2023 Draft tax legislation – Foreign Business Establishment amendment

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Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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In brief

The draft 2023 Taxation Laws Amendment Bill (published for comment on 31 July) proposes potentially far-reaching amendments to the Foreign Business Establishment (FBE) exemption for Controlled Foreign Companies (CFCs) of South African residents.

In summary, it is proposed that in order to qualify for the FBE exemption all the important functions for which the CFC is compensated should be performed by the CFC or another group CFC located and subject to tax in the same country as the CFC's fixed place of business.

In detail

General

On 31 July 2023, National Treasury and the South African Revenue Service published the 2023 draft tax legislation for comment (due by 31 August 2023).

The draft legislation proposes amendments to the FBE exemption (contained in section 9D of the Income Tax Act 58 of 1962, as amended), coming into operation on 1 January 2024 and applying in respect of foreign tax years of CFCs ending on or after that date.

Reasons for the amendments

The draft Explanatory Memorandum states that it has come to Government's attention that CFCs outsource certain important functions for which it (the CFC) is also being compensated by its clients.

Accordingly, since the location of the 'primary operations' (as referred to in the FBE definition) is vital in determining whether the FBE exemption applies, the draft amendments propose that, to qualify for the FBE exemption, *all important functions for which a CFC is compensated* should be performed either by the CFC or by another CFC in the same group of companies that is located and subject to tax in the same country as the CFC's fixed place of business.

Section 9D amendments

The proposed amendments to the FBE definition read as follows:

"'foreign 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 the primary operations of that business]** <u>perform all the important functions of that business for which the controlled foreign company is compensated</u>;

(iii) that fixed place of business is suitably equipped for **[conducting the primary operations of that business]** <u>performing all the important functions of that business for which the controlled foreign company is compensated</u>;

(iv) that fixed place of business has suitable facilities for **[conducting the primary operations of that business]** <u>performing all the important functions of that business for which the controlled foreign company is compensated;</u>

…"

Takeaway

The proposed amendments could have far-reaching implications for the taxation of CFCs. In particular, the shift from "primary operations" to "all the important functions" of a business could potentially significantly raise the bar for qualification for the FBE exemption in the event that the CFC outsources any aspect of the business that may be considered important. The proposed change will effectively mean that, in order to qualify for the FBE exemption, no important functions may be outsourced to third parties or to any group entity located and tax resident in a country other than where the fixed place of business is located. Examples where this may apply include:

- A company selling goods using a third party to deliver the goods to the customer
- A company using agents to sell its products to customers
- Outsourcing to or sub-contracting a third party to perform elements of a customer contract.

Taxpayers should carefully consider these proposals in the context of their businesses and make submissions as appropriate by 31 August 2023.