CONSTITUTIONAL COURT OF SOUTH AFRICA

Coronation Investment Management SA (Pty) Ltd v Commissioner for the South African Revenue Service

CCT 47/23

Date of hearing: 13 February 2024

Date of judgment: 21 June 2024

MEDIA SUMMARY

The following explanatory note is provided to assist the media in reporting this case and is not binding on the Constitutional Court or any member of the Court.

On 21 June 2024 at 10h00, the Constitutional Court handed down judgment in an application for leave to appeal and an application for leave to cross-appeal against a judgment and order of the Supreme Court of Appeal dated 7 February 2023, which had set aside a judgment and order of the Tax Court. The main issue before the Supreme Court of Appeal was whether the net income of a controlled foreign company (CFC) should be included in the taxable income of its parent company, which is resident in South Africa, in terms of section 9D(2) of the Income Tax Act 58 of 1962 (the ITA); or whether the CFC is a foreign business establishment (FBE) subject to a tax exemption in terms of section 9D(9) of the ITA. The Court's determination of this issue required an interpretation of the terms "the business of that controlled foreign company" and "the primary operations of that business" in the FBE definition.

Coronation Investment Management SA (Pty) Ltd (Coronation) is the applicant in the main application and the respondent in the cross-appeal. Coronation is a private company incorporated and registered in South Africa and a South African taxpayer. Coronation has various subsidiaries, including Coronation Global Fund Managers

(Ireland) Ltd (CGFM) in Ireland, Coronation Asset Management (Pty) Ltd (CAM) in South Africa and Coronation International Ltd (CIL) in the United Kingdom. CGFM was established as a fund management company and it delegates investment management trading activities to CAM and CIL. The Commissioner for the South African Revenue Services (SARS) is the respondent in the main application and the applicant in the cross-appeal.

In the 2012 tax year of assessment, SARS determined that the net income of CGFM, being a CFC, was to be included in Coronation's taxable income in terms of section 9D(2) of the ITA. SARS also imposed on Coronation an understatement penalty in terms of section 222 of the Tax Administration Act 28 of 2011, an underestimation penalty for provisional tax under paragraph 20 of the Fourth Schedule to the ITA, and interest in terms of section 89(2) of the ITA. Coronation objected and argued that because CGFM is an FBE, it is subject to the exemption in section 9D(9) of the ITA. As such, its net income ought not to be included in Coronation's taxable income, and the penalties and interest due to SARS do not arise.

Coronation appealed to the Tax Court. That Court ruled in favour of Coronation. It distinguished between the functions of fund management and investment management, and understood CGFM's primary operations to be fund management (which it conducts in Ireland) and not investment management (which it delegates outside of Ireland). It accordingly held that CGFM meets the requirements of the FBE definition and therefore qualifies for the tax exemption. The Tax Court also dismissed SARS' claims for penalties and interest.

SARS appealed to the Supreme Court of Appeal. That Court reversed the Tax Court's decision. It understood CGFM's primary operations to include both fund management and investment management (which it conducts outside of Ireland). Consequently, the Supreme Court of Appeal held that CGFM does not meet the requirements of the FBE definition and Coronation is required to pay tax on CGFM's net income. However, the Supreme Court of Appeal dismissed SARS' claim for the penalties. In doing so, it relied mainly on a recent decision of that Court, *Commissioner for the South African Revenue Service v The Thistle Trust* [2022] ZASCA 153; 2023 (2) SA 120 (SCA); 85 SATC 347.

Coronation appealed to this Court. Coronation submitted that the Supreme Court of Appeal erred in its interpretation of the FBE definition. Coronation submitted that the Supreme Court of Appeal employed a "notional-business interpretation", under which the business and primary operations of a CFC must be determined by having regard to the operations that the company could perform, and not what it does perform. Coronation maintained that the correct interpretation is the "actual-business interpretation", under which the business and primary operations of a CFC must be determined by having regard to what the company in fact does, and not what it could do. . It submitted that it cannot perform operations that are not part of its chosen, or

authorised, licensed business. Coronation further submitted that the FBE definition does not use the word "outsource" and its focus is squarely on economic substance.

Conversely, SARS submitted that CGFM outsources all its functions for which it is licensed as a management company, including its primary function of investment management, to offshore entities – CIL and CAM. SARS contended that the proviso to the FBE definition expressly permits outsourcing of the location permanence and the economic substance of a CFC, provided the requirements in the proviso are met. SARS submitted that a proviso is not a separate and independent enactment. It maintained that CGFM's delegation of functions to CIL and CAM do not meet the requirements in the proviso and CGFM therefore does not meet the requirements of the FBE definition. SARS submitted that the words of the proviso cannot be read as though divorced from their context.

