Comments on the Draft Taxation Laws Amendment Bill, 2013: **Proposed changes to the Research & Development Tax Incentive**

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Overview

The overall import of the proposed draft South African R&D legislative amendments seem to substantially change the nature of the current R&D legislation and ***prima facie disencourages companies to undertake R&D***. Overall, some of the changes are draconian, such as the:

- requirement for R&D in South Africa to be 'world beating' before one could qualify; &
- retrospective (backdating) application of the legislation to 1 October 2012.

Applying restrictive innovative criteria as part of the pre-approval process, so as to limit R&D to projects that are only "world-beating" (as opposed to R&D undertaken to maintain a degree of competitiveness) is in our view, likely to deter companies from participating in the incentive as it does not reward South African companies to invest in projects that will allow them to at least compete on an even footing with technologies of foreign companies operating in far more developed economies than ours.

In other words, the implication is that government is not interested in helping South African companies that invest in local R&D in an effort to catch up with the rest of the world. We are confident that this may not have been intended and hope that proposed legislation is modified to reflect this. South Africa is after all, still a developing economy.

R&D is very much an iterative process, with varying incremental successes as well as failures. Local companies often do not have access to state of the art technology (which is mainly the case due to its inherent proprietary nature) – we should be encouraging our local companies to invest in home grown technology that at least helps it to be competitive with companies that have a history of operating in much more developed economies where often their respective governments have already assisted them with incentives to advance their technology.

Need for more consultation

The media statement, which was released on 4 July 2013, states that the "*proposed amendments will streamline and accelerate the adjudication process…*" The proposed changes to section 11D, as discussed in more detail below, are more complex, subjective and open to interpretation than the current legislation.

The original R&D legislation relating to the new pre-approval application procedures were supposed to be introduced from April 2012, and were released in draft form for public comment during 2011. Workshops were also had with NT in this regard during 2011, and the current legislation was introduced with effect from 1 October 2012. Therefore, it appears that enough time to consider the R&D legislation and the impact thereof was previously undertaken to arrive at the current legislation. We therefore question the need to 'streamline' the current R&D legislation.

Of course, a refinement to encourage more active participation in the R&D regime is what would be expected, as is currently been offered in *other tax jurisdictions where even cash incentives* for R&D companies with assessed losses are being proposed.

Backdating of legislation – unconstitutional?

The draft legislation, if enacted in its current draft form, will be implemented with effect from 1 October 2012 (i.e. retrospectively). This has created concern for both current and prospective applicants, as to whether applications would need to be resubmitted and re-evaluated based on the new proposed 'retrospective' legislation. ***Retrospective implementation is therefore not supported as taxpayers relied on and undertook investments in projects based on the current legislation***. Often, R&D projects have duration of greater than one year as well.

Retrospective legislation prevents taxpayers from arranging their affairs and creates uncertainty for taxpayers that have to complete tax returns (provision/final) thus hampering effective business decisions. It is not uncommon to find that draft legislation is the subject of numerous changes before being passed into law, thus taxpayers also face uncertainty as to what will (or will not) be promulgated. Complying with the rules becomes even more difficult as a result. The above conflicts with the rule of law in that a person should be able to know the law in order to be able to arrange his/her actions accordingly. Accordingly, the imposition of retrospective amendments can be argued as being contrary to the principles of the South African constitution.

We submit that the draft changes to the section 11D legislation appears to be premature, without having undergone a broad-based, inclusive, consultative process. Therefore, we recommend that these, together with the Explanatory Memorandum (EM), be aligned with the intention of parliament, so as to provide a meaningful incentive for companies undertaking R&D in South Africa to invest in home-grown R&D. We need to encourage our companies to learn how to run before we expect them to be 'world-beating.'

1.1 First issue – draconian 'retrospective' application of amendments

The issue identified: retrospective application

The draft 2013 TLAB contains a number of amendments to section 11D of the Act, which fundamentally changes the nature of the existing legislation. This is therefore not a "streamlining" of the legislation as noted in the Explanatory Memorandum.

