Tax & Exchange Control

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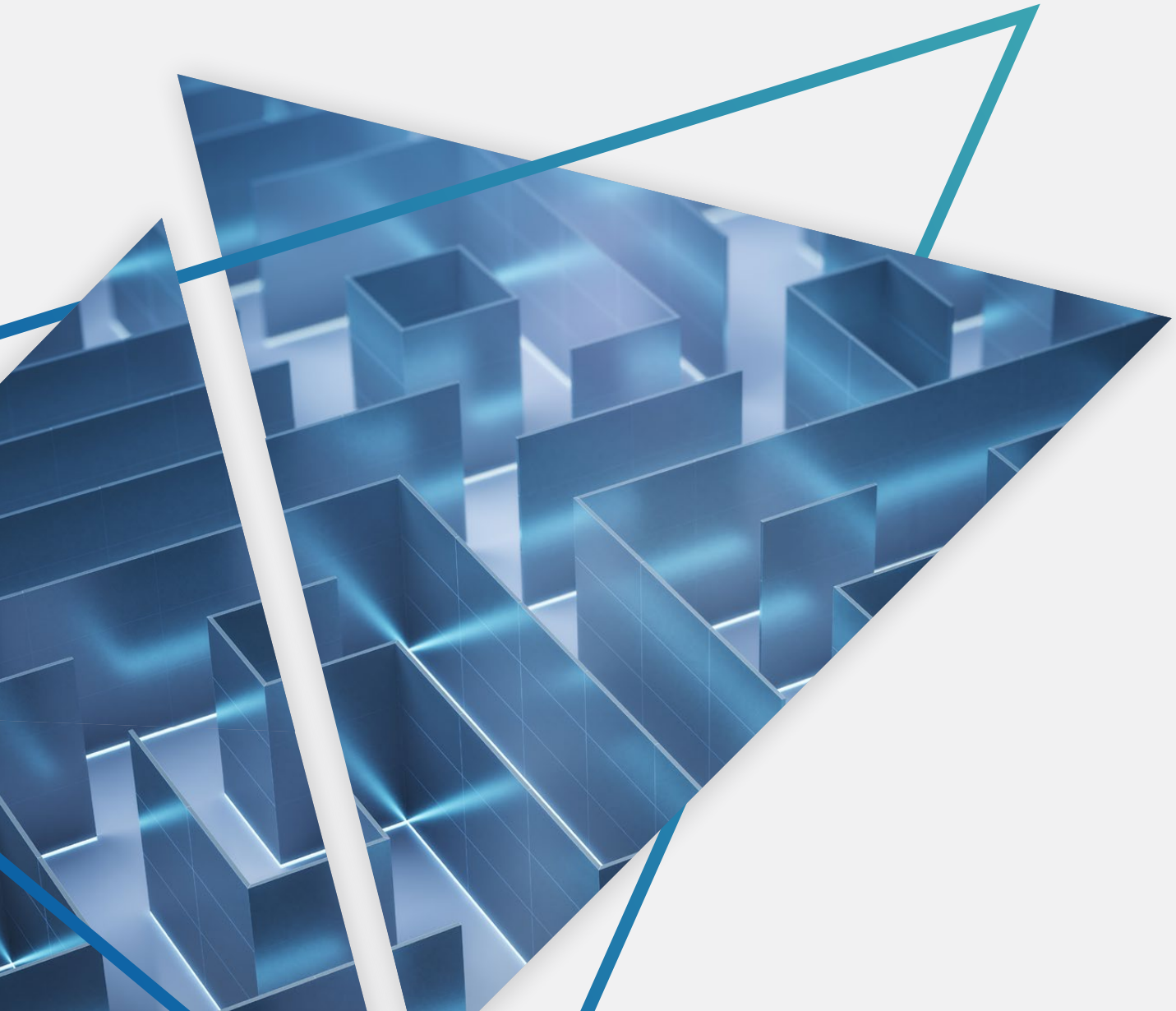

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SOUTH AFRICA

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Controlled foreign company rules: To outsource or not to outsource?

