CASE LAW SUMMARY – October 2024

Coronation Investment Management SA (Pty) Limited v Commissioner for the South African Revenue Service (CCT 47/23) [2024] ZACC 11; 2024 (9) BCLR 1128 (CC) (21 June 2024)

This is an appeal to the Constitutional Court by the taxpayer appealing a decision by the South African Revenue Service ("SARS") to disallow an exemption under section 9D of the Income Tax Act, No. 58 of 1962 ("the Act").

The facts and arguments

Coronation Fund Managers Ltd ("Coronation") is listed on the Johannesburg Stock Exchange ("JSE") with Coronation Investment Management SA (Pty) Ltd ("CIMSA") as its 100% subsidiary. CIMSA holds shares in various companies, one of which is a foreign subsidiary called Coronation Global Fund Managers (Ireland) Limited ("CGFM"). Ireland was selected as the location due to its highly regarded regulatory regime.

CGFM was established in 1997 as a fund management company to provide foreign investment opportunities in Irish collective investment funds as Irish law did not allow CIMSA or any South African domiciled company to manage Irish domiciled collective investment funds. As such, tax considerations did not factor in CIMSAs decision to set up in Ireland. The business model utilised for CGFM was similar to those used in similar activities based in South Africa.

CGFMs managerial functions included decision-taking, monitoring compliance, risk management, monitoring of investment performance, financial control, monitoring of capital, internal audit and supervision of delegates. Complaints handling and accounting policies and procedures were later added as functions. CGFMs licence does not authorise it to conduct investment management trading activities, as such, it delegated investment management trading activities to third parties who also happened to be part of the same group of companies as CGFM. It is important to note that the separation of fund management and investment trading is standard practice in the industry.

CGFM was a 'controlled foreign company' as defined in section 9D of the Act. CIMSA indicated CGFMs net income as exempt in its 2012 tax return, in accordance with section 9D of the Act. CIMSA applied the exemption as it was their view that CGFM qualified as a "foreign business establishment" (as defined) under section 9D(9)(*b*) of the Act. In assessing CIMSAs 2012 tax return, SARS included all of CGFMs net income as it was of the view that CGFM was not a foreign business establishment as, according to SARS, the primary functions of its business had been outsourced. CIMSA appealed SARS' assessment, referring the matter to the Tax Court.

Tax Court judgement

In assessing CGFMs activities, the Tax Court distinguished between fund management and investment management and was of the view that CGFM is a fund management company as its licence authorises it to conduct collective portfolio management activities. The Tax Court

was of the view that CGFM was indeed a foreign business establishment (its fixed place of business was conducted in a physical structure, it was suitably staffed and equipped, had suitable facilities to conduct its primary operations and was located outside South Africa for purposes other than postponing or reducing the tax imposed in South Africa). As such, CGFM had economic substance and therefore qualified for the section 9D exemption. SARS was ordered to issue a reduced assessment excluding CGFMs income. The Tax Court further held that SARS was not allowed to claim understatement penalties in terms of section 222 of the Tax Administration Act, No. 28 of 2011 ("the TAA"), understatement penalties for provisional tax under paragraph 20 of the Fourth Schedule to the Act and interest in terms of section 89(2) of the Act. The Tax Court further granted leave to appeal to the Supreme Court of Appeal.

Supreme Court judgement

SARS referred the matter to the Supreme Court of Appeal. The Supreme Court disagreed with the Tax Court's ruling, finding that CGFM was in the business of investment management and, given the outsourcing of its operations, it therefore did not meet the requirements of a foreign business establishment. In this Court's view, collective portfolio management, which CGFM had been authorised to conduct, included investment management, administration and marketing. The Court was further of the view that to qualify for the exemption under section 9D, the essential operations of a business must be conducted within the jurisdiction in respect of which exemption is sought, as such, its primary activities could not be outsourced. In the Court's view, to enjoy the same tax rates as its foreign rivals, therefore making it internationally competitive, the primary operations of that company must take place in the same foreign jurisdiction.

The Supreme Court of Appeal was therefore of the view that SARS' inclusion of CGFMs net income in CIMSAs 2012 return was justifiable. It also agreed with SARS' decision to levy interest, it however disagreed with the decision to levy understatement penalties. Disagreeing with the Supreme Court's ruling, CIMSA referred the matter to the Constitutional Court. There was also an application by SARS for leave to cross-appeal against parts of the Supreme Court's judgement relating to the penalties.

Constitutional Court

In order to determine whether or not CGFM qualified as a foreign business establishment, the Court assessed its business and primary operations. In SARS' view, CGFM could not be a foreign business establishment as its activities lacked economic substance as SARS alleged that CGFM had outsourced its entire core business and all that remained were ancillary, non-core activities. CGFM had outsourced its marketing and distribution functions and only engaged in investment management trading.

According to CIMSA, section 9D is not an anti-outsourcing rule or one that looks to an entity's business model, it rather focuses on economic substance. CIMSA further argued that CGFM was a fund manager and was sufficiently staffed and equipped to perform that function. As such, CIMSA held the view that CGFM met the requirements of (ii), (iii) and (iv) of the foreign business establishment definition in subsection (1) of section 9D.

SARS contended that the definition of foreign business establishment was not intended to apply where all the entity's activities are outsourced. Given that the entities', the activities were outsourced to, were not subject to Irish taxes, CGFM could therefore not be a foreign business establishment as it did not meet all the foreign business establishment requirements.

The judgement

The Constitutional Court was of the view that SARS and the Supreme Court were incorrect in their classification of CGFM as an investment management agency as they had both misconceived the distinction between fund management and investment management. According to the Constitutional Court, CGFMs involvement in the administration of funds, trusteeship or custodianship, the management of investments and distribution or marketing rightly makes it an entity involved in fund management. Given that CGFM was not involved in allocating funds invested in a collective investment fund, it would be incorrect to classify it as an investment management agency. Given CGFMs correct classification as a fund manager, it could therefore not be seen to have outsourced its primary functions and was therefore still eligible for classification as a foreign business establishment.

In the Court's view, section 9D was introduced with the purpose of striking a balance between international competitiveness and protecting the South African tax base. The Constitutional Court was of the view that the Supreme Court of Appeal and SARS' conclusion as relates to CGFM leads to an insensible and unbusinesslike result that does not achieve section 9D's objects nor does it supress the mischief the section was intended to address. Given that the decision to set up business in Ireland was due to legal constraints, there can be no accusations of foul play in this regard. Further to the above, given that the income earned by CGFM was not diversionary, passive or mobile and therefore able to erode the tax base, its income could not be said to fall outside the ambit of the foreign business establishment definition.

CGFM therefore qualified as a foreign business establishment, as a result, its net income should have been exempted from CIMSAs taxable income. CIMSAs appeal was therefore upheld, and SARS' cross-appeal was therefore not dealt with. Costs were granted in favour of CIMSA.

Editorial comments

This judgement is a massive win for Coronation and many taxpayers falling withing the ambit of section 9D. A misinterpretation of the facts and to some degree the law by both SARS and the Supreme Court of Appeal were thankfully corrected by the Constitutional Court.

<u>Mailer summary</u>

This is a summary of the Coronation Investment Management SA (Pty) Limited v Commissioner for the South African Revenue Service (CCT 47/23) [2024] ZACC 11; 2024 (9) BCLR 1128 (CC) (21 June 2024) case in which the Constitutional Court was tasked with determining whether an Irish subsidiary met the requirements of a foreign business establishment.