each of the parties.

The import of the license was to permit CGFM to perform functions listed therein. The question arises, therefore, as to whether, in determining the primary functions, the contents of the license should be imperious? Should the court look at the actual operations of the CFC or what the CFC is able, capable or allowed to do? The license allows one to do something. Whether they actually do it or not is not to be imposed by the license. In other words, a license does not oblige or force a person to do what the license allows the licensee to do.

It is submitted that the SCA unduly put too much emphasis on the license terms of CGFM. What the court should have considered is what CGFM, in actual fact, performed, and not merely what it was licensed to do. Often, licensees do not perform all functions that they are licensed to perform, due to many factors such as capacity, lack of capital, risk aversion, or because it outsources those functions. True, a principal cannot outsource what they do not have authority to do; however, "operations" are activities and tasks that the company actually undertakes and not what the company can undertake.

5.2 The need and importance of outsourcing

The benefits of outsourcing cannot be overstated. Studies show that outsourcing is one of the key sources for increasing a firm's performance.[37] Outsourcing allows firms to focus on their core business; it lowers production costs because specialised suppliers are used; it increases a firm's strategic flexibility to deal with technological or volume fluctuations; it helps avoid the costs associated with bureaucracy typically associated with production inside the firm, and it opens up the possibility of obtaining rents from relations with

36 Texas Tech University "10 Fund Managers responsibilities", https://www.fiscal.ttuhsc.edu/training/TrainingCenter/Top10/10FundManagerResponsibilities.pdf (accessed on 25 March 2023).

37 Quinn 1999:9-21; Domberger 1998.

suppliers.[38] The Davis Tax Committee (DTC) acknowledged the prevalence of outsourcing. It considered that outsourcing to connected persons does indeed seem suspect, but also that genuine businesses do indeed outsource activities for a variety of non-tax reasons (*e.g.* risk, employee versus contractor cost, and flexibility). Most importantly, the DTC reckoned that "outsourcing may indeed increase legitimate profitability of performance". Following these considerations, and in light of the developing focus on outsourcing, the DTC recommended that an inquiry of the tax base risks associated with outsourcing needs to be explored before some form of automatic tainting could be legislatively imposed.[39] Thus, the DTC impliedly anticipated that a proper analysis of the importance of outsourcing, the circumstances under which it is undertaken, and its importance should be considered in crafting a more suitable tax framework in the context of the FBE exemption. Thus, outsourcing should not be viewed as a ploy to avoid tax because it is important for businesses to be able to outsource. But most importantly, the outsourcing facility should not be thwarted by adverse tax implications.

5.3 Is the problem outsourcing or determining primary operations?

In the 2023 Budget Review released on 22 February 2023 (that is subsequent to the decision in *Coronation*), the National Treasury expressed the challenge with outsourcing in the context of FBE as follows:

> It has come to government's attention that some taxpayers are retaining certain management functions but outsourcing other important functions for which the CFC is also being compensated by its clients. This is against the policy rationale of the definition of a foreign business establishment. It is proposed that the tax legislation be clarified such that, to qualify as a foreign business establishment, all important functions for which a CFC is compensated need to be performed by the CFC or by the other company meeting the requirements listed above.[40]

This statement gives the impression that government does not think that the decision in *Coronation* clarified the issue of outsourcing in relation to FBE, or that the issue is wider, bigger or more complex than in *Coronation*. The statement also suggests that what needs to be clarified is the identity of the entity performing the functions. This statement misses the point that it is the identity of the operations that are primary as opposed to whether they are performed by the CFC or not. In *Coronation*, there was no dispute as to whether the operations were indeed outsourced or not, or what outsourcing meant.

38 Kotabe & Mol "Outsourcing and financial performance: A negative curvilinear effect", http://dx.doi.org/10.1016/j.pursup.2009.04.001 (accessed on 10 May 2023); Hendry 1995:218-229; Kotabe 1998:107-119.

39 Davis Tax Committee "Addressing base erosion and profit shifting in South Africa: Interim report summary of DTC report on OECD Action 3: Strengthening controlled foreign company rules", par. 4.2.2, https://www.taxcom.org.za/docs/New_Folder3/5%20BEPS%20Final%20Report%20-%20Action%203.pdf (accessed on 10 May 2023).

