THE SUPREME COURT OF APPEAL OF SOUTH AFRICA

JUDGMENT

Reportable

Case no: 1269/2021

In the matter between:

COMMISSIONER FOR THE
SOUTH AFRICAN REVENUE SERVICE **APPELLANT**

and

CORONATION INVESTMENT
MANAGEMENT SA (PTY) LTD **RESPONDENT**

Neutral citation: *Commissioner for the South African Revenue Service v Coronation Investment Management SA (Pty) Ltd* (1269/2021) [2023] ZASCA 10 (07 February 2023)

Coram: MAKGOKA and NICHOLLS JJA and NHLANGULELA, SALIE and MALI AJJA

Heard: 17 November 2022

Delivered: This judgment was handed down electronically by circulation to the parties' legal representatives by email, publication on the Supreme Court of Appeal website and release to SAFLII. The date and time for hand-down is deemed to be at 11h00 on 07 February 2023.

Summary: Revenue – income tax – Income Tax Act 58 of 1962 – section 9D exemptions – whether a ‘controlled foreign company’ is a ‘foreign business establishment’ as defined – Tax Administration Act 28 of 2011 – understatement penalties.

ORDER

On appeal from: Tax Court, Cape Town (Hack AJ, with two assessors):

1 The appeal is upheld.

2 The order of the Tax Court is set aside and substituted with the following:

'1 The appellant is directed to pay the additional tax imposed in respect of the respondent's additional assessment dated 23 March 2017, and the interest imposed thereon in terms of section 89*quat*(2) of the Income Tax Act 58 of 1962.

2 The appellant is to pay the respondent's costs, including the costs of two counsel.'

3 The respondent is to pay the appellant's cost of appeal, including the costs of two counsel.

JUDGMENT

Nicholls JA (Makgoka JA and Nhlangulela, Salie and Mali AJJA concurring):

[1] The Coronation Group is one of South Africa's most successful investment companies. It has subsidiaries across the globe. Its ultimate holding company, Coronation Fund Managers Limited, is listed on the Johannesburg Stock Exchange (JSE) securities exchange in South Africa. It describes itself as 'an active investment manager following a long term valuation-driven investment philosophy'.[1]

[1] Coronation website, *https://www.coronation.com*.

[2] The respondent, Coronation Investment Management SA (Pty) Ltd (CIMSA) is the holding company for the Coronation Group. It is registered and tax resident in South Africa. During 2012, CIMSA was a 90% subsidiary of Coronation Fund Managers Limited and the 100% holding company of Coronation Management Company and Coronation Asset Management (Pty) Ltd (CAM), both registered for tax in South Africa. CIMSA was also the 100% holding company of CFM (Isle of Man) Ltd, tax resident in Isle of Man. CFM (Isle of Man) Ltd, in turn, was the 100% owner of Coronation Global Fund Managers (Ireland) Limited (CGFM) and Coronation International Ltd (CIL), which were registered and tax resident in Ireland and the United Kingdom respectively. CFM has since been de-registered in Isle of Man.

[3] The issue in this appeal is whether the net income of CGFM should be included in the taxable income of its South African holding company, CIMSA, or whether a tax exemption in terms of s 9D of the Income Tax Act 58 of 1962 (the Act) is applicable to the income earned by CGFM. This depends on what the primary functions of CGFM in Dublin, Ireland are. If the primary operations are conducted in Ireland, then the s 9D exemption applies. Of particular significance is that CGFM has adopted an outsource business model and the attendant ramifications that may have for its tax status. Aligned to this is whether the primary business of CGFM is that of investment (which is not conducted in Ireland), or that of maintaining its licence and managing its service providers (which is conducted in Ireland).

[4] The appellant, the Commissioner for the South African Revenue Service (SARS), assessed the tax liability of CIMSA for the 2012 tax year to include in its income an amount equal to the entire ‘net income’ of CGFM. The Tax Court, Cape Town (the tax court) upheld CIMSA’s objection and found that CGFM was a ‘foreign business establishment’ (FBE) as defined in s 9D(1) of the Act and,

accordingly, qualified for a tax exemption. It set aside SARS's additional assessment against CIMSA and ordered it to issue a reduced tax assessment, in which no amount was included in CIMSA's income under s 9D of the Act pertaining to CGFM's income. Consequently, SARS was not entitled to claim (a) understatement penalties in terms of s 222 of the Tax Administration Act 28 of 2011 (the TAA); (b) understatement penalties for provisional tax under paragraph 20 of the Fourth Schedule to the Act; and (c) interest in terms of s 89(2) of the Act. SARS appeals this decision with the leave of the tax court.

