23 November 2018

The National Treasury
240 Madiba Street
PRETORIA
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The South African Revenue Service
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BY EMAIL: 2019AnnexCProp@treasury.gov.za & Adele Collins (acollins@sars.gov.za)

RE: ANNEXURE C PROPOSALS FOR 2019 BUDGET: BUSINESS TAX INCENTIVES

We have attached the comments from the SAIT Business Tax Incentives Work Group on the Annexure C tax proposals for the 2019 Budget pertaining to key business tax incentives issues. We have raised most of these issues before without success. We strongly believe that National Treasury needs to address these concerns otherwise the tax incentives will create unintended tax uncertainty and also unnecessary tax risk for clients who claim them in good faith. We also request a meeting to discuss these matters in more detail where we can share examples to demonstrate taxpayer concerns.

We are aware that the Department of Planning Monitoring and Evaluation has commissioned an evaluation of the national system of business incentives. We look forward to the outcome of the evaluation. However, there are certain matters that should receive attention in the meantime as indicated in our attached submission.

We appreciate the opportunity to participate in the process and would welcome further dialogue.

Yours sincerely

Duane Newman
Chair of the Business Tax Incentives Work Group
Enclosures:

Annexure C Proposals

SAIT representatives to be invited to National Treasury workshops

South African Institute of Tax Professionals

ANNEXURE C PROPOSALS FOR 2019 BUDGET: BUSINESS TAX INCENTIVES ISSUES

ANNEXURE C PROPOSALS FOR 2019 BUDGET: BUSINESS TAX INCENTIVES ISSUES

1. SECTION 12I ADDITIONAL INVESTMENT ALLOWANCES FOR INDUSTRIAL POLICY PROJECTS: DISPARITIES BETWEEN THE TAX ACT VERSUS THE REGULATIONS

Of all the tax incentives, section 12I is viewed as the most important tax incentive for large manufacturing investments. There are currently limited grants and incentives for large manufacturing investment outside those for automotive and black industrialists. The incentive should be reviewed to determine whether its period will be extended beyond December 2020 and to determine an additional budget allocation, given that the full budget originally allocated has been used. The incentive is still "open" for applications and the lack of budget is creating false promises to investors.

This incentive is considered very sensitive due to the discretionary nature of the approvals required and the rigorous progress reporting required to retain the incentive in light of the myriad of post-approval and post-claiming of the additional tax allowance requirements. This sensitivity means that certainty on what needs to be measured is vital, especially given the large amounts involved. As S12I is claimed when the assets are first brought into use, it is vital that all the mandatory and points scoring criteria that need to be measured over the 3-year compliance period need to be properly defined. If they are not, a taxpayer might not measure the correct items which could result in the allowance being added back way after it was initially claimed with its resultant interest and penalties.

One issue causing a high level of uncertainty involves the regulations as they not aligned with the S12I legislation which is creating challenges in monitoring and compliance for approved applicants. The regulations (dated 23 July 2010) supporting section 12I have not been updated for the past 7 years. This failure to update is calling section 12I compliance into question (during both the compliance period and the period following project implementation). Of immediate concern are the following two requirements:

i. The requirement of direct employment creation within the Republic has been deleted from section 12I. More specifically, paragraph (d) of subsection 10 has been deleted from the section 12I legislation as per the Taxation Laws Amendment Act 43 of 2014 dated 20 January 2015. This deletion has not been reflected in the regulations.

ii. Compliance period definition: The definition for the compliance period has been added to the section 12I legislation in the Taxation Laws Amendment Act 25 of 2015 dated 8 January 2016. This new definition is not reflected in the regulations.

iii. It is not clear whether brownfield projects need to attain or sustain their energy efficiency targets.

iv. Qualifying training is not adequately defined in the regulations.