40 National Treasury 2023b:147.

To determine the primary operations of an enterprise that undertakes multitudes of operations, one needs to examine what other operations the enterprise undertakes, what contribution those operations make to the overall returns of the organisation, and how much effort is put in by the enterprise in undertaking those operations. "Primary" in "primary operations", according to the *Cambridge Dictionary* means "more important than anything else".[41] The "else" in the definition, reckons that there are other things done. The examination thus needs to go into the else that a fund manager, to wit, CGFM undertakes. The analysis needs to be focused specifically on the activities that the fund manager performs, in order to earn the particular item of income that is to be imputed or exempted in terms of the FBE exemption.

Whether operations are primary or not is a subjective determination. In fact, the subjectivity extends further than the primary operations. In determining whether the business is suitably equipped, staffed, and has suitable facilities, it is the nature of the business that will determine what people, equipment, and facilities are needed. And this can only be evaluated on a case-by-case basis, which is subjective.[42]

It is correct to say, as the court did, that the essential operations of the business must be conducted within the jurisdiction in respect of which exemption is sought. The SCA proceeded to state that "[w]hile there are undoubtedly many functions which a company may choose to legitimately outsource, it cannot outsource its primary business. To enjoy the same tax levels as its foreign rivals, thereby making it internationally competitive, the primary operations of that company must take place in the same foreign jurisdiction."[43] It is not clear to me as to what makes investment management a primary function, among all the other multitudes of functions that CGFM undertook. If a company is found to have a multitude of primary functions, say five, would the outsourcing of one function totally disqualify the company from the FBE exemption or is it the outsourcing of all functions that should do so? Or is it the outsourcing of the majority of the functions? Would the majority be determined by the revenue, or the value of the function or the resources required to undertake that function? As averred by the judge and witnesses in the case, outsourcing is a normal business model, necessitated by various factors. Thus, if a company is to undertake a conglomerate of functions, which form part of a whole, but it is not able to undertake one or some, which it outsources as a result of its inability, it may not be good law for the company to then lose out on the FBE exemption for all its operations where it has the FBE merely because of a single outsourced primary operation. At least, the income from CAM and CIL should be disqualified from the FBE exemption, and not the entire CGFM income. For this reason, I contend that the National Treasury should clarify what primary operations are, how are they determined, and what ratio do they carry versus all the other functions.

41 *Cambridge Dictionary* meaning of "primary", https://dictionary.cambridge.org/dictionary/english/primary (accessed on 25 March 2023).

42 See Tickle 2022:42.

43 *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd*:par. 54.

5.4 Outsourcing poses no threat to the fiscus

The statement by the National Treasury that some taxpayers retain certain management functions but outsource other important functions, for which the CFC is also being compensated by its clients, is correct, as was in *Coronation*. The National Treasury finds this to be against the policy rationale of the definition of a foreign business establishment and proposes that, in order to qualify as a FBE, all important functions for which a CFC is compensated need to be performed by the CFC or by the other company meeting the FBE requirements. The FBE definition does not require that all functions should be performed by the CFC. The FBE exemption exempts income that is attributed to the FBE. In *Coronation*, the income from outsourced services was not attributable to the FBE and could, therefore, easily be segregated from the income that is so attributable, and taxed accordingly.

In this regard, the tax implications of the outsourced income would be separately determined as follows: CGFM is a service provider in relation to the clients. CGFM is also a service recipient in relation to the investment management functions that are outsourced to CAM and CIL. CGFM received fees and income from the clients and compensated CAM and CIL for the services provided by the latter two. Because CGFM is a CFC, CIMSA would include in its income the net amount from these transactions. There is no need for the part that is to be included in the income to render the entire income attributable to the CFC not eligible for the FBE exemption. Thus, only outsourced income should be excluded from the FBE exemption. Because that income would be included in the income of the resident participants, there is no loss to the fiscus or threat to the integrity of the tax system. This can, therefore, not be against the policy rationale of the definition of FBE, unless the rationale is itself irrational.