A key concern is that the proposed legislation is noted as to apply with retrospective proposed date of commencement (i.e. 1 October 2012), the effect of which is the back-dating of the proposed legislation. We submit that the back-dating of amendments to the legislation creates huge uncertainty and is considered unfair, prejudices the taxpayer and is contrary to the promotion of judicial administration.

The proposed retrospective amendment will create an immense burden on all applicants who submitted pre-approval applications to the Department of Science & Technology (**DST**) as they would need to resubmit their applications, or prepare additional information, to account for the proposed retrospective changes in the legislation. When taxpayers submitted their pre-approval application forms, they based their applications on established tax legislation at the time and furthermore the actual application forms used by taxpayers did not (and currently do not) cater for the proposed changes to the legislation.

In addition, companies that did not apply for pre-approval would have claimed the "normal 100%" section 11D deduction in not only their tax returns for periods of assessment ended post 1 October 2012 – but also taken this into account in their provisional tax calculations. Retrospective application of the proposed changes would result in such tax positions being needed to be re-evaluated and potentially being incorrect as well as having a potentially negative cash flow impact on taxpayers, thus prejudicing the taxpayer.

We are also aware that the DST has already granted pre-approvals to certain applicants since 1 October 2012. Due to the substantial change in the nature of the legislation, we submit that applying the changes with retrospective effect would render such pre-approvals null and void due to the fact that the basis of legislation would be substantially changed and the evaluation of the eligibility thereof by the DST would not have taken the proposed changes into account. Again, this would prejudice taxpayers who have taken tax positions based on existing legislation.

Proposed solution

Any proposed change to the section 11D legislation should apply to pre-approval applications that are received by the DST ***after*** the date of promulgation of the Taxation Laws Amendment Act, 2013.

1.2 Second issue – special dispensations for certain sectors

The issue identified: special dispensation for industry sectors

In the media statement, which was released on 4 July 2013, mention is made of the Information and Communication Technology (**ICT**) sector. However, the ICT sector is not catered for in the draft legislation.

Further, in the media statement and the draft legislation, there is specific legislation that supposedly provides a special dispensation for the pharmaceutical (generic medicine and clinical trial) industry.

We caution against introducing legislation that has one set of rules for a particular industry sector and another set for other sectors. The very aim of the Research and Development (**R&D**) incentive is to encourage investment in R&D across *all* sectors of the South African economy.

We also question whether the proposed changes to the section 11D legislation have been fully considered, as there is, currently, no draft guideline on what is proposed for the ICT nor for the pharmaceutical industry sectors.

On the face of it, we caution against introducing legislation that has one set of rules for a particular industry sector and another set for other sectors. The very aim of the R&D incentive is to encourage investment in R&D across ALL sectors of the South African economy. A broad based R&D system would certainly assist with the main purposes of the R&D Incentive, i.e. to promote private sector investment in R&D and to encourage employment in South Africa.

Proposed solution

We recommend that National Treasury conducts broad-based consultative workshops prior to drafting any changes to the current section 11D legislation that may impact any industry, and in particular, to the pharmaceutical and ICT industries referred to in the media release.

We also recommend that NT issues a draft guideline on what is proposed for these particular industries, for public comment – prior to any specific legislation being proposed.

Any changes relating to any 'special dispensation' for a particular industry, should also apply on a prospective basis. Retrospective application prejudices companies that have already taken tax positions based on current law.

1.3 Third issue – "carried on"

Nature of the problem

The proposed section 11D(1)(a) inserts the wording *"carried on"*

We are not aware of the relevance of the insertion of the words "carried on" in this section as a requirement to undertake the research 'in the production of income' and the "carrying on of any trade" is already existing in Section 11D(2) of the Act.

The words 'carried on' implies that R&D must be already conducted, whilst the nature of the pre-approval application process means that certain R&D projects would only commence at a later stage in time. The reference to 'carried on' would thus be an anomaly in law in that it may be seen to preclude any future dated/anticipated projects.