2. ENERGY EFFICIENCY SAVINGS – SECTION 12L

The energy efficiency incentive of section 12L is a critical part of National Treasury energy / environmental tax policy. This is one of the key incentive "carrots" that forms part of an overall package of "carrots and sticks" (with the pending Carbon Tax operating as a key stick). The incentive should be reviewed to determine whether its period will be extended beyond January2020.

We note that this incentive is difficult to access because of the energy efficiency expertise required. South Africa has only a small number of experts in this field. At a legislative level, a continuing set of questions involve the Baseline calculation that acts as a starting point for the incentive. Amongst other concerns, three recurring issues need to be considered to make this incentive viable:

- The timing of the baseline calculations needs to be more practical
- Drawing data from the previous year of assessment for the baseline, and
- Overlapping plans / projects over multiple years.

2.1 Timing of Baseline Calculations

We fully understand the need for tax certificates but the timing in terms of the law (and regulations) is problematic. Section 12L and the Regulations seem to suggest that the energy efficiency baseline must be aligned to the beginning of the year of assessment and the reporting period energy use at the end of the year of assessment. This is not always possible with many projects as their implementation period will overlap from one tax year of assessment to the next.

It is recommended that the baseline be aligned to a period that is compliant in terms of the South African National Standard for Measurement and Verification of Energy Savings (SANS 50010: 2011) (hereinafter referred to as the "M&V" body). The savings period will then be for a twelve (12) month period as determined by the M&V body in terms of the standard and as approved by SANEDI. Section 12L and/or the Regulations should be updated to allow SANEDI to issue more than one certificate for a project where the savings period overlap from one tax year of assessment to the next (this principle is currently being applied by SANEDI but not specifically set out in the Regulations). Alternatively, allow for the SANEDI certificate to be issued and the savings to be claimed in the year of assessment at the completion of the 12-month savings period irrespective of whether some of the savings has been achieved in the prior year of assessment.

2.2 Drawing data from the previous year of assessment for the baseline

Section 12L(3) suggests that that baseline information and data should be taken from the previous year of assessment for a brownfields project. This is not always practical for two reasons:

- Certain projects evaluated on a "whole facility" basis will be evaluated on 12 data points (for 12-months). This means in the event that any data point is missing or is an anomaly, the baseline model will not necessarily be robust nor statistically significant due to the limited number of data points. Practically, extending the period by a few more months increases the sample of data and allows for a more statistically significant baseline model to be developed; and
- Projects tend to have ramp-up periods, where the facility with the energy efficiency interventions does not operate at its optimum level at start-up phase. Strictly drawing data from the previous year of assessment may take these months (commissioning months) into account, which will either inflate the savings if the energy consumption in those months is abnormally high or under represent the savings if the production and energy consumption are abnormally low.

Again, it is recommended that the baseline be aligned to a period that is compliant in terms of the standard as determined and verified by the M&V body.

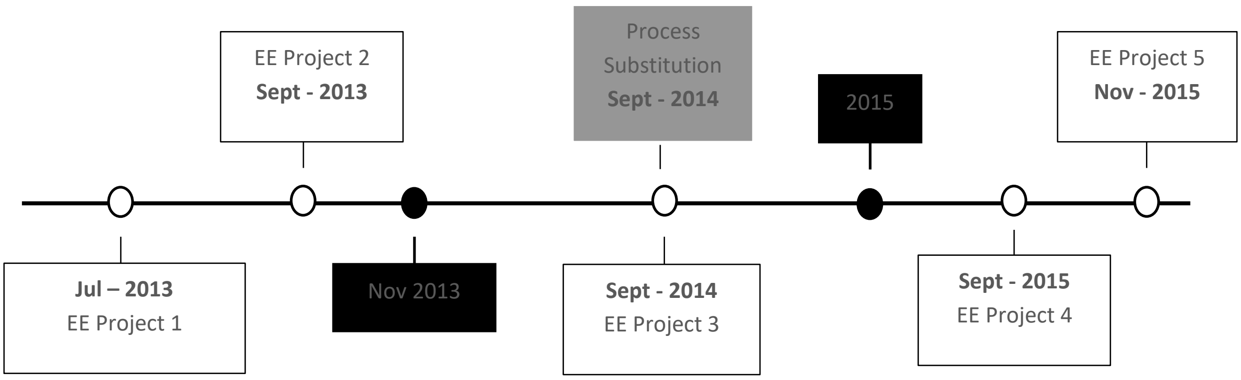
2.3 Overlapping plans / projects over multiple years

