10 February 2017

The South African Revenue Service
Lehae La SARS, 299 Bronkhorst Street
PRETORIA
0181

BY EMAIL: [redacted]

RE: DRAFT INTERPRETATION NOTE 50 (ISSUE 2): SECTION 11D

DEDUCTIONS IN RESPECT OF SCIENTIFIC OR TECHNOLOGICAL RESEARCH AND DEVELOPMENT

We have attached the comments from the SAIT Business Tax Incentives Work Group on the draft interpretation note 50 (issue 2) on section 11D deductions in respect of scientific or technological research and development. We appreciate the opportunity to participate in the process and would welcome further engagement.

Please do not hesitate to contact us should you need further information.

Yours sincerely

Duane Newman

Chair of the Business Tax Incentives Work Group

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SAIT BUSINESS TAX INCENTIVES WORK GROUP – COMMENTS

DRAFT INTERPRETATION NOTE 50 (ISSUE 2): SECTION 11D

DEDUCTIONS IN RESPECT OF SCIENTIFIC OR TECHNOLOGICAL RESEARCH AND DEVELOPMENT

General comments

The South African Revenue Service (SARS) have issued an interpretation note on section 11D deductions in respect of scientific or technological research and development (R&D). This draft interpretation note 50 (issue 2) is meant to update the current interpretation note 50 (issue 1). However, the Department of Science and Technology (DST) has also issued detailed guidelines for applicants for the R&D tax incentive. There are differences and duplications between the SARS interpretation note and the DST Guideline. We are concerned that this leads to uncertainty rather than providing clarity for taxpayers. These conflicts need to be resolved.

We request that clarity be provided between the role of the DST and the role of SARS. The documents should support these roles. A single document that that covers both the process/technical and the financial/tax aspects would be ideal. However, two separate documents that each deal with the relevant aspects that are the role of the DST and SARS, respectively, could also work provided that they don't conflict and that they cross-refer to each other as appropriate.

Generally, the examples used in the draft IN do not provide clarity. A number of the examples given do not demonstrate when and how a taxpayer would qualify for the deduction as most examples show what does not qualify. In addition, some of the examples do not relate to the heading/topic under which they are included. Using software in the examples does not demonstrate the principles clearly and should generally be avoided. Some of the examples are too simplistic to provide insight. Real life examples of R&D that qualifies would be more helpful. However, it would probably be best to exclude the examples from the draft IN and to deal with them in the DST Guideline only, given that they relate to the technical requirements.

There are conflicts between some of the wording used in the draft IN and the Patents, Designs & Copyright Acts which cannot be reconciled. The draft IN should be aligned with our intellectual property law, including the case law, which has been developed over the years.

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Specific comments

Par 1: Purpose

Legislative amendments up to 1 January 2015 have been taken into account in the draft IN. There have, however, been amendments since then. The draft interpretation note should be updated to also deal with the current tax law, as amended. Not doing so would mean that the IN would be outdated as soon as it is issued.

PART A: DEFINITION OF "RESEARCH AND DEVELOPMENT"

Consideration should be given to removing this part from the draft IN and to deal with it in the DST guidelines only. We have, however, made our specific comments thereon below.

Par 3.2: Discovery of non-obvious scientific or technological knowledge

Page 10: Example 1 – Technical vs technological

Using this example is not appropriate as software is a creation, not a discovery.

Page 10: "Technical Problems vs Technological Uncertainties"

We question the basis of the use of the Canadian Revenue Authority description as authority given that the Canadian tax and intellectual property law is not the same as the South African tax and intellectual property law. Also, the Frascati Manual is generally used as authority in the draft IN, hence it is not clear to us why it is not used here.

Par 3.3: Creating or developing an invention, functional design, computer program or knowledge essential

Page 12: Example 2 – New

This example is too simplistic and does not demonstrate what would qualify as an invention.

Par 3.3.2: Design

An example should be included to demonstrate the difference between an aesthetic and a functional design.

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Par 3.3.3: Computer programs

Clarity should be provided on the meaning of "innovative" specifically in the context of a computer program.

