THE ETHICS INSTITUTE

sait South African Institute of Tax Professionals

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The South African Revenue Service
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RE: ANNEXURE C FOR 2017 BUDGET: COMMENTS PERTAINING TO KEY BUSINESS TAX INCENTIVES ISSUES

We have attached the comments from the SAIT Business Tax Incentives Work Group on the Annexure C tax proposals for the 2017 Budget pertaining to key business tax incentives issues. We appreciate the opportunity to participate in the process and would welcome further dialogue.

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

Yours sincerely

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BUSINESS TAX INCENTIVE ISSUES

1. RESEARCH AND DEVELOPMENT (R&D) INCENTIVE – TREATMENT OF PROTOTYPES, PILOT PLANTS AND R&D ITEMS OF A CAPITAL NATURE

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.

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).

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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.

2. URBAN DEVELOPMENT ZONES (UDZ) – ALLOWING ADDITIONAL MUNICIPALITIES TO APPLY FOR THE UDZ TAX INCENTIVE

Section 13quat will be amended to provide a framework for the Minister to consider applications from municipalities currently not allowed to designate a UDZ area by applying assessment criteria. We generally support the controlled broadening of the scope of the UDZ incentive to cover additional municipalities who meet appropriate criteria. However, we are of the view that the inclusion of the assessment framework and process in section 13quat is too complicated an approach. We recommend that a list of municipalities should be directly identified and that the section 13quat(6) list should be expanded accordingly rather than including an assessment framework and process in section 13quat. The smaller municipalities do not have the capacity for such a process, and the exact locations should rather be identified by National Treasury.

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The profit margins for residential businesses are extremely low and the upfront cash costs are hindering low-income rental housing. The depreciation incentive does little for these businesses given that profit margins take several years to realise in the best of circumstances. We recommend that the transfer of property in a UDZ should be exempted from transfer duty under the Transfer Duty Act, 40 of 1949.

3. SMALL BUSINESS CORPORATIONS LOCATED IN SPECIAL ECONOMIC ZONES (SEZ's)

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. Given that many start-up companies make losses for a number of years, 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 continue to object to the connected person anti-avoidance rule in respect of SEZs. Large companies will not simply locate all of their operations within an SEZ. Allocations to an SEZ typically will occur only in terms of certain specified operations. 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. We again suggest a section 31 transfer pricing rule be applied to prevent perceived avoidance. The avoidance potential here is far less than cross-border connected person activity with a low-tax / no tax jurisdiction.

4. CLARIFYING THE TAX TREATMENT OF GOVERNMENT GRANTS

All government grants received or accrued on or after 1 January 2017 will be specifically included in gross income and may qualify for a special exemption granted in terms of section 12P read with the Eleventh Schedule. As we mentioned last year, 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

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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.

We 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.

The Eleventh Schedule that lists exempt grants should be kept up to date.
The following changes are 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

3. 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

7. 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

8. 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 following 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
- Black Industrialist Scheme 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

5. EXCEPTION TO THE RESEARCH AND DEVELOPMENT (R&D) INCENTIVE PRESCRIPTION RULES

An amendment to section 11D has been proposed to allow for a reopening of assessments in circumstances where delays in the processing of the approval cause assessments to prescribe before an application is adjudicated upon by the pre-approval committee.

Specific amendment: The proposed amendment is generally welcomed. However, section 93 of the Tax Administration Act which deals with reduced assessment has not been amended accordingly. Taxpayers should have the comfort that these R&D deductions can be claimed by way of reduced assessments without impacting the otherwise prescribed status of their tax returns. Section 93 of the Tax Administration Act should be amended to make it clear that reduced assessments should be made where section 11D(20) is applicable. The amendment should allow for reduced assessments to be made for the years directly affected by section 11D(20) as well as any subsequent years where the assessed loss brought forward should be increased as a consequence of the application of section 11D(20) in an earlier year.

Timing of the deduction: Taxpayers are also concerned that they may incur interest and penalties if they claim the deduction when the expenditure is incurred, as required by section 11D(2), but before receiving the approval from the Department of Science and Technology. We recommend that taxpayers should be given the discretion to claim the deduction of expenditure that has been incurred, as required by section 11D(2), in any year of assessment up to an including the year in which they receive the approval from the Department of Science and Technology.