In the case of industrial plants that involve multiple discrete processes or equipment connected in the same production process, energy efficiency interventions may be implemented on individual plant sections or equipment without pausing the entire operation. The result of this is that multiple interventions are often implemented at various times in the same facility. This sets up multiple overlapping timelines for the performance assessment if each intervention is treated as its own project. Evaluating these projects individually, presents the following practical problems:

  - Compromised assessment periods, where the accurate savings of the projects are not easily captured;
  - An inflated M&V cost, since extensive sub-metering will be required to isolate the equipment or process, which might still not solve the above issue of a compromised assessment period.

A solution to this overlap would be to set the baseline before the first energy efficiency intervention is implemented and the performance assessment after the last intervention is commissioned. This allows the whole facility M&V approach to be used on the entire facility, where all the savings are more accurately and cost-effectively captured.

The above scenario is illustrated by the figure below, which represents a real-life situation that has been encountered by a taxpayer. In this case, the taxpayer has a 31st of December tax year-end.



In the above figure, a major energy efficiency overhaul of a plant was carried out over a period of two years. This was carried out in phases with production in different sections of the plant and their associated equipment momentarily stopped so the interventions could be implemented. Each project took 3 months to implement and 1 to 3 months to ramp-up to normal operating conditions. This implementation schedule meant that the energy savings periods (12-months) overlap with implementation periods. Therefore, quantifying the energy savings per phase (or project), would mean certain project savings would be forfeited such as EE project 1, and EE Project 5 in the above figure.

Based on its operating characteristics, the above facility can be measured and verified using the whole facility approach. However, taking this approach per mini-project or phase, means a lot of the energy savings are not captured. Therefore, it would be more appropriate to set the baseline period before the first phase of the project (before July 2013) and setting the savings period after the last phase of the project (November 2015). This would allow for all the energy efficiency savings to be captured cost-effectively and comprehensively and in line with the standard.

If the baseline in terms of section 12L and the Regulations can be aligned to a period that is compliant in terms of the standard as determined and verified by the M&V body, it will allow for the above scenario to be claimed on a whole facility M&V approach and for all savings to be captured accurately and in accordance with the standard.

3. SPECIAL ECONOMIC ZONES (SEZ's) – S12R

SEZs are one of the critical tools that have been identified by the South African government for the purpose of giving effect to the industrialisation agenda in the country.

3.1 Need for Guidelines/Regulations

The process for applying and receiving S12R is still not clear. Government must issue guidelines/regulations on how an investor can receive the benefit.

3.2 Timing limitations

Given that many start-up companies make losses for a number of years and also receive accelerated tax allowances on capital items, during which period they would not benefit from a reduced tax rate, we recommend that the SEZ tax rate should continue to apply for 10 years once the qualifying company becomes taxable. We have numerous examples to share which show that the SEZ benefit as it stands is of no value to investors.

3.3 Anti-Connected Person Rule

We continue to object to the connected person anti-avoidance rule in respect of SEZs. Large foreign companies (and others) will not simply locate all of their operations within an SEZ because large companies operate in large supply chains. Only a portion of a supply chain will typically be viable for an SEZ given the limited number of potential stakeholders in these zones and the physical limitations of an SEZ (especially in the early years). This separation will occur via a separate subsidiary in terms of SEZ legislation. This anti-connected person limitation effectively knocks out most potential investors who buy or sell into their own supply chain unless the investor seeks to limit their South African operations to isolated activities of limited value.