Section 9D of the Income Tax Act 58 of 1962

[5] Prior to 2001, the South African tax regime was a source-based one. The Revenue Laws Amendment Act 59 of 2000 changed this to a resident-based system. Section 9D was introduced to address how South African tax payers should be taxed on their income earned abroad, especially income earned by South African owned foreign entities. A pure anti-deferral regime would immediately deem back all the South African owned foreign company income. As a result, no foreign income would receive any advantage over domestic income. However, international law only allows South Africa to tax foreign residents on their South African source income, not on their foreign source income, even if the entity is completely owned by South African residents. To address this, s 9D imposes tax on South African owners on the income earned by their foreign entities as if those entities immediately repatriated their foreign income when earned.[2]

[6] The section also provides for exemptions which allow certain foreign companies to operate free from tax to the extent that an objective rationale exists for maintaining operations abroad, and when such operations pose no threat to

[2] National Treasury's Explanation to Section 9D of the Income Tax Act, June 2002.

the South African tax base. The purpose of the exemption was to balance the desire for horizontal equity (equity among South Africans earning income at home versus those earning income abroad) against international competitiveness (allowing South African owned subsidiaries to operate on the same level tax fields as foreign owned rivals operating in the same low-taxed foreign countries). The s 9D exemptions were, therefore, introduced as a balancing mechanism between two competing interests: tax avoidance and competitiveness.[3]

[7] The exemption only applies to foreign entities that qualify as a 'controlled foreign company', which is defined as:

'[A]ny foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies . . .'[4]

[8] Section 9D(2) of the Act provides for the imputation of the 'net income' of a controlled foreign company to a South African resident company holding participation rights in that controlled foreign company, unless it falls within the ambit of the FBE exemption. This provides that in determining such net income, any amount 'which is attributable to a foreign business establishment' of that controlled foreign company must not be taken into account.

[9] It is common cause that in the 2012 tax year of assessment CGFM was a controlled foreign company as envisaged. Therefore, the income of CGFM would be imputable to CIMSA, unless it fell within the ambit of the FBE exemption. This, in turn, depends on whether CGFM is an FBE as defined.

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[3] National Treasury's Explanation to Section 9D of the Income Tax Act, June 2002.
[4] Section 9D(1)*(a)* of the Income Tax Act 58 of 1962.

[10] Section 9D(1) of the Act sets out the requirements of a FBE:

'[F]oreign 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 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:

Provided that for the purposes of determining whether there is a fixed place of business as contemplated in this definition, a controlled foreign company may take into account the utilisation of structures as contemplated in subparagraph (i), employees as contemplated in subparagraph (ii), equipment as contemplated in subparagraph (iii), and facilities as contemplated in subparagraph (iv) of any other company –

(aa) if that other company is subject to tax in the country in which the fixed place of business of the controlled foreign company is located by virtue of residence, place of effective management or other criteria of a similar nature;

(bb) if that other company forms part of the same group of companies as the controlled foreign company; and

(cc) to the extent that the structures, employees, equipment and facilities are located in the same country as the fixed place of business of the controlled foreign company.'

[11] The location of the 'primary operations', referred to in s 9D(1)*(a)*(ii)–(iv), is pivotal in determining whether CGFM is an FBE as defined. This requires a determination as to the nature of CGFM's business in Ireland, and in particular,

whether the primary operations have been outsourced, and if so, whether an exemption in terms of s 9D is applicable.

Pleadings and Evidence

[12] The undisputed evidence on behalf of CGFM was that it was incorporated in Ireland during 1997 to provide opportunities for clients to invest in South African and Irish domiciled collective investment funds (CIS). On 23 October 2007, CGFM applied to the Irish Financial Services Regulatory Authority for authorisation of an Undertakings for Collective Investment and Transferable Securities (UCITS). On 25 October 2007, it received its licence from the Central Bank of Ireland (CBI) as a 'management company' in accordance with the European Communities Regulations under Investment Services Directive 93/22/EEC 2125.

[13] In its business plan, attached to its licence application, CGFM presented an outsource business model where CGFM concentrates on being a 'product provider'. All non-core functions, such as investment, administration and custodial functions, are outsourced. The provision of investment management services and trading functions is outsourced to specialist investment managers, CAM in South Africa and CIL in the United Kingdom. The fund administration has been sub-contracted to JP Morgan Hedge Fund Services (Ireland) Limited and JP Morgan Administration Services (Ireland) Limited. CGFM has outsourced its distribution function to CIL and CAM, and its custodian function to JP Morgan Bank (Ireland) Plc. According to the business plan, because these functions are outsourced to independent third party service providers, CGFM is not subject to South African Transfer Pricing rules.[5]

[5] Transfer pricing refers to the prices of goods and services which are exchanged between companies under common control. South African transfer rules are found in s 31 of the Act and practice note 7.