The Frascati Manual is used as authority for the requirement that a computer program will qualify as R&D if its completion is dependent on the development of a scientific or technological advance and the aim of the project is to resolve a scientific or technological uncertainty. This is a deviation from the South African intellectual property law which does not contain the requirement for technological advance to resolve technological uncertainty. Words that have meaning in our law should be given such interpretation.

Page 15: Example 3 – Computer program

The conclusion reached in this example is not well argued and does not explain why the approach is not innovative. We suggest that you include an example of a computer program that would qualify.

Par 3.3.4: Knowledge essential

Knowledge essential is also referred to as know-how. The meaning is defined in our case law which should be referred to as opposed to the Oxford Dictionaries. As a starting point, Van Heerden & Neethling introduce know-how in their text on Unlawful Competition in the context of trade secrets (Chapter 9 section 1.2). They define it as trade, business or industrial information belonging to someone which has an economic value, and which is not known publicly (this secrecy element is critical). The draft IN does not take any of these things into account, and applies the wrong considerations.

Page 16: Example 4 - Knowledge essential to the use

The example should deal with knowledge essential as defined in South African case law in order to be helpful. We have attached a real-life example of R&D that qualified and was approved by the DST for section 11D purposes. The project got approval under design and knowledge essential to the use of the design.

Par 3.4.5: Improvements

Page 16: More guidance is needed on what is regarded as innovative in the specific context of improvements.

Page 17: The factual enquiry of whether an improvement is significant is quite subjective and more guidance is needed. The Oxford South African Concise Dictionary definition of "significantly" which is quoted is "extensive or important enough to merit attention". It is not clear whose attention. A worked example with numbers is needed.

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Par 3.5: Creating or developing a multisource pharmaceutical product

Not helpful for further understanding what would qualify as examples are not provided.

Page 19: Appropriate examples are needed to demonstrate the above.

Par 3.6: Conducting a clinical trial

Page 20: Example 5 – Clinical trial conducted and concluded before application approval

A better example that qualifies should be provided.

Par 3.7: What is meant by innovative

Different requirements are conflated in this paragraph.

Page 21: "Innovative" means different things in different contexts for example, in the case of designs v improvements v computer programs. Therefore, the "innovative" requirement should be dealt with separately in respect of each relevant kind of intellectual property.

Page 22: The R&D task team has recommended (recommendation 6) that the innovation need not be on a world-wide basis.

It is not appropriate to define "innovation" with reference to "novelty". Novelty is a different requirement and "novel" is given a specific meaning in the Patents Act and the Designs Act.

An innovative standard must be tested separately in the very different contexts of Patents, Designs, Copyright and Knowhow. A single, universal standard is not possible. More guidance is needed in respect of each relevant kind of intellectual property, based on its context.

Par 3.8: Exclusions

Par 3.8.2: Development of internal business processes

We fundamentally disagree that scientific or technological research and development to improve a company's manufacturing/production processes should be disallowed. We also question whether it was intended by the legislature that scientific or technological research and development to improve a company's

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manufacturing/production processes should be disqualified. This is the inference to be drawn from Example 7 – Internal business process not qualifying as R&D – dealing with the improved bottling process. We are not convinced that the interpretation given in the draft IN is correct. The draft IN uses the ABC judgement as authority for this proposition. In the ABC case it was accepted that the software program/s developed by ABC was a business process. However, the main question before the court in the ABC case was whether a business process developed for use by customers of the company, as opposed to use by the company itself, would also be regarded as an **internal** business process. In our view, the ABC case does not provide authority for the conclusion reached in Example 7 as the facts are very different and the ABC case did not deal with the question of whether or not a manufacturing/production process is a business process. We recommend that further consideration should be given to the correct meaning of the phrase "business process" contrasted with other processes such as "manufacturing/production processes".

Par 3.8.5: Oil and gas or mineral exploration or prospecting

An example should be included to demonstrate which mineral exploration and prospecting technology development activities qualify as R&D and which do not qualify. Qualifying R&D activities in the mining industry are discussed in the 2015 edition of the Frascati Manual - refer to section 2.95 - 2.98 (page 72 - 73).

PART B: DEDUCTION OF EXPENDITURE

This part should be updated to reflect the legislation as it currently stands, including the amendment in relation to the exception to the prescription rules for the R&D incentive.