We have numerous examples of investors who are in process of setting up in SEZ's who will fall afoul of this connected party rule. This is especially relevant in an agro processing value chain where processors will set up in the SEZ with farmers who must (by necessity) be located outside the SEZ.

We again suggest that a section 31 transfer pricing rule be applied to prevent perceived avoidance. The avoidance potential here is far less in the case of SEZs than a typical cross-border transaction. SEZs have a reduced rate; whereas, offshore jurisdictions are often wholly exempt. We also note that one of regional competitors (Kenya) has imposed section 31 transfer pricing to protect against avoidance involving their local SEZs (as opposed to the outright wholesale exclusion of South Africa).

4. CLARIFYING THE TAX TREATMENT OF GOVERNMENT GRANTS – S12P and 11th SCHEDULE

4.1 Missing Grants

The Eleventh Schedule that lists exempt grants should be kept up to date. We are currently experiencing challenges from SARS during audits of submitted tax returns where recipients of grants such as the Black Industrialist Scheme are being challenged on their tax treatment. The following changes are accordingly needed:

1. Automotive Production and Development Programme received or accrued from the (Department of Trade and Industry) should be deleted and replaced by the International Trade Administration Commission of South Africa
2. Black Business Supplier Development Programme received or accrued from the (Department of Trade and Industry) should be deleted and replaced by the Department of Small Business
3. Clothing and Textiles Competitiveness Programme received or accrued from the (Department of Trade and Industry) – should be deleted and replaced by the Industrial Development Corporation
4. Co-operative Incentive Scheme received or accrued from the (Department of Trade and Industry) – should be deleted and replaced by the Department of Small Business

The additions needed are:

- Incubation Support Programme from the Department of Trade & industry (the dti)
- Enterprise Incubation Programme from the Department of Small Business
- Strategic Partnership Programme from the dti
- Aquaculture Development and Enhancement Programme from the dti
- Cluster Development Programme from the dti
- Sector Specific Assistance Scheme from the dti
- Shared Economic Infrastructure Facility from the department of Small Business
- Agro-Processing Support Scheme (APSS)
  received or accrued from the Department of Trade and Industry
- Aquaculture Development and Enhancement Programme (ADEP)
  received or accrued from the Department of Trade and Industry
- Black Industrialists Scheme (BIS) received or accrued from the Department of Trade and Industry
- Capital Projects Feasibility Programme (CPFP)
  received or accrued from the Department of Trade and Industry

- Cluster Development Programme (CDP)
  received or accrued from the Department of Trade and Industry
- Comprehensive Agricultural Support Programme (CASP) received or accrued from the Department of Agriculture
- SHARED ECONOMIC INFRASTRUCTURE FACILITY (SEIF) received or accrued from the Department of Small Business Development
- The Green Technology Incentive Programme (GTIP) received or accrued from the Department of Tourism

4.2 Need for optionality

As we mentioned previously, although the receipt and accrual of grants is technically stated to be tax exempt, the relief is more akin to deferral due to the tax attribute reduction rules contained in section 12P. We note that mere deferral is a far cry from exemption because the loss of tax attributes might, in certain circumstances, be too high a price to be paid for the exemption (particularly in cases where certain SARS auditors take positions that could result in a double loss of tax attributes). Some taxpayers find the complexity (and resultant uncertainty) of tracing the exemption to tax attribute reduction as similarly problematic and often not worth the cost.

We accordingly request that the application of section 12P by taxpayers should be optional. This would mean that taxpayers would have the option of being taxed on receipt or accrual of the government grant and then not to be subject to section 12P to the extent that the grant was taxed upfront.

5. RESEARCH AND DEVELOPMENT (R&D) INCENTIVE – S11D

S11D has been a challenge for many years due to the uncertainty on what qualifies and the lengthy process to obtain approval. Sadly, these issues have resulted in many taxpayers not pursuing the incentive. We still believe that the fundamentals of the incentive work with no major policy changes needed.