Proposed solution

The insertion of the term *"carried on"* should be deleted.

1.4 Fourth Issue – arbitrary insertion of the word 'innovative'

Nature of the problem

The proposed section 11D(1)(a) (i)(cc) inserts the word *"innovative"*

The term “innovative” is not defined. The current references to the term within the section 11D legislation result in a very ‘subjective’ interpretation by the legislature. We question whether this was intended by the legislator especially when a definition of R&D already exists in current law.

Section 11D(9) of the Act currently provides the ‘innovative’ requirement in the hands of the Minister of Science & Technology, thus the Minister already has a subjective, discretionary ability in this regard. Insertion of the term ‘innovative’ within the definition of R&D itself, is therefore irrelevant and in the absence of a clear definition, problematic for companies to interpret.

Proposed solution

The term “innovative” should be defined or removed from the R&D definition due to its subjective nature of interpretation.

1.5 Fifth issue - reference to ‘general public’

Nature of the problem

Section 11D(1)(a)(i)(cc) contains the wording *“general public” ; and*

The term “general public” is not defined. The current references to the term within the section 11D legislation also limits the application of the legislation, as often groups of companies undertake R&D for the group as a whole, and we are also aware that some industries (e.g. the defence industry and medical industry amongst others), also undertake R&D, the result of which is marketed directly to governments or institutions.

The term “general public” therefore would preclude such R&D from the proposed incentive regime and is not in keeping with the stated aim of incentivising total R&D expenditure in the country. We also question whether this is indeed the intention of parliament.

Proposed solution

The term “general public” should be defined or alternatively removed.

1.6 Sixth issue – “world beating” requirement

Nature of the problem

Proviso (f) to section 11D(1) refers to R&D that *“... is already utilised or known by other persons within a market inside or outside the Republic...”*

In our experience, taxpayers are unable to fully be aware of developments not only within South Africa but also around the world. Desktop ‘Google’ searches often do not reveal the true nature of the mechanics of any developments. Patent searches are also very limiting in that unless the exact criteria is specified in the patent, any routine patent search is unlikely to disclose the required analysis/specifications. Also, many companies find it practically impossible and costly

to undertake patent searches both within South Africa and elsewhere in the world. In addition, from a pragmatic perspective, patents registered in foreign languages are often very difficult to translate.

Therefore, whilst a cursory understanding of the R&D may be gleaned from the above, it is more often information obtained from attendance of events/seminars and/or research papers that are published that are the likely sources of information available to South African companies.

It is directly as a result of the proprietary nature of the R&D that the critical elements of the R&D developed elsewhere that underpins the actual workings is **not** known by companies. Often, companies resort to either hiring personnel with such expertise from competitors to gain such knowledge, or as is mainly the case, resort to research and development of their own in-house 'know-how' for their particular application.

Given the above, the proposed proviso would substantially limit the ability for 'home-grown' technology to fall within the R&D legislative ambit, and is tantamount to only providing an incentive to companies that are undertaking 'blue-sky' or 'world-beating' R&D.

This is directly contradictory to the policy intention of parliament to encourage and stimulate R&D in the South African development context. We also submit, that the proviso in its current form, would act as a 'disincentive' and thus negatively impact on the focus of increasing expenditure in R&D and increasing jobs. To this end, we note that other tax jurisdictions offer more favourable R&D regimes, and the market for high-value R&D is very mobile on a global basis.

Proposed solution

We disagree with the proposed amendment above in that the DST should simply apply its expertise on the technical merits of the R&D application, taking into account the REAL purpose of the incentive as explicitly provided in section 11D(12) of the Act:

> *The Minister of Science and Technology shall annually and in anonymous form submit to Parliament a report advising Parliament of the* ***direct benefits*** *of the activities contemplated in subsection (1)* ***in terms of economic growth****,* ***employment*** *and* ***other broader government objectives and the aggregate expenditure*** *in respect of such activities.*

To achieve the above purpose, we recommend that *proviso (f)* should be removed. Such a proviso would rather be suitable to apply to a first world economy, where investment in R&D no longer needs to be incentivised.

