



## CFCs: The FBE exemption and outsourcing

The Constitutional Court considered the application of the foreign business establishment exemption from the CFC rules in the context of a fund management business. This judgment provides valuable guidance on the application of this exemption, especially in the case of business models that involve outsourcing of certain activities.

South Africa introduced controlled foreign company ('CFC') rules when it adopted a residence-based tax system in 2001. These rules target passive or mobile income that escapes South African tax by accruing or diverting it to offshore companies controlled by South African residents. Residents must impute their share of the net income of the CFC into their taxable income.

The rules do not apply to business activities with substance that an entity conducts outside South Africa for *bona fide* non-tax reasons. To achieve this, a CFC's net income excludes income attributable to a foreign business establishment ('FBE'). This exemption was the subject of a dispute between Coronation Investment Management SA (Pty) Ltd ('CIMSAs') and SARS, which proceeded all the way to the Constitutional Court (CC).

### Facts

CIMSAs indirectly held all the shares of Coronation Global Fund Managers (Ireland) Limited ('CGFM'), an Irish company. CGFM was a collective investment scheme fund management company licensed in terms of the relevant Irish regulations. The company provided foreign investment opportunities in Irish collective investment schemes. Irish law did not permit CIMSAs and its South African subsidiaries to do this. CGFM contracted with Coronation International Limited ('CIL') and Coronation Asset Management (Pty) Ltd ('CAM') to conduct investment trading activities. These entities were specialist and licensed investment managers in their countries.

### FBE dispute

SARS concluded that CGFM did not meet the requirements to be an FBE since the primary functions of its business had been outsourced to CIL and CAM. It considered the only activities conducted in Dublin to be ancillary non-core and lacking economic substance. CIMSAs contended that CGFM had adequate on-site operations, employees, and management to conduct its fund management business and qualified for the FBE exemption.

The Cape Town Tax Court ruled in favour of CIMSAs. The SCA overturned this judgment in 2023.

### Constitutional Court judgment

The CC stated that the Central Bank of Ireland approved CGFM to manage collective investment schemes in Ireland. The license did not authorise it to conduct investment management trading activities itself. In such a delegated fund management model, CGFM was responsible for all regulatory, legal and investor aspects of a collective investment fund. Insofar as investment management was concerned, CGFM established investment objectives and policies but appointed specialist investment managers to conduct investment trading activities. CGFM remained responsible for overseeing their activities.

The CC concluded that CGFM's primary business was fund management. The activities it conducted in Dublin satisfied the definition of an FBE despite delegating the investment trading activities to specialists. The SCA failed to distinguish between investment management and investment management trading activities.

### What can taxpayers who rely on the FBE exemption learn from this?

Although the judgment primarily deals with CGFM's business, the CC provided valuable guidance on applying the FBE exemption. This includes:

- The business envisaged in the FBE exemption is not everything a CFC can, theoretically and notionally, do to pursue a commercial endeavour. The company's actual business must be considered. This does not mean a company can subjectively define its business narrowly to fall within the exemption. Some activities lack economic substance and provide opportunities for avoidance. SARS and a court should look objectively at the actual operations of the business to determine whether they have a commercial rationale and whether the business has economic substance.
- The FBE definition does not counter outsourcing. Its aim is to ensure that offshore businesses have economic substance, irrespective of their chosen business model. This approach allows businesses to remain competitive with foreign rivals.