[14] CIMSA asserts that CGFM is not approved to perform investment management, which it sub-contracts to service providers. These are conducted under the oversight, direction and supervision of CGFM as the fund manager. It does not abdicate responsibility for those functions, but exercises oversight and supervision over the conduct of its service providers from Dublin. All this, contends CIMSA, is consistent with the terms of its licence issued by the CBI. Since the actual performance of investment trading functions is not envisaged as part of CGFM's business, nor has the CBI approved CGFM to perform these functions, they cannot be 'primary operations' as contemplated in the FBE definition. The primary business of CGFM, according to CIMSA is, therefore, not the actual performance of investment management, but 'the managed outsourcing of the investment management functions in accordance with the terms of the licence'.

[15] CIMSA's primary functions, as pleaded, are:

'26.1. ensuring compliance with all regulatory requirements of CBI and any other regulators under any licence, including reporting to and responding to communications from the regulator/s;

26.2. ensuring compliance by UCITS and other funds with all regulatory and constitutional document (e.g. trust deed) requirements;

26.3. the appointment and ongoing supervision and monitoring of service providers, including investment management service providers;

26.4. communication and reporting to investors in UCITS and other funds, including management of complaints, disputes and investment reporting;

26.5. overall risk management of the business of CGFM and all funds for which it is responsible;

26.6. compliance with all legal corporate requirements of the Republic of Ireland, including corporate governance;

26.7. financial control and reporting for CGFM and all funds for which it is responsible; and

26.8. investment change management, i.e. informing the investment manager of relevant changes to the investment objectives, policies and restrictions of any of the portfolios and constitutional documents.'

[16] CIMSA denies that CGFM outsourced functions of 'its business' as referred to in the FBE definition and contends that investment management services are not a necessary part of a fund manager's business. CIMSA states that its position is bolstered by the fact that the outsourcing of investment functions is common practice for fund managers in Ireland, Europe and South Africa. It is also recognised as a legitimate practice for fund managers by the CBI.

[17] SARS accepts that CGFM met the FBE definition, in all respects but one: economic substance.[6] As at 2012, CGFM had offices in Dublin with a staff component of four people, consisting of a managing director, two accounting officers and a compliance officer. All the staff were resident in Ireland. It is not disputed that CGFM had conducted its business for more than a year through one or more offices in Dublin (s 9D(1)*(a)*(i)), or that it had 'a fixed place of business' in Ireland (s 9D(1)*(a)*(ii)) which was suitably staffed and equipped with suitable facilities (s 9D(1)*(a)*(ii), (iii) and (iv)). SARS also accepts that the business was located in Ireland for a reason other than the postponement or reduction of South African tax (s 9D(1)*(a)*(iv)). However, it contends that CGFM does not meet the economic substance requirements, as 'the primary operations' referred to in s 9D(1)*(a)*(ii),(iii) and (iv) were not based in Ireland. Accordingly, the Dublin office was not suitably staffed with employees, not suitably equipped, nor did it have the suitable facilities to conduct 'the primary operations' of CGFM's business.

[6] National Treasury's Explanation to Section 9D of the Income Tax Act, June 2002 explains that the economic substance must be demonstrated in terms of operations and in terms of its business purpose.

[18] SARS submits that the FBE definition requires each of the requirements set out in s 9D(1)*(a)*(i) to (v) to be present in a fixed place of business in order for a controlled foreign company to qualify as a FBE. If not, the business is not entitled to a tax exemption under s 9D(1)*(a)*. While it is permissible for a controlled foreign company to outsource locational permanence and economic substance, it must then comply with the proviso set out in s 9D, and each of the discreet requirements in the subsections *(aa)*, *(bb)* and *(cc)* of the proviso have to be met. Whether CGFM qualifies as a FBE, notwithstanding the outsourcing of these primary functions, must be answered with reference to the proviso.

[19] In this regard, SARS contends that CGFM does not meet the requirements set out in the proviso. Had the investment functions been outsourced to a company which is subject to tax in Ireland – where CGFM is located (subsec *(aa)*), within the same group of companies (subsec *(bb)*), and to the extent that the structures, employees and facilities are located in Ireland (subsec *(cc)*) – it would have qualified as a FBE. But, because CGFM outsources its investment management functions to CAM and CIL, neither of whom are subject to tax in Ireland, the requirements of subsec *(aa)* and subsec *(cc)* have not been met.

[20] CIMSA places no reliance whatsoever on the proviso and denies that outsourcing may only take place in accordance with the proviso. While CGFM does not dispute that it did not have sufficient staff to conduct investment trading, it states that its staff complement was sufficient to maintain the licence which is a function of its primary business of a fund management.