The process is overly adversarial and obstructive. Most advisors now recommend that the incentive not be pursued. Given that R&D mostly takes place as an ongoing process, we would again recommend that taxpayers should be able to apply for approval of R&D after the R&D has been performed but before the deadline for the submission of the relevant tax return, in which case delayed approval should be deemed approval. In the Ayming Global R&D Tax Incentives: The Benchmark 2018 study amongst 14 prominent jurisdictions, it was found that South Africa was the only country that requires pre-approval. It is also mentioned that the pre-approval turnaround times can be lengthy.

Major other outstanding issues on S11D are:

Pilot Plants	In November 2016, during his last public discussion on 11D before retiring, Cecil Morden invited the audience to select one aspect of R&D tax incentives for National Treasury to address in 2017 - that was voted to be Pilot Plants. To date, nothing has come of it. We set out below more detail on this issue.
Task Team Report – General	The errors in the Task Team Report (April 2016) still remain uncorrected
Task Team Report - Recommendations	13 specific recommendations were made in that report. DST has yet to respond to these
Finalised Guideline: DST	The finalised Guideline is now almost 5 years overdue.
DST: online application system	This appears to remain the DST's primary priority - it is almost 4 years overdue, in itself. Apart from this, there is the constant concern that any online system is essentially useless when policies and guidelines remain unfinalised
SMEs System	A decision on whether & how to introduce a streamlined system for claiming the R&D incentive by SMEs
Appeals Process	At that same November 2016 meeting, Treasury undertook to discuss with SARS and DST the related issues of (i) the very long delays in processing applications (ii) the lack of appeals process (iii) the claiming process at SARS

5.1 Prototypes and pilot plants

- Prototype products or pilot plants in certain instances have to be tested in 'real' environments. The results from the testing is not necessarily separated from the income generating activities and can be used in an income generating environment. For example:
- A company is developing a new drill bit and it is tested for strength and durability in a current drilling environment for which the company is paid for the drilling service regardless. The understanding between the company and the client for which they perform the drilling service is that test/prototype products may from time to time be tested in the 'real' drilling environment.
- A pilot plant is used to produce a certain product and the output is potentially saleable and sold at either a reduced price, or if the results were satisfactory it is sold at an arm's length price to a willing buyer.

We suggest that when prototypes are used as described above (as the concept have to be proved), it should still be allowable to get the S11D deduction on the cost of producing the prototype until such time that the product is cleared for 'commercial' production. In the case of the products from pilot plants being sold, that the cost of the S11D deduction could be reduced by the revenue generated by the pilot plant. Should the pilot plant be of such a nature that it can be 'up scaled' to commercial production scale, the initial cost of the pilot plant should still be allowed to qualify for the S11D deduction.

5.2 R&D items of a capital nature

R&D deductions are not available for immovable property, machinery, plant, implements, utensils or articles (excluding any prototype or pilot plant created solely for the purpose of the process of R&D and that prototype or pilot plant is not intended to be utilised or is not utilised for production purposes after that R&D is completed).

While it is understandable that certain capital assets will not qualify for the S11D deduction, it should be noted that in the current technological environment, certain items that are of a capital nature are imperative to a process or project to enable meaningful R&D. Items that fall into this category and are part and partial to the R&D project cost are for example:

- Certain laboratory equipment
- Certain software
- 3D printers used for R&D
- Other related items

We suggest that items/cost of this nature should be considered for inclusion as part of the total project cost to qualify for the S11D additional allowance.

5.3 Automatic qualification of certain R&D items

We recommend that certain items (like prototypes, pilot plants and some other items listed be viewed as automatic R&D items due to their very nature. The discretion is needed only for items (e.g. salaries, basic operating expenses) that can have an R&D impact only once one understands the purpose / underlying activity.

SAIT REPRESENTATIVES TO BE INVITED TO NATIONAL TREASURY WORKSHOPS

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