In an article dated 17 May 2013 in Nature – International Weekly Science Journal, the following was stated:

> "*The country's total R&D spending as a percentage of gross domestic product (GDP) decreased for the third consecutive year, standing at 0.87% for 2009–10. South Africa had planned to increase R&D spending to 1% by 2008, but failed to meet this goal. A second goal, to reach 2% of GDP by 2018, now seems increasingly out of reach.*"

The proposed draft legislation in its current form will not assist in increasing the GDP as it limits the amount of R&D claimable even further.

South Africa is clearly not a first world economy and this proviso, if enacted, would substantially jeopardise local South African companies' legitimate R&D efforts to compete both locally and globally.

Our recommendation is also therefore that steps to increase the attractiveness of the South African R&D regime to global companies, in an effort to relocate R&D activities to South Africa – needs to be the priority. Consideration should be give to offer a cash incentive for qualifying R&D, especially in circumstances where taxpayers have significant start-up losses during the early stages of the R&D lifecycle.

1.7 Seventh issue – alternative definition to be used for R&D

Nature of the problem

In foreign jurisdictions, reference is made to the R&D definition provided for financial reporting standards as a definition for tax purposes.

Proposed solution

Consideration should be made as to a similar definition being adopted for South African purposes, as this will align with the current understanding of R&D in the accounting industry.

1.8 Eight issue – "making" significant improvement

Nature of the problem

Section 11D(1)(b) deletes the words '*developing or significantly improving*" and inserts the words "*making...a significant and innovative improvement to"*

We are not aware of the reason for the above proposed change and note that it critically curtails a good portion of any R&D project from qualifying. Also, refer to our comments on the insertion of the term 'innovative' above.

The word "*making*" implies that a project needs to succeed. This appears to totally disregard the very nature of R&D that involves trial and error, and that there are absolutely no guarantees that a research project will indeed result in a significant improvement. The result of the proposed amendment is that any R&D projects that result in failure would not qualify for the R&D incentive as the taxpayer would not be 'making any significant..." improvement.

Proposed solution

The proposed amendments should be removed and the words "*developing or significantly improving"* should be retained.

1.9 Ninth issue – "for the purposes of"

Nature of the problem

Section 11D(1)(b) inserts the wording *"for the purposes of"* and deletes the words *"if that development or improvement relates to any"*

We note that the term *"for the purposes of"* connotates a narrower interpretation than the current wording *"relates to any"*. We question the relevance of this change as it is not clear as to the reason for this change and the EM is silent in this regard.

We also question the relevance of the change in light of the overall aim of Parliament to encourage investment in R&D in South Africa.

Proposed solution

The proposed amendments should be removed and the words "*...relates to any*" should be retained.

1.10 Tenth issue – different use of R&D throughout its total life-cycle

Nature of the problem

Section 11D(1)(b) inserts the wording *"...for the purposes of the sale to, or for use by the general public of that ..."*

It is not clear whether the end result needs to be sellable nor for that matter to be used by the "general public". Please refer to our comments on "general public" above as well in this regard.

If one makes significant improvements to a machine that produces widgets, the machine itself is not for sale, nor intended for use by the general public. Rather, the widget itself may be sold or consumed internally in the production of another process, additive, or serves as input material into further processes.

The proposed amendment is a restriction on R&D undertaken for improvements of processes as well as restricts significant improvements being claimed by entities that may also license or provide the use of the final 'R&D' to internal organisations.

Proposed solution

The proposed amendment reference to "general public" should be removed.

1.11 Eleventh issue – consistency or wording

Nature of the problem

Section 11D(1)(b) refers to the wording *"improved"* and *"improvement"*

The inconsistency in the wording between *"improved"* and *"improvement"* creates confusion.