Par 4: The law

There is uncertainty amongst taxpayers regarding whether or not they can claim their R&D expenditure for tax pending pre-approval by the DST. National Treasury has indicated in in its Final Response Document on Taxation Laws Amendment Bill, 2016 and Tax Administration Laws Amendment Bill, 2016 on page 42 that, there was a request from taxpayers to allow a partial deduction while a taxpayer is waiting for pre-approval of its R&D deduction. It would be helpful if the draft IN discussed this matter and included National Treasury's response and confirmation whether SARS supports this approach.

Page 29: A specific section dealing with pilot plants and prototypes and practical examples thereon would be helpful.

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Par 4.3: Expenditure actually incurred by the taxpayer

Page 31: Directly and solely for the purpose of

Further clarity is needed on what activities and costs will qualify. Examples of general physical and administrative overheads should be given. Also, costs incurred by a dedicated R&D centre (electricity, water, security, insurance), where the majority of work is R&D and the centre will not be able to function without incurring these costs should be specifically addressed. An example where some of the R&D projects qualify and other projects do not qualify should be provided.

The note should clarify what is meant by "employee's salary". An employee dedicated to R&D will spend most of his/her time at the office doing R&D and maybe an insignificant portion of time doing some administration work. As most employees are on Total Cost To Company Packages ("TCTC"), the TCTC company should be applicable, without making any adjustments for annual or sick leave.

Training and subscriptions costs incurred as a direct cost to enable and equip the scientists to full fill their roles as scientists and to stay technically up to date in their fields of speciality should be addressed. Scientists also have to be members of the South African Council for Natural Scientific Professions ("SACNASP") to operate as scientists.

Par 6: Funding for R&D

Par 6.2: Funding received by a company undertaking R&D activities

Page 40: An example is needed to demonstrate the treatment where a company funds a group company.

Example 17 – Indirect funding

The example would be more relevant if the company funds the university and not the other way around.

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Par 8: Disallowance of deductions

Par 8.1: The law

Page 41: Section 11D(19)

Detailed clarification should be provided of how the process works and what the DST and SARS respective roles and responsibilities are in relation to the claiming of the incentive, the submission of progress reports and the withdrawal of the approval. This should give taxpayers practical insight on how the process could impact them.

PART C: R&D ADJUDICATION COMMITTEE

Par 10: Functions of the committee

Par 10.1: The law

Page 46: When and while a project is approved by the DST, SARS should not dispute with the taxpayer whether or not its approval is valid and it qualifies. SARS should focus on the verification of the expenditure claimed for tax purposes.

Par 12: Decision of the Minister

Par 12.1: The law

We are not comfortable that the discussion of what would suffice as adequate reasons accurately reflects our law. We are particularly uncomfortable with the table on page that makes a distinction between Reason and Evidence. Substantive reasons for an administrative action must be provided. The provision of adequate reasons might well require some of the information which is classed as evidence.

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PART D: OTHER PROVISIONS

Par 13: Reporting requirements

Par 13.1: Reporting by the taxpayer to the Minister

Par 13.1.1: The law

The note indicates that in terms of the law the taxpayer must submit an annual progress report to the Committee. In practice taxpayers submit these reports to the DST. It should be clarified that this is acceptable.

It should be mentioned in the note that the DST must inform SARS of their acceptance of the annual progress report.

Conclusion

In conclusion, the section 11D deduction has a very important role to play in incentivising R&D in South Africa. However, lack of certainty of whether or not a project will qualify works against the incentive. It is important that a taxpayer is able to assess themselves whether there is a good chance they would qualify for the incentive. The SARS IN and the DST Guideline need to assist in this self-assessment process. If the DST approval is seen to be a "game of chance", there is a high likelihood that the incentive will fall into disuse.

Therefore, we would like to emphasise that it is important that the SARS IN and the DST Guideline read together should provide taxpayers with practical assistance and that they should not cause confusion and add to the uncertainty and complexity of applying for the incentive.

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Real-life example of R&D that qualified and was approved by the DST for section 11D purposes

Example redacted for confidentiality reasons.

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