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BUSINESS UNITY SOUTH AFRICA COMMENTS ON THE DRAFT TAXATION LAWS AMENDMENT BILL, 2023 (DTLAB): FOREIGN BUSINESS ESTABLISHMENT EXEMPTION FOR CONTROLLED FOREIGN COMPANIES

INTRODUCTION

1. Business Unity South Africa ("BUSA") is a confederation of business organisations, including chambers of commerce and industry, professional associations, corporate associations, and sectoral organisations. It represents South African ("SA") business on macro-economic issues that affect it at the national and international level. BUSA's function is to ensure that business plays a constructive role in the country's economic growth, development, and transformation and to create an environment where businesses of all sizes and sectors can thrive, expand and be competitive.

2. BUSA welcomes the opportunity to submit comments on the draft Taxation Laws Amendment Bill, 2023 ("DTLAB") which was published on 31 July 2023 and to engage in a consultation process with National Treasury to ensure a robust, coordinated, and aligned policy framework.

3. BUSA believes a stable economic landscape is a prerequisite for economic growth. Tax policy and legislation contribute to this stability when a fine balance is struck between safeguarding the South African tax base and cultivating a conducive environment for domestic companies to grow and expand their operations. Certainty and stability are maintained through consistent tax policy that guides legislative amendments. It is feared that the proposed changes to section 9D do not support this much needed stability, but rather introduces uncertainty with potentially far reaching unintended economic consequences.

4. When section 9D was introduced, the National Treasury illustrated the tax policy and explained legislation by way of an example: a foreign company operating warehousing activities in a Mediterranean country, which operates as a central delivery point for products shipped to customers in Southern Europe and the Middle East. This company qualified for tax exemption under section 9D at the time. In this example the foreign warehousing operations qualify as a foreign business establishment even though it outsourced the trucking and airline transportation portion of its business to independent contractors. Under the new, proposed legislation, the profits of this company will be fully taxable in South Africa.

5. In terms of the historic tax policy, applicable up to now, foreign profits of legitimate, fully operational foreign subsidiaries are exempt from South African tax. Transfer pricing rules were introduced to protect the fiscus further against alleged 'postbox company scams and other diversionary activity. Profits are taxed in South Africa when holding companies are compensated for their investment by way of dividends received and profits on the sale of shares. Foreign treasury operations merely holding on to investment income for and on behalf of South African companies are fully taxable on foreign passive income by attributing these to the South African holding company.

6. The motivation put forward in the Explanatory Memorandum to the proposed changes to section 9D is that it clarifies the tax position in this regard. Our members are of the view that the proposed legislation goes much further than

clarifying the position; rather it introduces a completely new policy of prescribing how legitimate foreign business operations should be operated.

7. Prescribing how an active foreign business should conduct its business paves the way for prescribing how South African companies should operate their businesses. Bureaucracy and interference with commercial business operations will stifle economic growth and, as a result, shrink the tax base.

8. The optimum policy for economic growth is the current policy, namely determining whether proceeds should be within the South African tax net, and if so, whether it should be taxed. A policy of prescribing how business should operate and how to go about generating income inhibits growth.

9. In the 2022 Budget Speech, the Minister of Finance announced local legislative amendments will be implemented to give effect to Pillar One and Pillar Two of the OECD/G20 Inclusive Framework on BEPS. This policy will ultimately ensure that a minimum tax is paid by all group entities of large groups, irrespective of where these entities are resident and taxed. If this minimum tax is not paid by subsidiaries, the ultimate holding company should pay the shortfall tax in its jurisdiction. This policy aligns with the current section 9D wording, but the introduction of the proposed new wording is a significant deviation from this policy.

10. This submission covers specific comments in relation to the suggested proposals with regards to 'Income Tax: International – Clarifying the Foreign Business Establishment ("FBE") exemption for Controlled Foreign Companies ("CFCs")' contained in s9D of the Income Tax Act ("the Act").