5.5 Lessons from permanent establishment

The flip side of a FBE is a permanent establishment (PE). Rules relating to PE are mainly treaty rules that seek to ensure that the source state gets a primary right to tax income arising out of it. The FBE exemption inadvertently recognises that, and avoids double taxation by exempting FBE income that would ordinarily satisfy the PE definition in the source state. The definition of FBE broadly resembles that of PE as used in the OECD model tax convention. However, each of these have their own peculiarities that are crucial to the specific purposes they are enacted to serve.[44]

A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on.[45] It specifically includes an office, among other structures.[46] However, a PE is not constituted where the

44 See Oguttu 2015:527; Ngidi 2022:509-535.

45 Art. 5(1) of the OECD Model Convention.

46 Art. 5(2)(c) of the OECD Model Convention. The phrase "permanent establishment" includes especially: a place of management; a branch; an office; a factory; a workshop, and a mine, an oil or gas well, a quarry or any other place of extraction

maintenance of a fixed place of business is solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.[47] An auxiliary activity is one that provides supplementary or additional help and support.[48] Auxiliary is defined as "a person or thing that gives aid of any kind; helper, an organisation allied with, but subsidiary to".[49] Thus, in Ireland, CGFM would not constitute a PE as regards the investment management, as it would only be providing supplementary or additional help to the actual business of the enterprise conducted by CAM and CIL. As stated in the OECD Model Convention Commentary, "the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment". Thus, Ireland would not tax CGFM's income from outsourced activities. However, South Africa may, under CFC legislation. While this is not, and cannot be conclusive from a legal application point of view, from a policy perspective it makes sense. The converse also makes sense, in that, if CGFM does constitute a PE in Ireland, to result in Ireland having the source taxing right on its income, then South Africa should not have primary taxing rights on the same income sourced in Ireland. By implication, therefore, if South Africa commits into broadening the PE application, as recommended by the Davis Tax Committee,[50] it should also consider conversely relaxing the rules on what should constitute FBE to avoid double taxation at an international level.

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of natural resources. A PE also includes "[a] building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months" in terms of Art. 5(3) of the OECD Model Convention.

47 Art. 5(4) of the OECD Model Convention provides that the phrase "permanent establishment" shall be deemed not to include: a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character; f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

48 *Cambridge Dictionary* meaning of "auxiliary", https://dictionary.cambridge.org/dictionary/english/auxiliary (accessed on 24 March 2023).

49 See Dictionary.com meaning of "auxiliary", https://www.dictionary.com/browse/auxiliary (accessed on 24 March 2023).

50 See Davis Tax Committee "Second Interim Report on base erosion and profit shifting (BEPS) in South Africa - Summary of Report on Action 7: Prevent the artificial avoidance of permanent establishment status", https://www.taxcom.org.za/docs/New_Folder3/9%20BEPS%20Final%20Report%20-%20Action%207.pdf (accessed on 11 May 2023).

6. INTERNATIONAL DEVELOPMENTS' IMPACT ON THE FBE EXEMPTION

The OECD's Inclusive Framework consists, *inter alia*, of Pillar Two, which is aimed at assisting countries curb international tax avoidance by multinationals.[51] Pillar Two contains model rules that provide governments with a precise template for taking forward the two-pillar solution to address the tax challenges arising from digitalisation and globalisation of the economy.[52] Pillar Two proposes a global minimum corporate tax ("minimum tax"), which is intended to neutralise the incentives to shift profits based solely on tax outcomes. It is trite that countries competing to attract inward investment may offer tax incentives or lower tax regimes.[53] In addition, differences between domestic tax rules often create opportunities for multinationals (particularly those that derive significant value and profit from intangibles) to move income and profit to low-tax jurisdictions. This creates inappropriate tax competition and result in a 'race to the bottom'.[54]

Pillar Two applies where multinationals are regarded as undertaxed by reference to an agreed minimum level of taxation. Pillar Two endorses the creation of a globally agreed-upon minimum tax that would ensure countries tax corporate income at least at a base level.[55] Governments could still set

51 OECD "What is BEPS?", https://www.oecd.org/tax/beps/about/ (accessed on 27 July 2021); Cho 2020:1-2; International Monetary Fund 2018:6-8; Oguttu 2015:8-10.

52 OECD "OECD releases Pillar Two model rules for domestic implementation of 15% global minimum tax", https://www.oecd.org/tax/beps/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm (accessed on 15 March 2022). OECD "130 countries and jurisdictions join a bold new framework for international tax reform", https://www.oecd.org/tax/beps/130-countries-and-jurisdictions-join-bold-new-framework-for-international-tax-reform.htm (accessed on 15 March 2022).

53 Geiger "Global minimum tax: An easy fix?", https://home.kpmg/xx/en/home/insights/2021/05/global-minimum-tax-an-easy-fix.html#:~:text=At%20a%20global%20minimum%20tax%20rate%20of%2012.5%25%2C,to%2021%25%20would%20have%20changed%20this%20dynamic%20significantly (accessed on 14 February 2022).