Ongoing operational concerns: The proposed change does not fix the real problems associated with the Department of Science and Technology (DST) in terms of improved administration of the incentive. The process is overly adversarial and obstructive. Most advisors now recommend that the incentive not be pursued. Although the proposed amendment should mitigate problems experienced to some extent, it is not a comprehensive solution, taking into account the nature of R&D. Given that R&D mostly takes place as an ongoing process, we would 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.

The recommendations as contained in the Task Team report set up by the DST Minister should be accelerated.

6. ADMINISTRATIVE AND TECHNICAL CHANGES IN RESPECT OF INDUSTRY POLICY FOR SECTION 12I

It is proposed that section 12I be amended to enable SARS to recoup the difference in allowance claimed in respect of an industrial policy project (IPP) which was approved as a preferred status project but changes to a qualifying status project by the end of the compliance period. Such recoupment may be rolled-back into previous years. Currently taxpayers must claim the section 12I deduction when the assets are brought into use and not when they have complied with all the requirements.

SARS discretion: Giving the Commissioner a discretion regarding the making of an appropriate adjustment as envisaged in the proposed section 12I(13)(d) leads to unnecessary tax uncertainty. The Commissioner would likely use a formula based on the difference between the deductions previously claimed by the taxpayer under preferred status versus the deductions that the taxpayer would have been entitled to under qualifying status. Therefore, we do not see the need for an open-ended discretion to be exercised by the Commissioner. We recommend that the onus should be on the taxpayer to use a formula prescribed in the Act (based on the difference between the deductions previously claimed by the taxpayer under preferred status and the deductions that the taxpayer is actually entitled to under qualifying status). This difference should be the recoupment in its taxable

income for the year during which the approval status is substituted by the Minister of Trade and Industry.

Additional assessment rectification: It is proposed in section 12I(14) that the Commissioner may raise additional assessments to adjust for these differences in years of assessment prior to the year in which the change in the approval status of a project. We are of the view that raising additional assessments for past years would be administratively burdensome for SARS and taxpayers. In addition, taxpayers are concerned that they may incur SARS interest and penalties even though they claimed the deductions in good faith (as and when the costs were incurred in terms of section 12I) in order not to forfeit the deductions. A recoupment approach would be far simpler and less risky than a re-opening of assessments. The change in status is often due to factors beyond the taxpayer's control. The difference should not create interest and penalty charges. This risk would mean that many businesses would choose to fall outside the incentive. Alternatively, taxpayers should be given a discretion to defer the section 12I deductions until they are comfortable that they will meet the relevant approval status. This deferral mechanism would eliminate the risk for both the taxpayer and government.

It is also a concern that the regulations (dated 23 July 2010) supporting section 12I have not been updated. This is creating uncertainty during the compliance and the period once a project is implemented. The following regulations should be brought into line with the legislation:

i. The requirement of direct employment creation within the Republic has been deleted from section 12I:
   Par (d) of subsection 10 have been deleted from the section 12I legislation as per the Taxation Laws Amendment Act 43 of 2014 dated 20 January 2015.

ii. Compliance period definition:
   A definition for compliance period has been added to the section 12I legislation in the Taxation Laws Amendment Act 25 of 2015 dated 8 January 2016.

7. ENERGY EFFICIENCY SAVINGS

The draft interpretation note for section 12L is creating a major problem. Under the draft note, SARS is seeking to place the same pre-approval limitation as currently exists for R&D. Pre-approval for section 12L energy efficiency savings is wholly impractical given that energy efficiency improvements are ongoing. These improvements are not set as new separate projects.

We further point out that the draft note has no basis in law. Section 12L imposes no explicit pre-approval obligation. However, in light of the SARS draft note, we suggest that section 12L be amended to clarify that no such pre-approval be required. The imposition of this form of pre-approval would simply kill the incentive altogether.

Issue

The legislation is unclear on whether an implementation period is actually allowed as the section S12L (3) *"A person claiming the deduction allowed in terms of subsection (1) during any year of assessment must obtain a certificate issued by an institution, board or body prescribed by the regulations contemplated in subsection (5) in respect of the energy efficiency savings for which a deduction is claimed in respect of that year of assessment containing—*

(a) the baseline at the <u>beginning of the year of assessment</u>;

(b) the reporting period energy use at the <u>end of the</u> <u>year of assessment</u>;" (our underlining)

Recommendation

We recommend that section 12L is amended as follows:

(a) the baseline before the implementation of the project;

(b) the reporting period after the implementation of the project.