

Proposed tax law amendments raise concerns for global business outsourcing

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Proposed amendments to the tax laws, following the Coronation SCA judgment, will make it very difficult for controlled foreign companies with foreign business establishments to outsource functions.



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National Treasury and SARS published the draft Taxation Laws Amendment Bill 2023 for comment on 31 July 2023. The draft bill proposes to amend the foreign business establishment (FBE) exemption for controlled foreign companies (CFCs) in section 9D.

Section 9D of the Income Tax Act 58 of 1962 (Act) contains certain anti-avoidance rules for CFCs, which may result in a notional amount of a CFC's foreign income being taxed in the hands of its South African tax resident shareholders.

A foreign company will be a CFC if, for example, more than 50% of the rights to participate in the shares of the company or voting rights in that company are directly or indirectly held by South African tax residents.

The net income of a CFC is calculated as if the CFC were tax resident in South Africa, and such income is attributed to and taxed in the hands of its resident shareholders holding more than 10% of the CFC.

Two of the common exemptions relied on by CFCs to avoid attributing "net income" to its tax resident shareholders are the high-tax exemption and the FBE exemption.

- The high-tax exemption applies when, broadly, the CFC is subject to a total foreign tax of at least 67.5% of the normal tax which would have been payable had the CFC been a South African tax resident.
- The FBE exemption applies when, among other requirements, the CFC has a fixed place of business of sufficient substance, carries on business for at least a year, is suitably staffed, and has the necessary equipment and facilities to carry on the primary operations of the business.

The proposed amendment

The proposed amendment in the draft bill requires CFCs of South African multinationals (SA MN) to, among others, be suitably staffed with employees and suitably equipped, and to have suitable facilities to "perform all the important functions of that business for which the CFC is compensated" to qualify as an FBE. (The current wording of the FBE exemption refers to "conduct the primary operations of that business").

Practical difficulties arising from the proposed amendment

To understand how onerous the FBE exemption will become if the amendment is implemented as proposed, it is necessary to analyse the meaning of the phrase "important functions" in the context of the objective of the proposal in the explanatory memorandum (EM). The EM provides background and reasons for the proposed change and examples when necessary.

The EM on the proposed amendment states that "It has come to the Government's attention that some taxpayers are retaining certain management functions but outsourcing other important functions for which the CFC is also being compensated by its clients."

As there is no definition of "important functions", the ordinary dictionary meaning of these words would apply. The functions of a business are the activities carried out by an enterprise and can be the core revenue-generating activities or support activities. The word "important" means of significance or value.



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The proposal means that no important functions of a CFC's business, which are revenue-generating (ie compensated) may be outsourced to third parties, with the CFC employing people to manage the outsourcing. Alternatively, the CFC can still rely on the FBE exemption only if it outsources to a group entity located and tax resident in the same country as the CFC's fixed place of business.

Here are some examples where the proposed amendments to the FBE exemption could be problematic.

It is common for businesses to outsource their call centre needs. Is a call centre of a CFC, which is a selling, marketing and distribution subsidiary in the region an important function for which the CFC is compensated? A call centre for enquiries on sales may be an important function, but what about a help desk? Does a help desk fall within the "all important functions ..." In our view, it does.

- What about the entire logistics chain of shipping and customs clearance of goods to customers in the same country and also internationally? Without delivery of goods to customers, there is no completion of the sale. Therefore, delivery of goods is a vital function. Will a CFC need to have employees, equipment and suitable facilities to carry out the international logistics functions of its business in its entirety?
- Taken to the extreme, will CFCs now have to employ their own shipping and logistics staff if they intend to continue relying on the FBE exemption?
- What about an online retailer with a website and an app for sales? Can the retailer outsource the development and maintenance of its website and app to the best and most cost-efficient programmers globally?
- The proposed amendment compels the retailer to employ its own developers or contract with developers employed by another group entity living in the same country as the CFC's fixed place of business. This is contrary to the growing trend for developers and programmers to consult as remote workers globally.
- What if a CFC's sales and marketing strategy is to use social media influencers in multiple countries to generate interest and sales for its products? Is sales and marketing "an important function ..."? The sales and marketing function is usually the core activity for which a business generates revenue. At what point can a CFC use services of a third party without such usage being seen to be "managing" an important function?

There are many commercial reasons why South African businesses may wish to outsource their business requirements to a foreign country rather than grow the business organically. Outsourcing to an experienced service provider with an existing network of local relationships will almost always be more cost-effective, time-efficient and less risky.

Establishing and maintaining a footprint in foreign markets can be a very costly exercise for South African multinationals. Some businesses may also lend themselves more easily to outsourcing and this would be the norm in the industry globally.

Problematic effective date of proposal

The effective date of the proposal is also problematic and leaves no time for a SA MN with CFCs to meet the new requirements if it wants to continue to rely on the FBE exemption to avoid attributing income of the CFC to its South African tax resident shareholders.

The proposed amendment comes into operation on 1 January 2024 and applies to foreign tax years of CFCs ending on or after that date. This means that the proposal applies to all CFCs with financial years ending on or after 1 January 2024. CFCs with a financial year ending on 29 February 2024, 31 March 2024 or 30 June 2024 (which are common financial year-end dates) would already be caught in the proposals.

Webber Wentzel has submitted comments to the National Treasury on these issues which we hope will be taken into account. As is usually done in previous years, the tax bills should be introduced to the National Assembly around the last week of October 2023, together with National Treasury's response document on comments to the draft tax bills.

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