THE FOREIGN BUSINESS ESTABLISHMENT EXEMPTION FOR CONTROLLED FOREIGN COMPANIES

Applicable provisions

11. Clause 7 of the DTLAB, amending the 'Foreign Business Establishment' definition contained in s9D (1) of the Act in relation to a CFC, and more specifically paragraph (a)(ii), (iii) and (iv) as follows –

    (a) (ii) that fixed place of business is suitably staffed with on-site managerial and operational employees of that CFC who **[conduct the primary operations of that business]** <u>perform all the important functions of that business for which the CFC is compensated</u>:

    (b) (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 CFC is compensated</u>;

    (c) (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 CFC is compensated</u>".

12. The proposed effective date for the abovementioned suggested changes to come into effect is 1 January 2024, applicable in respect of foreign tax years of CFCs ending on/ after that date.

Problem statements

Proposed changes to the s9D (1) "Foreign business establishment" definition

13. In the Draft Explanatory Memorandum ("DEM") on the DTLAB, as 'Reasons for change' it is stated that some taxpayers are retaining certain management functions but outsourcing other important functions for which the CFC is also being compensated for by its clients. The same reasoning was provided in the Budget speech that was presented on 22 February 2023, stating that this is against the policy rationale of the definition of an FBE, and it was therefore proposed that the tax legislation be clarified such that, to qualify as a FBE, all important functions for which a CFC is compensated need to be performed by the CFC or by a group company in the same jurisdiction meeting certain requirements.[1]

    In BUSA's view, albeit the objective with the proposed changes is to create more clarity, the current wording and determination of 'important functions for which the CFC is compensated' is likely to give rise to even more ambiguity in the interpretation of already complex legislation.

    The policy rationale when introducing the FBE exemption of achieving a balance between anti-deferral and international competitiveness[2] may also be adversely impacted with the proposed suggestions (see more detail further below).

14. The DEM further emphasises that the location of the 'primary operations' (referred to in the FBE definition) is vital in determining whether a company meets the definition of an FBE as defined in the Act. The DEM then concludes that in essence, this determination established whether the primary operations have been outsourced, and if so, whether an exemption in terms of s9D of the Act is still applicable or not. BUSA agrees with this statement and supports the other requirements of the current FBE definition to ensure a substantive, suitably

[1] 2023 Budget review, Annexure C: Additional tax policy and administrative adjustments, p148
[2] National Treasury's detailed explanation to Section 9D of the Income Tax Act (June 2002), p1

equipped business enterprise, which was not set up for the sole or main purpose of avoiding tax.

15. The DEM explains the proposal that 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, to qualify for the FBE exclusion. And further that although it is permissible for a CFC to outsource other important functions and be compensated for it, the CFC must still comply with the proviso set out in s9D(1) of the Act, the definition of FBE, and each of the requirements in the subsections (aa), (bb) and (cc) of the proviso have to be met (i.e. outsourcing to a group company, located and subject to tax in the same jurisdiction as the FBE). BUSA has serious concerns that the introduction of the proposed DTLAB changes will lead to uncertainty and non-commercial outcomes and will be detrimental for multinational entities ("MNEs") conducting their business in the most commercial and cost-efficient way or conforming to best practice in a specific industry to remain competitive. A further concern is the potential loss of skills and capacity (see more detail further below).

16. Given that the requirement is that the CFC must perform all important functions for which it is compensated, this could arguably mean even that back-office support functions would need to be performed by the CFC, e.g., finance, treasury, HR, IT, etc. For example the following business models are most likely to be affected: any business selling goods or services through the agency of another entity, e.g. the entire travel and hospitality industry, telecoms (contracts and prepaid); any business that sub-contracts parts of a customer contract to another entity (whether related or third party), e.g. consulting contracts, maintenance contracts; any business selling goods where the seller is responsible for delivery of the goods to the customer and outsources the logistics function (a very common if not usual scenario); outsourced customer support functions (e.g. helplines); centralised procurement functions within a group; group strategic management services provided to subsidiaries and centralised group brand and marketing services.