Proposed solution

The term *"improved function"* to be reworded to *"improvement of functionality"*.

1.12 Twelfth Issue – restriction on capital deductions

Nature of the problem

Section 11D(2)(b)(i) disallowance a deduction for *"immovable property, machinery, plant, implements, utensils and articles"*.

This disallowance of claiming selected capital expenditure as revenue deductions is contrary to the nature and intention of the R&D regime and to past practice. All expenditure, even if capital in nature is noted as potentially eligible. The Explanatory Memorandum under paragraph C1 specifically states *"R&D is deductible even if the expense is of a capital nature. Expenses of a capital nature are included within the deduction because taxpayers should not lose the deduction merely because the activities can lead to the development of an intangible asset."*

In addition, guidance has previously been provided in SARS Interpretation Note that specifically provides for capital costs to be claimed when constructing a '*pilot plant*'. This is also the approach taken by foreign R&D tax regimes as well – to not allow the latter would be prejudicing the international competitiveness of the South African R&D regime.

Proposed solution

This section should be amended to allow capital expenditure, or in the alternative – to allow an accelerated depreciation allowance. Not doing so limits the application of the incentive regime and prejudices taxpayers undertaking capital intensive research programmes.

We also submit that an exception is provided to allow capital costs to be eligible for the additional 50% tax deduction if it relates to the construction and development of "pilot plants' – as provided for in the Interpretation Note 50 issued by SARS.

1.13 Thirteenth issue – methodology of R&D

Nature of the problem

Section 11D(6) in the current legislation is proposed to be deleted. It appears that elements of section 11D(6) is included in a new proposed "section 11D(2)(c)".

The latter appears to be an anti-avoidance section in that it deems R&D to **not** be undertaken in the Republic in instances where a natural person does not "*possess[es] any significant authority to determine or alter the methodology of the [R&D]*".

(We note that section 11D(2)(a) provides that R&D must be undertaken in the Republic).

It is not clear what the section 11D(2)(c) proposed legislation is seeking to achieve as:

- The current R&D legislation applies only to companies and NOT to natural persons;
- Any authority is usually vested in the name of a corporate entity, thus a natural person would only ever have such authority if such natural person operated in their own capacity (and thus would not in any case qualify for the R&D incentive); **or** if they were designated as such to hold out this authority by the respective company (in which case the proposed legislation prejudices corporate entities);
- It caters for a 'carve-out' for pharmaceutical research (which in itself is not defined) and overall does not refer to any carve out for ICT research (as per the media release). The above carve out, in itself is discriminatory (see our comments regarding special dispensation for industry sectors above)
- The wording is also problematic in that it can be interpreted to apply to only R&D that occurs in a cross-border context and therefore not to any wholly South African R&D activity, the entire life-cycle of which takes place in South Africa ;
- It contains the word "duration" which can be interpreted as applying to segmented period/portion of the R&D lifecycle, **or** to the entire R&D life-cycle (which may extend beyond South African borders as part of global collaboration or as part of contracted R&D). Thus the term '*duration*' also needs to be clarified as to the meaning thereof;

- The current section 11D(6) legislation already adequately provides for the determination of the possible authority levels between entities, thus we do not see any apparent reason for the proposed changes.

Proposed solution

The existing section 11D(6) should be retained, and the proposed section 11D(2)(c) should be removed. We also request clarification from the NT as to the intent and relevance of the proposed section 11D(2)(c) insertion as the wording is very problematic.

1.14 Fourteenth Issue – subjective and discretionary legislation

Nature of the problem

The proposed amendments to section 11D(9)(a) is extremely subjective in that it adds the following criteria to be taken into account by the Minister:

the R&D should, in addition to being "*innovative*', should:

- "*constitute fundamentally and substantially novel, innovative and unique results that adds substantial value to the industry or market sector..*".