Over the last few weeks, the South African tax advisory and business community have on various platforms debated the Constitutional Court's (CC) recent judgment in *Coronation Investment Management SA (Pty) Limited v Commissioner for the South African Revenue Service* [2024] ZACC 11. The CC held that the taxpayer, Coronation Investment Management SA (Pty) Ltd, had a foreign business establishment (FBE) in Ireland despite the Irish business outsourcing some of its functions. As a result, the CC held that the taxpayer was exempt from section 9D of the Income Tax Act 58 of 1962 (ITA), so that the (net) income of its Irish subsidiary, which is a controlled foreign company (CFC) under section 9D, was not subject to tax in South Africa.

In this article we delve into this issue in a bit more depth and consider some of the judgment's potential broader implications. However, before doing so, we provide a brief overview of section 9D, which forms the basis of the case.

Section 9D overview

While this case focuses on investment management companies, it potentially has an impact on all South African resident multinational companies that currently rely on or may wish to rely on the FBE exemption when setting up operations outside South Africa.

Section 9D of the ITA is an anti-avoidance provision aimed at imposing tax on South African taxpayers, specifically on income earned by South African owned foreign corporate entities. The phrase CFC is broadly defined to include any foreign company where more than 50% of the company's voting rights are held or participation rights are owned by South African residents. In other words, one looks at the cumulative holding of voting rights or cumulative ownership of participation rights to determine whether the entity is a CFC.

In terms of section 9D, the net income of a controlled foreign company (CFC) is imputed to its South African resident shareholders and is taxable in South Africa. The imputation of income is subject to certain exceptions, one of which relates to whether that CFC is considered an FBE. Should the requirements of an FBE be met, the income of the foreign company will be exempted from South African tax.

For the avoidance of doubt, section 9D does not seek to impose South African tax on a foreign company. It subjects the South African residents in relation to whom the foreign entity is a CFC to tax on the net income of the CFC, in proportion to their percentage of voting rights held or participation rights owned.

Facts

Coronation Fund Managers Limited (Coronation), is a South African public company listed on the Johannesburg Stock Exchange. It has various subsidiaries within South Africa and abroad that operate within the fund management and investment management space.

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Coronation Investment Management SA (Pty) Limited (Coronation SA) is a wholly owned subsidiary of Coronation and is in turn the holding company of Coronation Management Company (RF) (Pty) Limited and Coronation Asset Management (Pty) Limited (CAM), both registered as tax residents in South Africa.

Coronation SA was also the holding company of the now deregistered Coronation Fund Managers (Isle of Man) Limited. The latter company was the 100% owner of Coronation Global Fund Managers (Ireland) Limited (Coronation Ireland) and Coronation International Limited (CIL), which are registered and tax resident in Ireland and the UK, respectively.

Coronation Ireland holds a licence issued by the Central Bank of Ireland (CBI), the regulatory authority for investment funds in Ireland. In terms of the licence and its business plan, Coronation Ireland is licenced to perform various functions, including decision making, monitoring compliance, risk management, monitoring of investment performance, financial control, monitoring of capital, internal audit, complaints handling, accounting policies and supervision of delegates. The licence did not authorise Coronation Ireland to conduct investment trading activities.

CAM and CIL are specialist investment managers licensed to conduct investment trading activities within their respective jurisdictions, being South Africa and the UK.

It was accepted that Coronation Ireland was a CFC (as defined) of Coronation SA. In this regard, Coronation SA, in relation to Coronation Ireland, utilised a delegated business model whereby Coronation Ireland delegated the investment trading activities to CAM and CIL. These entities performed investment trading activities in respect of the collective investment funds in South Africa and the UK respectively, under the supervision of Coronation Ireland. Coronation Ireland's oversight formed a significant part of its roles.

With regard to the 2012 year of assessment, the Commissioner for the South African Revenue Service (SARS) raised an assessment on Coronation SA's tax liability. The assessed amount included the entire net income of Coronation Ireland.

SARS had concluded that Coronation Ireland did not meet the requirements for recognition as an FBE and the exemption in section 9D(9)(b) did not apply. This was based on SARS' view that Coronation Ireland had outsourced the primary functions of its business and all that remained were ancillary non-core functions. Coronation SA objected to the additional assessment.

The Tax Court held that Coronation Ireland met the requirements of an FBE and accordingly qualified for the tax exemption. This court set aside SARS' additional assessment(s) against Coronation SA and ordered SARS to issue a reduced assessment that excluded any amount pertaining to Coronation Ireland's income.

