28 November 2008

The South African Revenue Service
Private Bag X923
PRETORIA
0001

BY E-MAIL: policycomments@sars.gov.za

Dear Sir/Madam

CALL FOR COMMENT: DRAFT INTERPRETATION NOTE SECTION 11D - DEDUCTION FOR SCIENTIFIC OR TECHNOLOGICAL RESEARCH AND DEVELOPMENT COSTS

Set out below please find the SAICA National Tax Committee’s submission on the Draft Interpretation Note on S11D Research and Development ("R&D") costs.

1. General

1.1 The Draft Interpretation Note ("Draft Note") does not deal with situations where taxpayers, such as taxpayers involved in the agricultural market, who may either voluntarily or by way of statutory requirements pay specifically identified research and development levies to a research and development organisation which specialises in conducting generic research and development for the benefit of these taxpayers. We are of the opinion that generic research and development activities which will benefit taxpayers of a particular industry can be undertaken for the purposes of the discovery of novel, practical or non-obvious information or for the devising, developing or creation of any invention as defined in section 2 of the Patents Act, No. 57 of 1978, design as defined in section 1 of the Designs Act, No. 195 of 1993, computer programme as defined in section 1 of the Copyright Act, No. 98 of 1978 or knowledge essential to the use of such inventions, designs or computer programmes.

1.2 We accept that there has to be a direct link between the expenditure incurred and the research and development undertaken in the sense that the organisation receiving the levies must be obliged to fund research and development activities with the amounts received as opposed to a situation where the organisation may decide the extent to which the amounts received will be used to fund these research and development activities. Another prerequisite is that the section 11D deduction for scientific or
technological research and development will only be allowed to the extent that the research and development activities undertaken by the research and development organisation qualifies in terms of section 11D.

2. **Paragraphs 3.2, 3.2.1, 3.2.2, 3.2.3, 3.2.4 and 3.2.5**

2.1 The discussion regarding qualifying R&D activities, although useful, is broad and regrettably does not go into sufficient detail to clarify which activities will qualify and which will not. This is particularly relevant as there appears to be a difference between those activities which qualify as R&D activities per SARS and activities which will qualify as such based on definitions provided by the Department of Science and Technology ("DST"). The result of the apparent difference in interpretation is that activities which will qualify based on the interpretation offered by the DST may not necessarily qualify as such based on SARS's interpretation and vice versa. As noted in paragraph 2 of the Draft Note, the "scientific or technological research and development program or tax-incentive scheme, as it is now called, is an indirect approach by government to increase national scientific and technological research and development expenditure and complements government expenditure on scientific or technological research and development activities". This initiative can only be successful once the interpretation of SARS and the DST regarding what activities qualify as research and development are the same.

2.2 For example, the Draft Note does not refer to definitions of "research", "development" and "scientific and technological research and development activities" as defined by the Organisation for Economic Co-operation and Development, yet the DST refers to those definitions in its "Guide to Tax Incentives". A distinction is further drawn between the physical characteristics of the physical environment in which scientific research and development is undertaken, i.e. a laboratory environment, and the physical environment in which technological research and development is undertaken, i.e. an industrial setting.

3. **Paragraph 3.3.2 – Expenditure actually incurred by the taxpayer**

3.1 The issues raised in paragraph 3.3.2 dealing specifically with the sub-heading "Directly for the purpose of" may be misleading. We refer specifically to the comment made in the third paragraph under that sub-heading which provides as follows:

The words “directly for the purpose of” imply that any activity undertaken merely indirectly for an R&D purpose is not eligible for the deduction. To illustrate the point, the following extract from SIR v Consolidated Citrus Estates Ltd might be helpful:

“It would thus seem that ‘directly’ refers to and qualifies the act of incurring the expenditure. Obviously the expenditure must have been incurred by the taxpayer, i.e. he must have incurred the liability or made the payment. ‘Directly’ appears to have been deliberately added in order to serve some purpose that the legislature had in mind. That purpose, I think, was to postulate that the connection between the taxpayer’s incurring the expenditure and the object for which it was incurred (being one of those specified in paras (a) to (f) in the subsection) should be direct, i.e. straight, and close, not devious and remote (cf Concise Oxford English Dictionary sv ‘direct’). The reason was probably to stimulate the personal efforts of the individual exporter to develop an export market for his products; and therefore to ensure that for the expenditure to
qualify for the additional and special allowance, it had to be incurred by the exporter himself and also had to be easily identifiable and thus readily provable to the Secretary’s satisfaction, as being clearly expenditure for one or other of the specified objects.”.

3.2 It is noted that SIR v Consolidated Citrus Estates Ltd ("Citrus Estates") is not the only tax case dealing with the meaning of the term "directly". There are various other cases which also deal with the meaning of the term "directly" such as:

ITC 1061 [26 SATC 317(C)] in which the court stated that, The Corbett J, the President of the court said "(T)he word “directly” in this sense, is defined by the Shorter Oxford English Dictionary to mean –

“Without the intervention of a medium; immediately; by a direct process or mode.”

The same dictionary defines the adjective “direct”, in a cognate sense, as meaning –

“Without intervening agency; immediate”.

3.3 CIR v Wandrag Asbestos (Pty) Ltd [57 SATC 123] ("Wandrag case").

The Wandrag case is in our view of particular importance here as the outcome of the court decision for the taxpayer in the Wandrag case was different from the situation for the taxpayer in Citrus Estates. The reference to the Citrus Estates case only without referring to the Wandrag case is therefore misleading. In this regard, we are of the opinion that the following reference taken from the Wandrag case should be included:

"Thus in this case it is the connection between payment in terms of clause 4(a) and the procurement of the export orders that must be direct. It is not necessary that there should be a direct connection between the payment and the orders themselves.

It cannot be gainsaid that this payment was, and was intended to be, remuneration for Gefco for such procurement through its (Gefco's) appointed agents and perhaps employees. It was conceded that had Wandrag appointed and paid its own foreign agents for this purpose, the expenditure would have been directly incurred by Wandrag whether or not they in turn appointed subagents who actually secured the orders. I see no distinction in principle between that situation and the present in which Gefco was commissioned and paid to undertake this task and it in turn appointed agents who obtained the orders. It is true that the agreement as a whole cannot classified as one of agency, But on the assumption that the selling commission in clause 4(a) was the quid pro quo for marketing Wandrag's asbestos and for nothing else, one may validly regard this term of the agreement as one of agency in the sense of a mandate given by Wandrag (the mandator) to Gefco (the mandatory) in terms of which the latter undertook to perform the task of procuring orders for export for the former."

3.4 The term "directly" therefore also applies in circumstances where a specifically identified amount is paid to a third party and that third party is not in a position to redirect the funds so received to any other activity other than the activity specifically identified by the payee of the funds.
Please do not hesitate to contact me should you wish to discuss the above.

Yours faithfully

M Hassan CA(SA)

**PROJECT DIRECTOR: TAX**

*The South African Institute of Chartered Accountants*