



*SOUTH AFRICAN REVENUE SERVICE*

**INTERPRETATION NOTE: NO. 50**

DATE: 28 August 2009

**ACT : INCOME TAX ACT, NO. 58 OF 1962 (the Act)**  
**SECTION : SECTION 11D**  
**SUBJECT : DEDUCTION FOR SCIENTIFIC OR TECHNOLOGICAL RESEARCH AND DEVELOPMENT**

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**Preamble**

Legislative references in this Note to sections and subsections are to sections and subsections of the Act unless otherwise stated.

For the purposes of this Note –

- “**R&D purpose**” refers to any one of the purposes listed in section 11D(1)(a) and (b); and
- “**eligible asset**” refers to “any building or part thereof, machinery, plant, implement, utensil or article”.

This Note is divided into parts to deal with each deduction separately, as well as the other requirements of the section.

**1. Status of this Interpretation Note**

This Note is not a binding general ruling issued under section 76P of the Act. Should an advance tax ruling be required, visit the SARS website [www.sars.gov.za](http://www.sars.gov.za) for details of the application procedure.

**2. Purpose**

This Note provides guidance on the interpretation and application of section 11D, which provides deductions for scientific or technological research and development (R&D).

**3. Background**

Section 11D was introduced in 2006 to encourage private-sector investment in scientific or technological research and development. It replaces the old research and development regime under section 11B.

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.

In contrast to section 11B, the section has been simplified to ensure that South African enterprises of all sizes and in all sectors are encouraged to conduct scientific or technological research and development locally which will lead to scientific or technologically advanced products or processes.

Section 11D allows a deduction for expenditure actually incurred by a taxpayer directly for activities undertaken in the Republic for an R&D purpose.

The section came into effect on 2 November 2006.<sup>1</sup> A deduction for R&D expenditure incurred before that date must be sought under section 11B. This Note reflects section 11D as amended by the Revenue Laws Amendment Act, No. 60 of 2008.

Two types of deductions are allowable under section 11D. First, the 150% deduction of expenditure incurred for an R&D purpose under section 11D(1) and secondly, an accelerated depreciation deduction under section 11D(2) for capital expenditure incurred on any building or part thereof, machinery, plant, implement, utensil or article used for R&D purposes.

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<sup>1</sup> Section 11D was inserted by section 13(1) of the Revenue Laws Amendment Act, No. 20 of 2006 deemed to have come into operation on 2 November 2006 and applicable in respect of any activities undertaken on or after that date, or any building or part thereof, machinery, plant, implements, utensils or articles brought into use for the first time on or after that date. The effective date in section 13(2) of Act No. 20 of 2006 was amended by section 99(1) of the Taxation Laws Amendment Act, No. 8 of 2007.

## PART 1: DEDUCTION OF EXPENDITURE

### 4. The law – section 11D(1)

**11D. Deductions in respect of scientific or technological research and development.**—(1) For the purposes of determining the taxable income derived by a taxpayer from carrying on any trade there shall be allowed as a deduction from the income of such taxpayer so derived, an amount equal to 150 per cent of so much of any expenditure actually incurred by that taxpayer directly in respect of activities undertaken in the Republic directly for purposes of—

- (a) the discovery of novel, practical and non obvious information; or
- (b) the devising, developing or creation of any—
  - (i) invention as defined in section 2 of the Patents Act, 1978 (Act No. 57 of 1978);
  - (ii) design as defined in section 1 of the Designs Act, 1993 (Act No. 195 of 1993) that qualifies for registration under section 14 of that Act;
  - (iii) computer program as defined in section 1 of the Copyright Act, 1978 (Act No. 98 of 1978); or
  - (iv) knowledge essential to the use of such invention, design or computer program,

if that information, invention, design, computer program or knowledge is of a scientific or technological nature, and is intended to be used by the taxpayer in the production of his or her income or is discovered, devised, developed or created by the taxpayer for purposes of deriving income.<sup>2</sup>

#### 4.1 Entitlement to the incentive

Under section 11D(1), a taxpayer is entitled to the incentive if that taxpayer –

- is carrying on any trade;
- has actually incurred expenditure;
- directly for activities undertaken in the Republic; and
- directly for an R&D purpose (see **Preamble** and **4.2**); and

that R&D purpose –

- is of a scientific or technological nature, and
- is intended to be used by the taxpayer in the production of his or her income; or
- is discovered, devised, developed or created by the taxpayer for purposes of deriving income.