[21] SARS's position on the CBI licence is that CGFM elected to apply for a licence whereby its investment functions are outsourced, as opposed to an in-source model. This election, however, does not alter the nature of its business, which remains that of investment. SARS points out that the revenue generated by

CGFM (as per its transfer pricing report) is percentage based and calculated on the market value of the assets of the Irish fund. Other service costs, such as those in respect of administration, custodial and distribution, are paid out of the fees earned by CGFM.

Tax Court

[22] The distinction between investment management and fund management found favour with the tax court, which held that fund management is multi-faceted requiring the securing of the correct licences; ensuring compliance with statutory, regulatory and other laws; making 'broad' decisions about where to invest; and deciding the amounts and when to distribute profits to investors. On the other hand, investment management is more one dimensional and 'the actual discretionary decisions of investment managers play a relatively minor role in the overall picture of fund management'. The tax court relied on CGFM's Transfer Pricing Report, which states that CGFM is responsible for the overall management of the Irish Funds, including but not limited to the investment management function.

[23] 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 has 'economic substance and does not merely exist on paper', 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.

[24] While accepting that the assets under management consist of money which investors invest in collective investment schemes, the tax court had the following to say:

'[T]he fee income of [CGFM] is based on the quantum of assets under management. Fees are raised on the amounts invested by individuals and apportioned to various role players and a

portion is retained by [CGFM] and the balance paid to [CIMSA]. The relevant basis of calculating the fees is on the globular amount under management. [CIMSA] submits, and I agree, that the evidence is that the fee is based on the capital contributed by the investors which occurs before any investment management takes place. Even therefore if raising fees were the primary conduct of the company this would still not be as a result of investment management. Fees are received 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. It is correct, as contended by [SARS] that investment performance does have some impact on the quantum of the fee. But I agree with the submission of [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. As submitted by [CIMSA] it is the confidence that investors place in the fund manager per se in placing its assets with the fund manager that gives rise to the fee, rather than the investment management activity.'

[25] The tax court held that without the execution of the management function by CGFM, none of the other functions could lawfully take place. The tax court reasoned that without the existence of a licence to conduct the business of making investments into the CIS, CGFM would not be able to conduct business and there would be no other functions of investment management, administration, custody or distribution:

'[CGFM] is not an investment management company it is a Fund Management company – it is a licensed fund management company. The licence states that it [is] 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 is outsourced on contract to others.'

[26] On this basis, the tax court was satisfied that the management function performed by CGFM was the primary operation of the business of CGFM. It set aside the additional assessment raised by SARS against CIMSA and directed

SARS to issue a reduced assessment for its 2012 year of assessment, in which no amount was included in CIMSA's income pertaining to the income of CGFM.

CBI Licence

[27] What is the precise nature of the business that CGFM's license approves? The licence, which is headed 'Authorisation of a UCITS Management Company', provides 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'. The accompanying letter sets out the procedures with regard to anti-money laundering and terrorist financing.

[28] Schedule 1 of the licence reads:

'Coronation Fund Managers (Ireland) Limited may not engage in activities other than the management of UCITS authorised according to the Regulations and other collective investment undertakings which are not covered by the Regulations and for which Coronation Fund Managers (Ireland) Limited is subject to prudential supervision but which cannot be marketed in another Member State under the Directive.

This authorisation does not include the provision of individual portfolio management services or other non-core services as set down in Regulation 16(3)(b). Coronation Fund Managers (Ireland) Limited must revert to the Financial Regulator seeking appropriate approval in the event that it proposes to engage in these activities.'

[29] What is immediately apparent is that CGFM's licence is limited to collective investment management. It does not have the authority to engage in individual portfolio management. However, the fact that it is licenced to perform collective investment management is inconsistent with CIMSA's assertion that it is not licenced to perform any investment management. Instead, it appears that investment management is integral to its licence as an authorised management company.

[30] The UCITS Regulations, 2011[7] as amended (the regulations) define collective portfolio management as 'the management of UCITS and other collective investment undertakings, and includes the functions specified in Schedule 1'. The definition of a management company is one whose 'regular business . . . is the management of UCITS in the form of unit trusts, common contractual funds or investment companies (or any combination thereof), and includes the functions specified in Schedule 1'.

[31] Schedule 1 of the regulations deals with the functions. It reads as follows:

'Functions included in Activity of Collective Portfolio Management

1. Investment Management.
2. Administration:

(a) legal and fund management accounting services;

(b) . . .