54 Geiger "Global minimum tax: An easy fix?", https://home.kpmg/xx/en/home/insights/2021/05/global-minimum-tax-an-easy-fix.html#:~:text=At%20a%20global%20minimum%20tax%20rate%20of%2012.5%25%2C,to%2021%25%20would%20have%20changed%20this%20dynamic%20significantly (accessed on 14 February 2022).

55 OECD "OECD releases Pillar Two model rules for domestic implementation of 15% global minimum tax", https://www.oecd.org/tax/beps/oecd-releases-pillar-two-model-rules-for-domestic-implementation-of-15-percent-global-minimum-tax.htm (accessed on 15 March 2022); Mboweni *et al*. "Why we support a global minimum tax rate of 15%", https://www.news24.com/fin24/opinion/mboweni-yellen-why-we-support-a-global-minimum-tax-rate-of-15-20210610 (accessed on 23 August 2021).

whatever local corporate tax rate they want.[56] However, if companies pay lower rates in a particular country, their home governments could "top-up" their taxes to the minimum rate, eliminating the advantage of shifting profits.[57]

6.1 Does minimum tax mark the demise of the FBE exemption?

The National Treasury announced in the 2023 Budget that government will, in the 2023 legislative cycle, publish a draft position on the implementation of Pillar Two for public comment and that draft legislation will be prepared for inclusion in the 2024 Taxation Laws Amendment Bill.[58] In terms of the general principles of minimum tax, if a CFC of a South African resident is resident in a low-tax jurisdiction and has an FBE in that country, ordinarily South Africa would exempt that income. With the application of the minimum tax, South Africa will be entitled, and indeed, obliged to top up whatever tax is levied in the low-tax jurisdiction. This basically means that the FBE would become obsolete, to the extent that the CFC is resident in a country that taxes at lower rates than South Africa. However, this is only to the extent of the 15 per cent tax rate. This would mean that the low-tax jurisdictions would probably increase their taxes to a minimum of 15 per cent, in order to not forgo the benefit of the tax that the investor would pay anyway, albeit in the parent company jurisdiction.

South African residents with participation rights in a CFC, who are liable to imputation, but exempted therefrom by the FBE exemption, may find themselves being subject to a minimum tax in the CFC jurisdiction or in South Africa through the top-up provisions, if or when enacted. This would be because the FBE test and the substance-based exclusion tests are different. Pillar Two contemplates that, where a CFC income is attributed to a resident, then the tax must be treated as tax paid by the CFC in the low-tax CFC jurisdiction, for the computation of the 15 per cent effective tax. This implies a

56 Schoeman-Louw "A global minimum tax? What could it mean?", https://www.golegal.co.za/global-minimum-tax/ (accessed on 3 September 2021).

57 OECD "Tax challenges arising from digitalisation – Report on Pillar One blueprint: Inclusive framework on BEPS", https://assets.kpmg/content/dam/kpmg/uk/pdf/2020/10/pillar-two-global-minimum-taxation.pdf (accessed on 14 February 2022). Pillar Two addresses BEPS challenges and is designed to ensure that large MNEs pay a minimum level of tax regardless of where they are headquartered or the jurisdictions they operate in. It achieves this through a number of interlocking rules that seek to (i) ensure minimum taxation while avoiding double taxation or taxation where there is no economic profit; (ii) cope with different tax system designs by jurisdictions as well as different operating models by businesses; (iii) ensure transparency and a level playing field, and (iv) minimise administrative and compliance costs.

58 National Treasury "Revenue trends and tax proposals", Chapter 4 pages 50-51, https://www.treasury.gov.za/documents/National%20Budget/2023/review/Chapter%204.pdf (accessed on 11 May 2023).

credit system that does not exclude the top-up liability in South Africa, where South Africa could have had no tax to collect because of the exemption.[59]

While this might seem to annihilate the importance, relevance, and validity of the FBE exemption, the following factors render the FBE exemption beyond obsolescence:

- First, minimum tax only applies to multinationals with an annual global revenue of over EUR 750 million.[60] Very few multinationals with that much annual revenue have their parent entities in South Africa. Globally, this rule excludes roughly 85 to 90 per cent of multinational groups.
- Secondly, if the MNE group satisfies the global revenue requirement of EUR 750 million, the MNE group may elect for the top-up tax to be zero if the average revenues of all constituent entities in a specific jurisdiction are less than EUR10 million and the income is less than EUR1 million.[61]
- Thirdly, the income of the minority-owned constituent entities is excluded from the determination of the remainder of the MNE group's effective tax rate.[62]

Therefore, based on the above, a large majority of multinationals would still benefit from the FBE exclusion.