#### 4.2 Qualifying R&D activities

In order to qualify for the tax incentive, the R&D activities must be directed towards one of a closed list of R&D purposes, each discussed more fully below (see **4.2.1** to

<sup>2</sup> The words “or is discovered, devised, developed or created by the taxpayer for purposes of deriving income” were added to section 11D(1) by section 19(1) of the Revenue Laws Amendment Act, No. 60 of 2008 and deemed under subsection (2) to have come into operation on 2 November 2006 and apply in respect of any activities undertaken on or after that date.

**4.2.5).** It is not sufficient that the activity be generally directed towards advancing scientific or technological knowledge.

#### **4.2.1 Discovery of novel, practical and non-obvious information**

##### ***Discovery***

A discovery is something that has already been in existence and brought to the discoverer's awareness. This is usually the ascertaining of an existing fact of nature. An example of such an existing fact is the genetic sequence of a virus.

A discovery can be contrasted with an invention which is the product of human ingenuity. An invention is created while a discovery is pre-existing.

##### ***Novel***

The information must be new or unusual and must not be available in South Africa or elsewhere to be considered novel.

#### **Example 1 – Novelty of discovery**

##### *Facts:*

The research team of Company A, based in South Africa, is conducting genetic research on infertile human males. In the process, the DNA sequence of a gene which causes obesity is discovered. With the relevant genetic information the team then developed a therapeutic product for promoting weight-loss. This product is patented.

Is any of the research expenditure deductible under section 11D?

##### *Result:*

The expenditure incurred in the research which leads up to the discovery of the obesity gene is deductible under section 11D, since the activity was originally directed towards the discovery of another novel, practical and non-obvious information, namely, the genetic cause, if any, of male infertility.

The work conducted after the discovery is also deductible as it relates to the "devising, developing or creation of" an invention, being the therapeutic product.

##### ***Non-obvious***

See **4.2.2**

#### **4.2.2 Invention as defined in section 2 of the Patents Act, No. 57 of 1978 (the Patents Act)**

Under section 25(1) of the Patents Act, an invention must be new, involve an inventive step and be capable of being used or applied in trade or industry or agriculture.

An invention does not need to be protected by way of a granted patent or be the subject of a patent application for the activity to qualify for a deduction. While there are many reasons why a taxpayer may choose not to apply for patent protection, it is necessary for the work to be protectable by way of a patent. In other words, all the

requirements of the Patents Act for an “invention” as defined in that Act must be met but a patent application does not need to be made.

The word “new” implies that it has not been made available to the public anywhere in the world (not only South Africa). Public disclosure may take many forms, such as publication, use, written or oral description [section 25(6) of the Patents Act].

### **Example 2 – New**

*Facts:*

A research team from a South African-resident Company B visits the Congo and makes contact with a Congolese healer. The healer has developed a new formula for a lotion which alleviates eczema. The team returns to South Africa with a sample of the lotion and, after some investigation, is able to determine its formula. Company B now wishes to enter the South African market.

Can the cost incurred by Company B for the research conducted in identifying the lotion’s formula qualify as a deduction under section 11D?

*Result:*

No. There is no invention as the formula is not new. It was manufactured and used in the Congo before it was developed in South Africa.

### ***Inventive or non-obvious***

Non-obvious means that the invention must be inventive [see section 25(10) of the Patents Act]. This is a subjective inquiry. In the event of obviousness being contested, SARS will take into account any examination report or opinion conducted by an expert in the field, such as an examining patent authority or a professional patent attorney.

Several categories of works are expressly excluded from patentability under the Patents Act. Any activity which is for the purpose of development or creation of any such excluded categories also does not qualify for the deduction.

Under section 25(2) of the Patents Act the following are not an “invention” and therefore will not qualify for the deduction (except when specifically allowed as indicated):

- A discovery [but this category does constitute qualifying intellectual property under section 11D(1)(a) – see **4.2.1**].
- A scientific theory.
- A mathematical method.
- A literary, dramatic, musical or artistic work or any other aesthetic creation.
- A scheme, rule or method for performing a mental act, playing a game or doing business.
- A program for a computer (but this category is included in section 11D(1)(b)(iii) – see **4.2.4**).
- The presentation of information.

Although scientific theories and mathematical methods may not be patentable, they may constitute a discovery or novel, practical and non-obvious information [paragraph (a) of section 11D(1)] so that, in certain instances, the discovery of any such theory or method would be an R&D purpose for purposes of the tax incentive.