17. It remains important for the CFC tax avoidance legislation to strike a balance between taxing foreign income and not stifling global competitiveness, in line with global trends, as was also acknowledged in the OECD/G20 2015 Final Report on Action 3.[3] An unbalanced approach will adversely impact on South African MNE's competitiveness compared to their peers in other jurisdictions.

18. It was also stated in the Davis Tax Committee ("DTC") Report on OECD Action 3: Strengthening CFC Rules[4] as well as the Executive summary of the Second Interim Report[5] that for SA, an emerging markets economy, which has adopted CFC rules, any consideration to propose tighter CFC rules or redesign CFC rules needs to be carefully contemplated. This report highlighted that any proposed changes to the CFC rules should consider not only its ability to combat Base Erosion and Profit Shifting ("BEPS") but also the competitiveness of its home grown MNEs and their ability to compete globally against MNEs from countries without CFC rules or more lenient CFC rules. As a result, tighter CFC rules can adversely affect the ability of home grown MNEs to compete in low tax markets. The DTC's concludes that SA's CFC legislation is very sophisticated and comparable to other G20 countries and that there is no need to strengthen the legislation. BUSA supports this recommendation and conclusion.

19. As an observation, the DTC does however raise the question as to, at a mechanical level, the current CFC regime requires enough substance under the FBE test to meet the policy objective of having meaningful CFC local activity.[6] The DTC recommended that a review of the substance requirement may be appropriate, but also recommended that a further inquiry of the tax base risks associated with outsourcing needs to be explored before some form of automatic tainting could be legislatively imposed to this practice. In BUSA's view, to introduce any sort of substance test, which may include for example a threshold test (e.g.

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3 OECD/G20 Base Erosion and Profit Shifting Project Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report para 14

4 Forming part of the Second and Final Report on Base Erosion and Profit Shifting, issued September 2016

5 Davis Tax Committee: Executive summary of Second Interim report on Base Erosion and Profit Shifting (BEPS): OECD BEPS project from a South African perspective: Policy perspectives and recommendation for South Africa, p28

6 Davis Tax Committee: Executive summary of Second Interim report on Base Erosion and Profit Shifting (BEPS): OECD BEPS project from a South African perspective: Policy perspectives and recommendation for South Africa, p30

employees to factually demonstrate a substantial contribution to the CFC income earning activity) or a specified numerical size of for example the number of staff members required, the amount of equipment required, size of office/factory, etc. to substantiate the CFC having meaningful local activity to conduct its core/primary operations will be extremely difficult to implement and control, as this will vary depending on the type of activities required by the business and industry of the taxpayer and remains a factual question. It is suggested by BUSA that whether a company has enough substance to conduct its primary business operations need to be tested objectively on a case-by-case basis.

20. The proposed s9D changes to the FBE definition will in BUSA’s view adversely impact on MNEs where staffed and suitably equipped businesses (CFCs) conduct core/primary operations which may include outsourcing certain important activities for which the CFC is compensated. These CFCs will no longer qualify for the FBE exclusion, going against international tax trends and the initial policy rationale when the legislation was introduced, i.e., to achieve a balance between anti-deferral and international competitiveness.[7]

21. Commercial reasons for most MNEs outsourcing important and other functions for which CFCs may be compensated include *inter alia* to focus on the business’ core/primary operations, reduce costs (e.g., salaries, equipment, etc.), increase efficiencies, gain access to specific skills and resources, etc. Functions that may be outsourced could include, for example, shipping and logistics, manufacturing, customer service, sales, research, IT, marketing, finance and tax compliance, research, etc.[8]

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[7] The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2002 p14 states under the heading ‘Business Establishment’ that: ‘The CFC regime strikes a balance between competitiveness and international tax neutrality. Under this balance, passive income, and diversionary income (tax schemes artificially shifting income offshore) are subject to immediate taxation in the hands of a resident who holds participation rights in the CFC. Active income of the CFCs is, however, exempt under section 9D (9) in order to ensure that foreign businesses remain competitive with local businesses in the foreign country from a tax point of view. This active income includes income attributable to a business establishment unless it is passive or diversionary.’