6.2 The not-so-substantial substance-based income exclusion

The Pillar Two substance-based exclusion operates similarly to the FBE. The substance-based carve-outs consist of a reduction in the tax base on which the worldwide minimum tax will be applied. This reduction is determined based on two factors: employee compensation and tangible assets. The employee compensation, or payroll carve-out is calculated as 5 per cent of the

59 OECD "Tax challenges arising from digitalisation of the economy – Global anti-base erosion model rules (Pillar Two)", https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en#page29 (accessed on 19 April 2023).

60 OECD "Tax challenges arising from digitalisation of the economy – Global anti-base erosion model rules (Pillar Two)", https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en#page29 (accessed on 19 April 2023). This amount is determined by reference to the annual financial statement of the multinational entity for at least two of the four years preceding the year in question.

61 OECD "Tax challenges arising from digitalisation of the economy – Global anti-base erosion model rules (Pillar Two)":par. 5.5, https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en#page29 (accessed on 19 April 2023).

62 OECD "Tax challenges arising from digitalisation of the economy – Global anti-base erosion model rules (Pillar Two)":par. 5.6.1, https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en#page29 (accessed on 19 April 2023).

eligible payroll costs in respect of eligible employees in the relevant country.[63] Tangible asset carve-out is calculated as 5 per cent of the carrying value of the relevant country's tangible assets. The carrying value is the average of the value after depreciation, amortisation, or depletion at the beginning versus the end of the year.

Substance-based carve-outs reduce the tax levied in the parent company's residence jurisdiction. The tax value of carve-outs is quite minimal (5 per cent of the employee cost and the carrying value of tangible assets) and are deducted from the tax base on which the residence country's 15 per cent surtax is applied. In the South African context, it would apply to those few multinationals that the minimum tax would be applied to, where the FBE is overridden by the minimum tax, to lessen the impact of the minimum tax, albeit ever so slightly compared to the FBE.

7. CONCLUSIONS

The *Coronation* case is very important to the South African tax law jurisprudence in that it reinforces the law in relation to the application of the FBE exemption as well as the rules regarding the inapplicability of the FBE exemption where primary operations are outsourced. It does not, however, clarify the position as to what primary operations are and how they should be determined. I am adamant that the terms and conditions of the contracts, the founding statements, and the permissions provided by the license are not supposed to determine what the primary operations are. Primary operations are what is active and what the company actually actively undertakes.

In my view, the Tax Court cannot be faulted. It came to a well-reasoned conclusion, based on the facts and its own distinction between fund management and investment management, and most importantly, what each of these functions entail. The issue was not determining what outsourcing entails, but what the primary functions of a fund manager are.

Indeed, income from outsourced services should not benefit from the FBE exemption. However, the FBE exemption should not be denied to all other income that would otherwise qualify for the exemption. The impact of the minimum tax on FBEs would not necessarily reduce the effect or attractiveness of the FBE exemption more than it would overall reduce the impetus to locate the CFC in a low-tax jurisdiction. This would also equally apply to the outsourced company.

Perhaps the concern would be that the income of the company, to which the services are outsourced, would not be taxable in South Africa. However,

63 OECD "Tax challenges arising from digitalisation of the economy – Global anti-base erosion model rules (Pillar Two)":par. 5.3.3, https://read.oecd-ilibrary.org/taxation/tax-challenges-arising-from-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two_782bac33-en#page29 (accessed on 19 April 2023). Eligible payroll costs and eligible employees are specifically defined. The costs exclude employee costs that are capitalised and included in tangible assets and costs attributable to any international shipping income.

that is no threat, as no income would be diverted there if the outsourcee is a third party and if not, transfer pricing rules are designed to address that kind of international tax avoidance. According to Musviba, the current definition of an FBE assumes that a business must be conducted using set traditional and often archaic business structures. Musviba hopes that Treasury will take the new and modern working arrangements into account. These have often become the norm when reviewing the FBE exemption.[64]

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64 Musviba "SA Budget 2023 – Does your controlled foreign company have real substance?", https://www.sataxguide.co.za/sa-budget-2023-does-your-controlled-foreign-company-have-real-substance/ (accessed on 23 March 2023).

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