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SARS appealed the Tax Court's decision to the Supreme Court of Appeal (SCA). The SCA disagreed with the Tax Court's findings and concluded that Coronation Ireland had outsourced its primary business, did not meet the requirements for an FBE exemption, and that the net income of Coronation Ireland was attributable to Coronation SA in respect of the 2012 year of assessment. Therefore, the SCA ordered Coronation SA to pay income tax on Coronation Ireland's net income and interest thereon in terms of section 89(2) of the ITA.

Aggrieved by the SCA's decision, Coronation SA took the matter on appeal to the CC.

Questions of law

The key issue before the CC was whether the net income of Coronation Ireland was exempted from tax for the 2012 year of assessment, in terms of section 9D of the ITA.

The exemption would only apply if Coronation Ireland had met the requirements of an FBE as defined in section 9D(9)(b).

Before discussing the judgment, we set out the requirements of an FBE which are applicable to this case.

What is an FBE?

An FBE in relation to a CFC is defined in section 9D(1) of the ITA as:

> *"a fixed place of business located in a country other than the Republic that is used … for … carrying on of the business of that controlled foreign company for … not less than one year …"*

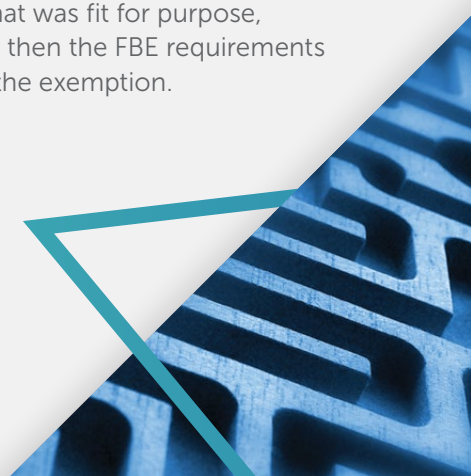
That fixed place of business must be a suitable facility that is suitably staffed and equipped for conducting the "primary operations of that business". Further, it must be located outside South Africa *"solely or mainly for a purpose other than the postponement or reduction"* of South African tax.

Included in the definition is a proviso which permits the outsourcing of certain functions of a business.

The fundamental enquiry to the main legal question stems from the definition of FBE and is two-fold:

- identifying the "*business*" of Coronation Ireland; and
- determining what the *"primary operations of that business"* are.

This determination was crucial because if it was found that Coronation Ireland had not outsourced its core business and operated from a facility that was fit for purpose, equipped and suitably staffed, then the FBE requirements were met, and it qualified for the exemption.



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Key arguments raised by SARS

SARS submitted that Coronation Ireland had outsourced its core functions, including its primary function of investment management, to offshore entities.

While SARS acknowledged that the proviso to the FBE definition permits the outsourcing of certain functions, it submitted that Coronation Ireland fell short of the definition's proviso.

According to SARS, after Coronation Ireland outsourced its main function, it lacked economic substance.

Judgment

In determining Coronation Ireland's "*business*" and the "*primary operations of that business*", the CC noted that the point of departure must be the distinction between a fund manager and an investment manager. This formed the crux of the issue.

The court first set out the rationale behind the enactment of section 9D with reference to the relevant Explanatory Memorandum. Section 9D was enacted to deter South Africans from moving taxable income beyond South Africa's taxing jurisdiction by investing through a CFC. Section 9D also has the purpose of permitting South African multinational corporations to establish corporate entities abroad to enable them to compete in those jurisdictions.

Therefore, the aim of section 9D is to strike a balance between offshore competitiveness and protecting the South African tax base.

The CC then considered the difference between fund management and investment management and according to the court, SARS and the SCA had failed to appreciate this distinction, resulting in the wrong conclusion.

On the one hand, the court noted that Coronation Ireland performed the role of managing a collective investment fund, which entailed administration of the fund, trusteeship or custodianship, management of investments and distribution or marketing. Coronation Ireland also set policies, maintained oversight over them and set restrictions for investments. These roles were performed in the Dublin office under the auspices of the CBI. The court termed these functions as investment management in the 'broad' sense.

On the other hand, the court held that investment trading or investment management in the 'narrow' sense entails "*professionally and expertly allocating the funds invested in a collective investment fund. These allocations are made strictly within the parameters, policies, mandate and limits set out in the prospectus issued by the fund manager*".

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These are the functions Coronation Ireland delegated to CAM and CIL.