[8] See also A de Koker and R Williams *Silke on South African Income Tax* at 5.44, 5-63 who stated the following: ‘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 activities of a business establishment to be outsourced to third party suppliers, some outsourcing activity is possible…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…Clearly the personnel, equipment and facilities for the critical “primary operations” of a business cannot be outsourced.’

The way of doing business has also changed significantly in the last decade, with many of the most successful companies today not making any products or owning any inventory. Some well-known examples include Uber, the world's largest taxi company owning no vehicles, Airbnb, the world's largest accommodation provider owning no real estate, to name but a few. These providers need a service/platform or connect people to things as its business model. Should a specific business model be imposed on these companies, e.g., the provision of transport or accommodation being an important function that these companies get compensated for, it would always fail the FBE test.

22. The proposed amendments that the FBE must perform all the important functions of that business for which the CFC is compensated will cause significant uncertainty and concern amongst SA multinationals and would frustrate the establishment of innovative and competitive foreign businesses by SA tax residents. It is likely to lead to non-commercial outcomes in that it would require a significant and uncertain expansion of how a substantive operation must be structured (ignoring best practice and commercial considerations), forcing companies to move whichever functions that may be considered to be important offshore (which might be very impractical or near impossible), leading to a further loss of skills and tax base for the country.

23. It will adversely impact on commercial and cost-efficient global business models, with the reality that although the business' primary operations (as per the current legislation) cannot be outsourced to qualify for the FBE exemption, very often some of the important functions are outsourced.

24. It would further mean that any outsourcing of any activities (except for to a group entity located and tax resident in the same country as the CFC) would potentially jeopardise its current FBE exemption, even though it does have a fixed place of business that is suitable staffed and equipped for conducting its primary operations. This uncertainty will not be palatable for taxpayers in general.

25. A likely further potential impact on the SA economy could be the real risk of companies moving their holding companies abroad or delisting from the Johannesburg Stock Exchange (“JSE”) and may also hinder any new potential foreign direct investments.

26. It is noted that in addition to the CFC provisions, transfer pricing rules should enforce restoring the taxing rights and correct profit allocations of all jurisdictions.

***Proposed effective date*.**

27. The proposed effective date of 1 January 2024, applying in respect of foreign tax years of CFCs ending on/after that date is also problematic as CFCs with financial years ending on 29 February, 31 March, or 30 June 2024 would already be subject to these proposals.

Proposed solution

28. In BUSA’s view, what constitutes the ‘primary operation(s)’ of a business remains a question of fact, and if correctly applied (also considering the policy objective when this legislation was introduced), the current legislation and wording specifically referring to the FBE definition is adequate and strike a balance between protecting the SA tax base and enabling SA MNE’s to compete offshore. It is therefore suggested that the current wording of the FBE definition should be retained.

29. If National Treasury is still of the view that changes to the current FBE definition is in fact required despite the concerns raised above, these should be done in consultation with industry and any proposals should not hinder legitimate FBEs. Alternatively, given the potentially significant implications for South Africa’s competitiveness, BUSA firmly believes that any potential amendments to the FBE exemption in section 9D should be deferred to allow for more comprehensive research and consultation with stakeholders.

30. Further, the current effective date proposed should be deleted until more research has been done on the potential economic impact on the country arising from these proposals.

31. BUSA contends that the current legislation and specific transfer pricing rules have been sufficient to protect the fiscus against alleged ‘postbox company scams’ and hence these changes are not necessary and should be removed.

32. Lastly, BUSA has included Annexure 1 as a supplementary comment on both the Draft Taxation Laws Amendment Bill and the Draft Tax Administration Amendment Bill.

Yours faithfully

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