3. Marketing.'

[32] The regulations specifically make provision for outsourcing or delegation. Clause 23 of the regulations provides:

'(1) A management company may delegate activities to third parties for the purpose of the more efficient conduct of the company's business provided that –

(a) the management company has informed the Bank in an appropriate manner (whereupon the Bank shall, without delay, transmit the information to the competent authority of the home Member State of a UCITS managed by that management company),

(b) the delegation mandate does not prevent the effectiveness of supervision over the management company, and in particular it shall not prevent the management company from acting, or the UCITS from being managed, in the best interests of its investors,

(c) when the delegation concerns investment management, the mandate is only given to undertakings which are authorised or registered for the purpose of asset management and subject to prudential supervision; the delegation shall be in accordance with investment-allocation criteria periodically laid down by a management company,

[7] European Communities (Undertakings for Collective Investment and Transferable Securities) Regulations, 2011.

(d) where the mandate concerns investment management and is given to a third country undertaking, cooperation between the Bank and the supervisory authorities of the third country concerned is ensured,

(e) a mandate with regard to the *core function of investment management* is not given to the trustee or to any other undertaking whose interests may conflict with those of the management company or the unit-holders,

(f) measures are put in place which enable the persons who conduct the business of the management company to monitor effectively at any time the activity of the undertaking to which the mandate is given,

(g) the mandate does not prevent the persons who conduct the business of the management company either from giving at any time further instructions to the undertaking to which functions are delegated or from withdrawing the mandate or both with immediate effect when this is in the interest of investors,

(h) having regard to the nature of the functions to be delegated, the undertaking to which functions will be delegated is qualified and capable of undertaking the functions in question, and

(i) the prospectuses issued by a UCITS list the functions which a management company has been permitted to delegate in accordance with this Regulation.

(2) Neither the management company's nor the trustee's liability shall be affected by the fact that the management company delegated any functions to third parties, nor shall the management company delegate its functions to the extent that it becomes a letterbox entity.' (My emphasis.)

[33] From the above, two points are apparent. First, collective portfolio management, which CGFM has been authorised to conduct, includes investment management, administration and marketing. That fund management included investment management, administration and marketing was confirmed by Tara Doyle (Ms Doyle), the Irish solicitor with expertise in the legal and regulatory aspects of investment services in Ireland. This was also the evidence of Alan West King (Mr King), the managing director of CGFM since 2008. John Ashley Snalam (Mr Snalam), one of the founders of the Coronation Group, now retired, testified that the licence permitted investment management of

collective investment schemes and this was one of the 'core functions' which the company 'elected to outsource as it did with administration and distribution and trusteeship by custody'.

[34] Second, 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 entails supervision of the core business which, in terms of regulation 23(1)*(e)*, is recognised as investment management. In terms of regulation 23(1)*(b)* the management company acts in the best interest of the investors. The liability of the management company is also not affected by the fact that it has delegated its core function. All CIMSA's witnesses were unequivocal that the delegation of trading activities did not relieve CGFM of its responsibilities to the CBI.

[35] This is entirely consistent with the fact that CGFM is authorised as a UCITS management company pursuant to the Investment Intermediaries Act, 1995 in Ireland. This Act is aimed at 'investment business firms', and its purpose is 'to make provision in relation to investment business firms and investment product intermediaries and for the authorisation and supervision of investment business firms and investment product intermediaries by the Central Bank of Ireland . . .'.[8]

[36] The evidence given by the witnesses for CIMSA was that the regulatory functions were incidental. Mr King testified that the licence largely looked after itself. Ms Doyle went so far as to state that it was unnecessary to have employees in Ireland, as the board members could have carried out the function of fund

[8] Investment Intermediaries Act 11 of 1995 (Republic of Ireland).

management at their quarterly meetings. That managerial functions are ancillary to the investment function is also evidenced by the appendix to the application for the authorisation, in which 'managerial functions' are listed. These are decision-taking, monitoring compliance, risk management, monitoring of investment performance, financial control, monitoring of capital, internal audit and supervision of delegates.

[37] The 'delegate oversight' guidance of the CBI deals with 'delegated' and 'retained tasks' and provides that a fund management company may delegate 'in whole or in part certain specific tasks which form part of the fund management company's management functions'.[9] It goes on to state that delegation is permitted but responsibility is retained and that the company should 'take all major strategic and operational decisions affecting the fund management company and any investment funds it manages'.[10] The reference to the investment funds it manages in the CBI guidance is yet another indication that the authorisation by the CBI was for fund management, which comprises investment management, administration and marketing.

[38] CIMSA has conflated the role of a management company with its outsourcing or delegation of its investment and other functions. By so doing, it has impermissibly elevated the management role. The licence granted to CGFM was for fund management, which includes investment management, administration and marketing. That it elected to outsource these functions and merely manage these functions, does not change the nature of the licence or elevate the managerial role into any other than an ancillary one.

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[9] Section 14, Part 1 'Delegate Oversight' of web-based guidance issued by the Central Bank of Ireland in November 2015 titled 'Fund Management Companies – Guidance' and in relation to which UCITS management companies are expected to comply.
[10] Ibid, s 15.

