KPMG

Comments on the Draft Taxation Laws Amendment Bill, 2015: **Proposed changes to the Research & Development Tax Incentive**

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1 Introduction

Applicable provisions: section 11D of the Act: General comment on R&D proposed amendments (section 11D of the Act)

Overview

At the outset, we note that proposed amendments in the 2015 DTLAB has been proosed. Notwithstanding this, we set out below proposed amendments for consideration and note that these proposals have been previously communicated during 2014 but were not addressed by National Treasury.

We believe that the below proposed amendments to the current Section 11D remedies unintended consequences arising from changes implemented in the 2013 and 2014 set of amendments, as well as proposals for enhancing application of the legislation for both regulatory authorities and taxpayers.

1.1 Retrospective application for approved projects

1.1.1 Unlodged applications due to uncertainty of process followed by DST

Since 1 October 2012, companies have had to submit an pre-approval application in order to qualify for the South African R&D tax incentive, and the legislation currently has the effect that the incentive can only be claimed from the date of submission of the pre-approval application.

Over the past 3 years, many companies have awaited the outcome of applications and have become disillusioned with the R&D regime in its current form due to the lengthy delays in receiving feedback from the DST. We are pleased that the DST has recently acknowledged that their response times need to improve that they are now more pro-actively working towards improving their interaction with applications.

The problem is that during these past years since 1 October 2012, additional R&D projects were undertaken by companies however no pre-approval application was submitted by companies for these projects directly as a result of the uncertainty of the length of time to get a response from the DST. This leaves companies in a prejudiced position in that the projects should qualify for the R&D regime but for the administrative delay in submitting an application

1.1.2 Proposed solution

Section 11D (2)(iv) is amended as follows:

"that expenditure is incurred ~~on or after the date of receipt of the application by the Department of Science & technology n~~ <u>on or after 1 October 2012</u>"

The above amendment would provide an equitable and just treatment to all projects submitted for approval to the Department of Science & Technology, regardless of the actual date of submission of the application.

1.2 Deterrent for foreign companies to outsource R&D to South Africa

1.2.1 Changes to internal business processes exclusionary requirements (effective 1 January 2014)

Subsection 11D(8)(d) of the Act effective 1 October 2012 prohibited companies from claiming R&D project expenditure where the R&D related to the development of internal business processes, unless those developments were mainly intended for sale or for granting the rights to use those developments to other companies (including connected companies).

This was modified to fall within proviso (b) of subsection 11D(1) of the Act with effect from 1 January 2014, such that an exclusion was inserted stating that the sale or the granting the use or right to use or permission to use thereof must be to "persons who are not connected parties in relation to the person carrying on that research and development".

The purpose of this amendment appears to be to prevent companies based within the republic from providing access to such internal business processes to connected entities in order to claim deductions under section 11D.

However, this provision also now excludes companies claiming deductions under section 11D where they have received contracts to conduct research and development from connected parties outside of South Africa whom are not subject to tax in South Africa.

This discourages multinationals from outsourcing their R&D to South African companies, and is therefore contrary to the purpose and intention of Parliament when the incentive was introduced.

1.2.2 Practical example

A foreign parent company, *Parent Co*, has contracted a South African tax resident subsidiary, *Subsidiary Co*, to develop an innovative computer program used for internal purposes across a global group of companies.

Each foreign company within the group will pay a license fee to use the computer program developed by *Subsidiary Co*. *Subsidiary Co* will be required to include in its taxable income the revenue received from *Parent Co* as well as from the other subsidiary companies within the group, with an appropriate arm's-length mark-up.

Under the previous wording of 11D, *Subsidiary Co* would have been able to claim a 150% deduction under section 11D for the R&D portions of this work (encouraging *Parent Co* to outsource the project to the South African company).

With the wording of the Act in effect from 1 January 2014, *Subsidiary Co* would only be able to claim the R&D expenditure at 100% (i.e. there is no longer an incentive for R&D to be given to South Africa).

In fact, this incentivises multi-nationals to locate their outsourced R&D in jurisdictions that offer more favourable R&D regimes (for example Spain and Singapore) as opposed to South Africa.

1.2.3 Proposed solution

The provision should be reworded so that R&D related to the development of internal business processes may be claimed under 11D where it is for sale or for the granting of use to or permission to use thereof to

"*persons who are not connected parties in relation to the person carrying on the research and development* ***or connected persons that are not tax residents of South Africa***".

Alternatively, proviso (b) to subsection 11D(1) should be removed.

1.3 Transparency for application of subsection 11D(9)

1.3.1 No Recourse

Two key issues have been encountered in relation to the application of subsection 11D(9).

These are:

1 No recourse exists in the current legislation which allows an aggrieved taxpayer the opportunity to request that the Minister of Science and Technology (or appointee) re-evaluate any pre-approval applications submitted under subsection 11D(9) of the Act.

2 The only exception to this is to apply for an administrative review to be undertaken by the courts. This opportunity is afforded to the taxpayer through section 33 of the Constitution of the Republic of South Africa. It is noted that this is the sole option of recourse available to an aggrieved taxpayer. The administrative review acts as an option of last resort, and is often an undesirable option for both taxpayers and government.