No guidance is provided as to how the above would be met by the taxpayer. In addition, previous draft legislation in 2011 specifically removed the words "*new*" and "*novel*" as it was considered to be a disincentive to companies seeking to qualify for the incentive. The proposed amendment goes a step too far in providing extremely subjective, and apparently totally 'discretionary' powers to the Minister.

Proposed solution

If a company meets the definition of R&D in the legislation, then it should be able to qualify automatically for the incentive. That is the purpose of inserting a specific R&D definition. Having additional and very subjective 'discretionary' criteria to be applied by the DST simply defeats the purpose of having an R&D definition and its attendant exclusions.

The proposed amendments to section 11D(9)(a) should be removed. Guidance should be provided as to the criteria that the Minister will apply, so as to provide certainty to taxpayers who apply for the approval. The pre-approval application form also would need to be updated to reflect such guidance as well.

Given the above subjective criteria (which is not in the current legislation), we refer to our previous comments that the proposed amendments should NOT apply retrospectively as to do so would be prejudicial and discriminatory to taxpayers who have already submitted pre-approval applications to the DST.

1.15 Fifteenth issue – removal of long-existing definitions

Nature of the problem

The proposed amendments substantially change the definition of R&D as follows:

- Deletion of the terms '*discovering non-obvious scientific or technical knowledge*', & deletion of the term '*knowledge essential to the use of such invention, design or computer program' in the definition of R&D"*;

- Removal of an '*aesthethic*' design from the qualifying criteria and thus limiting this only to 'functional' designs of a scientific or technological nature;

Many taxpayers have relied on the above definitions in their submission of pre-approval; applications, as well as to claim the normal 100% deduction in their tax returns.

The above definitions have also been in our legislation, mainly since 2006 and therefore it is not clear what the proposed changes seek to achieve.

Furthermore, many designs have both an aesthetic and functional purpose, and it also happens that it sometimes cannot be distinguished which is the main quality of the design as both aesthetic and functional aspects are embodied in the final design.

We also note that section 11D(9)(c) still contains a reference to 'non-obvious knowledge', which is proposed to be deleted in its entirety in the definition of R&D itself.

Proposed solution

We request clarity as to the intention and reason for deleting these sections as there does not appear to be a logical reason for their proposed deletion in its entirety.

It appears that the proposed amendments have thus not been fully thought-through and given the substantial changes proposed, we caution that broad-based consultation with the industry needs to take place ahead of any proposed amendment to the legislation.

Any changes need to occur prospectively, as taxpayers would already have taken positions in completing their tax returns (in case where no pre-approval was submitted), as well as relying on these definitions in terms of applying for the pre-approval applications since 1 October 2012.

1.16 Sixteenth issue – insertion of new definitions

Nature of the problem

The proposed amendments substantially changes the definition of R&D as follows:

- Inserting additional two qualifying criteria:

    1. "*discovering applied scientific knowledge that is innovative in nature and mainly intended for the purposes of the sale to and for use by the general public"; or*

    2. "*making a discovery that leads to the advancement of purely theoretical scientific knowledge"*.

Proposed solution

With regard to 1 above, please refer to our comments above on "*innovative"* and "*general public"*. In addition, the term '*applied*' is not defined and we recommend that a definition is provided in this regard.

With regard to 2 above, we welcome this insertion and do believe that this provides clarity for taxpayers who undertake purely theoretical research.

1.17 Seventeenth issue – removal of exclusion

Nature of the problem

We note that previous exclusion relating to "*management or internal business processes*" has been deleted.

Many taxpayers have relied on the exception to the previous exclusion regarding "*management or internal business processes*" in both their pre-approval applications as well as in tax positions already taken (where no pre-approval was submitted).

The deletion of the entire exclusion relating to "*management or internal business processes*" is thus prejudicial and discriminatory. We are also unsure of the purpose of such deletion would achieve.

Proposed solution

Clarity should be provided as to the reason for the deletion of the exclusion.

Furthermore, any proposed change in this regard should apply on a prospective basis, and NOT on a retrospective basis (refer to our previous comments on retrospective application as well).

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