[39] Therefore, CIMSA's pleaded case that CGFM 'has not been approved by the CBI to perform investment functions' is incorrect, nor is it borne out by its own witnesses. The fact that CGFM did not obtain approval for individual portfolio management, or other core services, does not mean that the licence 'expressly excluded investment management from its ambit'. Indeed, the contrary is true, as the CBI licence authorised 'collective investment management' and if it were to engage in individual portfolio management, then it was required to apply for 'appropriate approval'.

The Primary Operations of CGFM

[40] Having established that the CGFM's licence entails investment management, it must be determined whether the nature of CGFM's business in Ireland is that of an investment company or a management company with 'the managed outsourcing of the investment management functions in accordance with the terms of the licence'. It is common cause that the investment function is not located in Ireland. Therefore, if its primary business is that of investment, then its net income as a controlled foreign company will be imputable to CIMSA.

[41] Outsourcing is a commercial reality, particularly in Ireland where, according to Ms Doyle, 70-80% of the businesses operate on an outsourcing basis. CGFM's rationale for setting itself up as a fund manager in Ireland, was to exercise its right to grow internationally and appoint the 'best in the class' investment managers, thereby advancing the best interests of its investors.[11]

[42] De Koker and Williams[12] had the following to say on outsourcing:

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[11] On 5 October 2015, the OECD released its final report on the strengthening of CFC rules and stated that '[a] substance analysis looks at whether the CFC engaged in substantial activities in determining what is CFC income'. It pointed out that many member states of the EU combine a categorical approach with some carve-out for genuine economic activities. Substance analyses use a variety of proxies to determine whether the CFC's income was separated from the underlying substance, including people, premises, assets and risks. 'Regardless of which proxies they consider, the substance analyses are generally asking the same fundamental question, which is whether the CFC had the ability to earn the income itself'.

[12] A de Koker and R Williams *Silke on South African Income Tax* at 5.44, 5-63.

‘Few companies function completely independently, and businesses form partnerships with suppliers as well as outside contractors. Working with outside contractors, or outsourcing, enables companies to conduct their activities more effectively and more efficiently. Although it would be contrary to the definition of a FBE for all the activities of a business establishment to be out-sourced to third party suppliers, some outsourcing activity is possible. To the extent that it is provided by a group company, this is expressly recognised subject to certain conditions. But which functions may be outsourced to other parties must always depend on the particular facts and, to some extent may vary according to the nature of the industry. Where outsourcing does occur, a manager should possess experience, knowledge and skills in relation to the primary business operations and must also have the authority to dismiss an underperforming outsourced service provider. Clearly the personnel, equipment and facilities for the critical “primary operations” of a business cannot be outsourced, but the secondary operations are presumably determined in accordance with reference to turnover, profitability or assets employed, need not necessarily require dedicated personnel, equipment and facilities.’

[43] CIMSA argues that the business[13] of the foreign controlled company must be determined first, since it must have ‘a fixed place of business . . . for the carrying on of the business of the foreign controlled company for a period of not less than one year’. This should be determined by what that entity actually does, the normal commercial activity which it undertakes on a day-to-day basis. Here the daily business is that of fund management, entailing the active management of its service providers, plus regulatory compliance.

[44] According to CIMSA, the ‘primary operations’ referred to in s 9D(1)*(a)* (ii)-(iv) are practical actions required to operate that particular business. On this interpretation CGFM is suitably staffed, equipped and resourced to carry out its primary operations which are conducted in Ireland. In short, CIMSA contends that the functions which CGFM outsourced are not functions of the business that

[13] The word ‘business’ is not defined in the Act, but the dictionary meaning of ‘business’ is ‘one’s regular occupation, profession, trade, task or duty’.

it actually conducts in Ireland on a daily basis, but of the larger fund management service provided to investors in conjunction with the investment manager.

[45] This argument cannot hold water. The meaning to be ascribed to 'primary operations' and 'business' must be contextual, relative to the definition of a FBE, where the words are found. The FBE definition refers to the 'primary operations of that business', which is a direct reference to the business of the controlled foreign company. The phrase 'primary operations' is not defined in either the Act or the Tax Administration Act[14] (TAA). The dictionary definition of the word 'primary' is, inter alia, 'first in importance, chief, leading, main . . .'.[15] 'Operations' means, inter alia, 'working activity, the exertion of force or influence, the way in which a thing works'.[16]

[46] In the Memorandum of Association the objects of CGFM are described as:

'(a) To carry on the business of establishing, either on the Company's own behalf or on behalf of other persons or bodies, specified collective investment undertakings, defined in Section 18 of the Finance Act, 1989 ("Collective Investment Undertakings") and to 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.

(b) . . .