Before this Court, SARS brought a cross-appeal against the Supreme Court of Appeal's findings in respect of the penalties, which Coronation opposed. Amongst other things, SARS submitted that Coronation was deliberate in claiming the FBE exemption and, even if the tax position taken by Coronation was in good faith, it was not unintentional and therefore falls outside the scope of "inadvertence", making SARS liable for the understatement penalty. Coronation submitted that SARS failed to engage with the substantial evidence demonstrating that Coronation was acting in good faith by relying on an opinion from a tax expert and did not deliberately misstate its tax liability or act with the intention to deceive. It also argued that SARS' approach in declaring that "inadvertence" requires only a "slip of the pen" as opposed to a tax position deliberately adopted is flawed.

In a unanimous judgment penned by Majiedt J (Zondo CJ, Bilchitz AJ, Chaskalson AJ, Madlanga J, Mathopo J, Mhlantla J, Theron J, and Tshiqi J concurring), the Constitutional Court held that this matter engaged its jurisdiction, because the proper interpretation of "the business of that controlled foreign company" and "the primary operations of that business" as they appear in Section 9D for the purposes of applying the FBE exemption is a question of law, as it involves forming a view on the meaning of section 9D of the ITA. This is a question that transcends the interests of the parties and is of general public importance as it has a direct impact on South African resident companies which hold CFCs, and therefore rely on the FBE to avoid being subjected to tax on an amount equal to the CFC's net income under section 9D. The interests of justice required that leave be granted so that certainty regarding a matter of significant importance to the South African economy is attained given the diverging conclusions of the Tax Court and the Supreme Court of Appeal. Given the Court's conclusion in the appeal, the cross-appeal did not arise so nothing further was addressed in the judgment on that point.

The Constitutional Court held that CGFM met all the requirements of an FBE in terms of Section 9D. Thus, CGFM's net income ought to have been exempted from tax for the 2012 year of assessment and costs must subsequently follow the outcome. For that reason, it is not necessary to deal with the cross-appeal. The Court held that SARS fundamentally misconceived the central issue in the case, the distinction between fund management and investment management. The Court found that the Supreme Court of Appeal committed the same error leading to its fallacious conclusions. In accordance with its business plan, presented as part of its licence application, CGFM employed a delegated business model through which it could conduct specified fund management functions, and would delegate investment management trading activities (which it is not authorised to do by its licence) to competent third parties, CAM and CIL, while retaining overall supervision of, and responsibility to the regulator for those functions.

CGFM performed a number of core management functions under its licence, including the supervision of delegates like CAM and CIL as investment managers. Moreover, its day-to-day operations from its Dublin office in pursuit of these management functions met the "economic substance" requirements of the FBE definition, namely that the company must have a fixed place of business which is suitably staffed and equipped to conduct the primary operations of its business—the provision of fund management in accordance with the delegation model. Therefore, the Court determined that the Tax Court was correct in holding that CGFM qualified for a tax exemption and that SARS must issue a reduced tax assessment, excluding in it any amount that was concluded in CIMSA's income under section 9D of the ITA pertaining to CGFM's income.

Next, the Constitutional Court considered the flaws in the reasoning and ultimate outcome of the Supreme Court of Appeal. The Supreme Court of Appeal held 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." The Constitutional Court found that in adopting this "notional business" approach (as it was called by CIMSA's counsel), the Supreme Court of Appeal erred which ultimately led to its holding that CGFM does not meet the requirements for an FBE exemption and, instead, the net income of CGFM is imputable to CIMSA for the 2012 tax year under section 9D(2). The Constitutional Court explained that the Supreme Court of Appeal should have had regard to CGFM's business model (the manner in which it elects to do business) and its licensing conditions (what it may lawfully do). The Constitutional Court further held that the Supreme Court of Appeal failed to draw the important distinction between investment management in its wide sense and investment management trading, the narrower concept.

The ultimate effect of the Supreme Court of Appeal's erroneous "notional business" approach is that CGFM's primary business is that which it calculatedly chose not to do, did not apply to do and by law was not able to do, namely investment trading. The Constitutional Court reasoned that is inconceivable that the business of a controlled foreign company envisaged in section 9D is everything that the controlled foreign company can in theory and notionally do in pursuing a commercial endeavour, even if that company does not actually do it. The Constitutional Court then had regard to the Supreme Court of Appeal's further conclusions that "the FBE definition is not aimed solely at advancing international competitiveness for offshore businesses. Nor is the legislation concerned only to prevent diversionary, passive or mobile income eroding the South African tax base. It is also to limit a situation where an exemption is obtained over earnings in a low tax jurisdiction when the primary operations for the business are not conducted there." The Constitutional Court found that these statements entirely undermine the stated objects of section 9D, to ensure that offshore companies remain competitive in relation to their foreign rivals. Thus, these statements by the Supreme Court of Appeal lost sight of the fact that a South African company is legally constrained to move offshore to service their investor clients who want to take up the opportunities created abroad after the relaxation of foreign exchange controls.

For the reasons stated above, the Constitutional Court upheld the appeal and ordered that the order of the Supreme Court of Appeal be set aside and substituted with the following: "The appeal is dismissed with costs, including the costs of two counsel." The Court ordered the respondent to pay the costs, including the costs of the two counsel.