Should a pre-approval application submitted under subsection 11D(9) be denied by the Minister of Science and Technology, subsection 11D(16)(a) stipulates that written reasons need to be provided to the applicant.

In practice no reason is given other than simply that the application does not meet the requirements of subsection 11D(9). Detailed reasons to taxpayers as to why this is the case are not provided.

If reasons had to be given by the minister as to why pre-approval applications were not approved, a taxpayer would be able to use this information in determining whether they submit pre-approval applications for future projects, and whether they would opt to take recourse against a determination made by the Minister.

1.3.2 Proposed solution

In order to overcome the issues above, the following solution should be adopted:

1 There should be a recourse mechanism for taxpayers to request that the Minister of Science and Technology consider additional information, or reconsider an initial decision where an application submitted under subsection 11D(9) has not been approved. Representation to the committee by the applicant should also be permitted.

2 If pre-approval applications to claim R&D deductions submitted under section 11D are not approved, the minister should have to explain in detail to taxpayers why this was the case as opposed to simply stating that the applicant does not meet the R&D definition.

1.4 Interpretation: Subjective application of the term 'innovative'

1.4.1 No definition for the term "innovative" in subsection 11D(1)(c)

Subsection 11D(1)(c) requires the making of "a significant and innovative improvement to any invention, functional design, computer program or knowledge (essential to the use thereof)".

The term 'innovative' is not defined and is inherently subjective.

Given that subsection 11D(9) of the Act currently provides the 'innovative' requirement in the hands of the Minister of Science & Technology, the Minister already has a subjective and 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.

1.4.2 Proposed solution

The term 'innovative' should be defined, or alternatively removed from the R&D definition in subsection 11D(1) due to its subjective nature of interpretation. The DST should also publish guidelines on its interpretation of the word "innovative" and this is to be applied on a prospective basis in accordance with the *contra fiscum* rule.

1.5 Restrictions on capital equipment used for R&D

1.5.1 Providing allowance for use of capital assets in the R&D process

Subsection 11D(2)(a) provides a 150% deduction for expenditure incurred on R&D.

Subsection 11D(2)(b)(i) denies such a deduction in respect of "immovable property, machinery, plant, implements, utensils or articles excluding any prototype or pilot plant created solely for the purpose of the process of research and development and that prototype or pilot plant is not intended to be utilised or is not utilised for production purposes after that research and development is completed".

There are two key issues here:

1 Rarely do taxpayers know at the outset exactly how an asset will be used throughout its entire life.

2 There may be assets that would facilitate R&D, but have previously been used for a commercial purpose. The current legislation provides no incentive to taxpayers to remove assets from their otherwise commercial usage and utilise them for R&D.

1.5.2 Practical example

A company that provides specialised medical care to patients owns a centrifuge. The centrifuge cost R1 million and has been in operation for one year, solely used for analysing patient blood samples (which is not R&D). The expected useful life of the centrifuge is four years.

The company is considering embarking on a one year program of R&D with a view to developing a vaccine for a new disease that many of its patients have recently been diagnosed with. The company determines that to enable the R&D to occur, it requires the use of the existing centrifuge and the purchase of a specialised freezer. The specialised freezer costs R5 million and has an expected useful life of five years.

The company determines that the centrifuge would not be able to be used for analysing patient blood samples throughout the year of R&D, and would therefore negatively impact the company's revenue in the short-term. However, should the R&D be successful, the long-term revenue of the company would increase dramatically.

The company also determines that whilst the centrifuge is required for the entire year of R&D, the freezer is only required for nine months for R&D. The company could use the freezer for providing medical care to its patients once the R&D has been completed.

The current legislation provides no relief for the use of either asset for R&D.

1.5.3 Proposed solution

The depreciation of assets is allowable for the 150% deduction to the extent that those assets are utilised in the R&D process.

In the practical example above, the section 11D deductions would be as follows:

1 The centrifuge's annual depreciation deduction in its first year was R250 000. However, as the centrifuge is used for the entirety of its second year for R&D, the section 11D deduction would be R375 000 (R250 000 x 150%).

   The depreciation deduction of R250 000 that otherwise would have been allowable in the second year is foregone.

   The depreciation deductions in the following two years reverts back to R250 000 since it is not being used for R&D in those years. The total deductions received on the R1 million centrifuge equates to R1 125 000.

2 The freezers' annual depreciation deduction would normally be R1 million. However, as the freezer is used for nine months of its first year for R&D, its section 11D deduction would be R1 125 000 (R1 million x 9/12 x 150%) and its depreciation deduction would be R250 000 (R1 million x 3/12 x 100%), totalling R1 375 000 of deductions in its first year.

   The depreciation deduction of R1 million that therwise would have been allowable in the first year is foregone. The depreciation deductions in the following four years reverts back to R1 million since it is not being used for R&D in those years. The total deductions received on the R5 million freezer equates to R5 375 000.

We recommend that implementation of the above suggestion will contribute to the success of the South African R&D regime in an increasingly competitive global market.

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