(c) 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 other than Collective Investment Undertakings international corporate bodies, governments or other authorities both as principals and agents and to transact and do all matters and things incidental thereto which may be usual in connection with the business of financing or dealing in monies. PROVIDED

[14] Tax Administration Act 28 of 2011.
[15] Collins English Dictionary *https://www.collinsdictionary.com/dictionary/english/primary*, accessed on 30 January 2023.
[16] Oxford English Online Dictionary.

THAT the Company shall not act as or accept any appointment as a fund manager for any investment scheme or undertaking other than a Collective Investment Undertaking without the prior approval of the Irish regulatory authority but for the avoidance of doubt 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.'

[47] The notion that investment management is not CGFM's core business is at odds with what is stated in its memorandum of association. The stated objects of CGFM are to carry on the business of establishing specified collective investment undertakings; to promote, establish, manage, regulate and carry on any investment, unit or other trust or fund; and to carry on the business of investment and financial management.

[48] What then constitutes the core function of the business that CGFM operates in Ireland? It obtained its licence in terms of the relevant legislation under the Investment Intermediaries Act in Ireland. Investment management is a function integral to the fund management licence. The UCITS regulations refer to investment management as a core function of a management company. Mr Snalam testified that investment management, administration and marketing are 'core functions' for which CGFM is responsible. This sentiment was echoed by Mr King.

[49] In addition, CGFM pays a fee to CAM and CIL out of the fees derived from investment management in terms of the investment management agreements it entered into between CAM and CIL, respectively. In terms of the agreements, CAM and CIL receive a fee amounting to '50% of the net fund management fee received by CGFM Ireland for the fund management services that it performs to

the Irish funds, plus any net performance fees, where applicable'.[17] Notwithstanding the delegation of the investment management to CAM and CIL, the fees in respect of investment was earned by CGFM. Mr King and Mr Snalam testified that CGFM derives its fees from the assets under management, which are essentially the monies of investors in the collective investment schemes. That GCFM's primary source of income is from investment is another indication that CGFM's core function is investment management. Having found that CGFM is licensed as an investment management company, the business of the controlled foreign company (in this instance, CGFM) is unquestionably that of investment, as is also evidenced from the source documents.

[50] The fact that CGFM was permitted to outsource functions does not mean that the scope of its business is confined to supervision of the functions which it has outsourced, together with regulatory compliance. Its operations are determined by those activities for which it sought, and was granted, a licence. That it elected to outsource these functions, does not exclude these functions from the scope of its business. On the contrary, these functions had to fall within the ambit of its business in order to be outsourced. An agent cannot perform a function which does not form part of the business of the principal. In other words, CGFM could not outsource a function that it did not possess in the first place.

[51] The function of investment management is, per the licence, a component of fund management, irrespective as to whether it is outsourced or not. The choice of a particular business model cannot alter the primary operations of a company. The nature of CGFM's business was not transformed from an investment business to a managerial one by outsourcing its investment functions. Put differently, the true business of investment management cannot be transformed into 'managed

[17] Transfer Pricing Report.

outsourcing of investment management funds', simply because it elected a business model of outsourcing in which the function of investment management is outsourced.

[52] If 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'.

[53] 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[18] 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.

[54] The essential operations of the business must be conducted within the jurisdiction in respect of which exemption is sought. While 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.

[18] Diversionary income relates to tax schemes which artificially shift income off-shore; passive income includes dividends, interest and royalties; and mobile income is that from a shell business which merely retains a post-box address and has no non-tax reason for its existence.

[55] On 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. These are not conducted in Ireland. Therefore, CGFM does not meet the requirements for an FBE exemption in terms of s 9D(1). As a result, the net income of CGFM is imputable to CIMSA for the 2012 tax year in terms of s 9D(2).

Understatement Penalty and Under-Estimation of Provisional Tax

[56] SARS imposed an understatement penalty in respect of the imputed net income of CIMSA's 2012 tax year of assessment, in terms of s 222(1) read with s 223 of the TAA, on the basis that there had been a 'substantial understatement resulting in a penalty of 10% of the tax that would otherwise have been paid'.[19]

[57] In the event of an understatement, the taxpayer must, in addition to the proper tax that should have been paid, pay an understatement penalty, unless it is the consequence of a '*bona fide* inadvertent error'.[20] SARS bears the onus of proving the facts upon which the penalty was imposed.[21] A substantial understatement as defined is where the prejudice exceeds 5% of the proper amount that should have been paid, alternatively, exceeds R1 million. Clearly, the threshold has been met in the present case – none of the net income of CGFM was taxed in the hands of CIMSA. This exceeds 5% of the tax otherwise payable.