Having established the distinction, the CC held that Coronation Ireland's core business was fund management and not trading activities, and outlined three factors from the evidence to support this position.

1. The conditions of the CBI licence were such that Coronation Ireland was authorised to provide oversight and overall management of a collective investment fund. Coronation Ireland could not itself conduct investment management trading as that would be in contravention of the licensing conditions.
2. Separating the investment management function from the trading function was prudent, as it ensured that the investment manager retained supervision and prevented the investment trader from taking risks that were not acceptable to the investment manager.
3. Uncontested evidence showed that the separation of investment management and investment trading is standard practice in the industry, which is utilised by most of the Irish fund management companies.

Therefore, the court concluded that Coronation Ireland's core business and primary operations were fund management, which included the management, oversight and supervision of investment trading, which it had delegated.

In summary, Coronation Ireland had adopted the delegated business model where it would perform investment management functions while delegating the investment trading functions, albeit retaining oversight over the delegated function.

In addition, it was shown that in carrying out its core function of investment management, Coronation Ireland had a fixed place of business that was suitably staffed and equipped to conduct the primary operations of its business. It is important to note that SARS accepted that Coronation Ireland had adequate on-site operations, employees and management.

For these reasons, the court held that Coronation Ireland qualified for the FBE exemption and SARS was ordered to issue a reduced tax assessment in which the income of Coronation Ireland was excluded in the determination of Coronation SA's tax liability.

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Comment

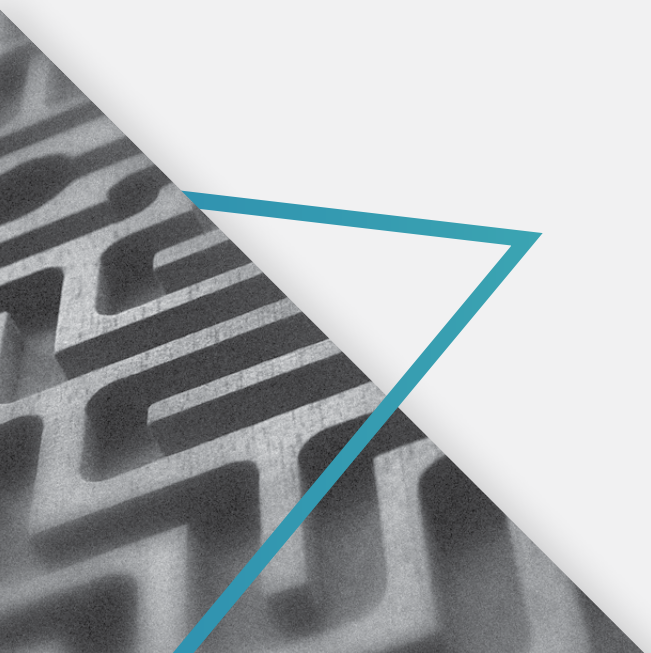
On the facts, it was found that the CFC (Coronation Ireland) did not delegate its core functions. Nevertheless, the implications of the judgment are potentially far-reaching in that it likely affects not only the investment and fund management industries, but also South African resident multinational companies in general. South African holding companies with CFCs, or CFCs with multiple South African resident shareholders can potentially claim the FBE exemption even where the CFC outsources or delegates certain functions, provided that those functions are not core to the business and within the limits of the proviso.

This is evident from the CC's judgment where it states that section 9D:

> *"... is not an anti-sourcing enactment, as the [SCA] appears to approach it. Instead, it aims to ensure that an offshore business, regardless of its chosen business model, has economic substance in that foreign country and is not merely illusory or 'paper' business. And its objects are to ensure that the offshore company remains competitive with its foreign rivals."*

An interesting question is exactly how National Treasury will respond to this. In 2023, after the SCA judgment in this matter, Treasury initially proposed amending section 9D but then decided to postpone any amendment until after the matter is heard by the CC. Now that the CC's judgment has been handed down, Treasury will likely consider addressing the issue either in the 2024 Taxation Laws Amendment Bill (not yet published) or in 2025. One major difference however is that the composition of Parliament's Standing Committee on Finance (SCOF) has changed pursuant to the outcome of the recent elections, compared to 2023. This means that if the same proposal now comes before the SCOF, it is not a foregone conclusion that a majority of its members will support the proposed amendment, which was more likely to be the case before the outcome of the recent elections.

Naomi Mudyiwa and Louis Botha



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