[19] Section 221 of the TAA defines 'understatement' as 'any prejudice to SARS or the *fiscus* as a result of – *(a)* failure to submit a return required under a tax Act or by the Commissioner; *(b)* an omission from a return; *(c)* an incorrect statement in a return; *(d)* if no return is required, the failure to pay the correct amount of "tax"; or *(e)* an "impermissible avoidance arrangement"'.
[20] Section 222 of the TAA.
[21] Sections 102(2) and 129(3) of the TAA.

[58] CIMSA stated that it relied on a tax opinion procured from a leading tax expert in the country.[22] However, it did not disclose the contents thereof, or make the opinion available to SARS. SARS relies on this non-disclosure to draw a negative inference that the tax opinion did not support CIMSA's claim for an FBE exemption and that a deliberate and conscious decision was taken to exclude the net income of CGFM. It is contended that this was not an inadvertent error.

[59] Similar reasoning is applied to the underestimation of provisional tax for the 2012 year of assessment. In the case of an underestimation of provisional tax, SARS has a discretion to impose additional tax of up to 20% where CIMSA's income is more than R1million and the provisional tax was estimated at less than 80% of the actual amount taxable.[23] In such an instance, SARS must have due regard to the factors bearing thereon. Once again, SARS calls upon this Court to draw an inference from the non-disclosure of the tax opinion that it did not support CIMSA's position on the FBE exemption.

[60] There is nothing to gainsay CIMSA's evidence that it prepared and submitted all its tax returns under the guidance of PricewaterhouseCoopers, and that Ernst & Young were the external auditors of CGFM. Nor is there anything to suggest that CIMSA's tax returns were not submitted in the bona fide belief that CGFM may be eligible for a s 9D exemption. The fact that this Court has now found that this course is not open to it, does not in any manner reflect on the bona fides of CIMSA, any more than it reflects on the bona fides of any losing party in litigation. Insofar as the tax opinion is concerned, it was not incumbent on CIMSA to disclose a tax opinion that it had obtained, any more than it would be on any other party which litigates on the basis of a procured legal opinion.

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[22] The tax opinion was referred to in Mr Snalam's evidence.
[23] Paragraph 20(1)*(a)* of the Fourth Schedule to the Income Tax Act.

[61] In *Commissioner for the South African Revenue Service v The Thistle Trust*,[24] an argument was presented on behalf of SARS that the taxpayer in that matter had consciously and deliberately adopted a certain position when it elected to distribute the capital gains. This Court held that it was correctly conceded that the understatement was a bona fide error and that SARS was not entitled to impose the understatement levy.

[62] Although dealing with the raising of an additional assessment, in *Commissioner, SARS v Pretoria East Motors (Pty) Ltd*,[25] this Court said that there must be proper grounds for believing that there is undeclared income or that a claim for a deduction or allowance is unjustified. It is only in this manner that SARS can engage the taxpayer in an administratively fair manner, as it is obliged to do.

[63] To speculate that a tax opinion must have gone against CIMSA merely because it was not produced to SARS, is simply speculative. It is not sufficient to attribute male fides on the part of CIMSA.

[64] For these reasons, the claim for understatement penalties and underestimation penalties must fail.

[65] All that remains is s 89*quat*(2) of the Act, which provides for interest to be charged on the underpayment of provisional tax. Interest is payable in terms of this section if the 'normal tax' payable by a tax payer in respect of its taxable income exceeds the credit amount in relation to such year. Normal tax includes any additional amounts payable in terms of s 76 of the Act and paras 20 and 20A

[24] *Commissioner for the South African Revenue Service v The Thistle Trust* [2022] ZASCA 153 (SCA) para 29.
[25] *Commissioner, SARS v Pretoria East Motors (Pty) Ltd* [2014] ZASCA 91; [2014] 3 All SA 266 (SCA); 2014 (5) SA 231 para 11.

of the Fourth Schedule thereto. Here, there has been an underpayment on the normal tax and, accordingly, interest is payable in terms of s 89*quat*(2).

[66] In the result, the following order is made:

1 The appeal is upheld.

2 The order of the Tax Court is set aside and substituted with the following:

‘1 The appellant is directed to pay the additional tax imposed in respect of the respondent’s additional assessment dated 23 March 2017, and the interest imposed thereon in terms of section 89*quat*(2) of the Income Tax Act 58 of 1962.

2 The appellant is to pay the respondent’s costs, including the costs of two counsel.’

3 The respondent is to pay the appellant’s cost of appeal, including the costs of two counsel.

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C HEATON NICHOLLS

JUDGE OF APPEAL

Appearances

For appellant:	R T Williams SC (with her H Cassim)
Instructed by:	State Attorney, Cape Town
	State Attorney, Bloemfontein
For respondent:	M W Janisch SC (with him C M Rogers and V M Jere)
Instructed by:	Bowmans, Cape Town
	Matsepes Attorneys, Bloemfontein