The following are also excluded from patentability under section 25(4)(b) and (11) of the Patents Act respectively:

- Any variety of animal or plant or any essentially biological process for the production of animals or plants, not being a micro-biological process or the product of such a process.
- An invention of a method of treatment of the human or animal body by surgery or therapy or diagnosis practised on the human or animal body.

#### **4.2.3 Design as defined in section 1 of the Designs Act, No. 195 of 1993 (the Designs Act)**

Although the Designs Act protects both aesthetic and functional designs, generally only functional designs qualify as an R&D purpose under section 11D. Aesthetic designs are not, generally, scientific or technological in nature.

The term “functional design” is defined in section 1 of the Designs Act as –

“any design applied to any article, whether for the pattern or the shape or the configuration thereof, or for any two or more of those purposes, and by whatever means it is applied, having features which are necessitated by the function which the article to which the design is applied, is to perform, and includes an integrated circuit topography, a mask work and a series of mask works”.

A functional design must be new and not commonplace in the art in question in order to be protectable (section 14 of the Designs Act).

Similar to an invention, a design will be deemed to be new if it is different in form or if it does not form part of the state of the art, in other words, it is new if it has not been made publicly available anywhere in the world.

#### **4.2.4 Computer program**

The Copyright Act, No. 98 of 1978 (“the Copyright Act”) defines the term “computer program” as –

“a set of instructions fixed or stored in any manner and which, when used directly or indirectly in a computer, directs its operation to bring about a result”.

Under section 11D(5), expenditure or cost is not deductible at 150% or as a depreciation allowance if it relates to –

- exploration or prospecting;
- management or internal business processes;
- trade marks;
- social sciences or humanities; or
- market research, sales or marketing promotion.



These excluded activities are especially relevant in considering whether the tax incentive applies to computer programs. The development of websites, internet sales systems, or customer satisfaction questionnaires is accordingly not eligible for the deduction as these constitute market research, sales or marketing promotion. Software packages developed for administration, human resources or accounting purposes are similarly excluded from the tax-incentive scheme as they constitute management or internal business processes.

For the devising of software to qualify as an R&D purpose, the computer program must –

- meet the definition under section 1 of the Copyright Act;
- be of a scientific or technological nature;
- be intended to be used by the taxpayer in the production of his or her income; or
- be devised, developed or created by the taxpayer for purposes of deriving income; and
- not be for excluded activities under section 11D(5).

Research into developing software for management and internal business processes will therefore not be eligible for a deduction. In this regard it is irrelevant whether such software is developed for use in-house or is developed for the purpose of sale to end-users.

If a taxpayer develops a computer program for sale for use under licence, any related R&D expenditure would qualify for the section 11D deduction insofar as the program is not for internal business processes and all other requirements are met.

### **Example 3 – Computer software**

*Facts:*

Software Co. designs computer software which allows its clients' employees to monitor how much time is spent on the telephone. The software is licensed to clients. The company employs several computer programmers to improve the software and adapt it to clients' needs.

Does the development of Software Co.'s software constitute an R&D purpose and will the expenditure incurred qualify for a deduction under section 11D(1)?

*Result:*

The software constitutes a "computer program" as defined in the Copyright Act, and it therefore comprises an R&D purpose under section 11D(1)(b)(iii). However, under section 11D(5)(b) the cost of developing and adapting the software will not qualify as a deduction because the software relates to management or internal business processes.

#### **4.2.5 Knowledge essential to the use of such invention, design or computer program**

The word "knowledge" bears its ordinary dictionary meaning and is defined in the Oxford English Dictionary as –

"facts, information, and skills acquired by a person through experience or education; the theoretical or practical understanding of a subject; what is known in a particular

field or in total; facts and information; or awareness or familiarity gained by experience of a fact or situation”.

Under section 11D(1)(b)(iv) the knowledge must be essential to the use of an invention, design or computer program. This requirement is more stringent than that in the old section 11B regime, which referred to knowledge connected to the use of an invention, etc.

#### **Example 4 – Knowledge essential to the use**

*Facts:*

A manufacturing company develops a new machine for manufacturing widgets which is faster than older machines and requires less maintenance. Several parts of the machine are protected by way of registered designs.

While developing the new machine, the manufacturing company develops extensive know-how relating to the operation of the machine and maintenance procedures. One of the company’s employees spent three months writing a comprehensive operating manual for the machine.

Is the cost of drawing up the operating manual deductible under section 11D?

*Result:*

The cost of drawing up the operating manual is deductible under section 11D as it represents know-how essential to the use of the design.

### **4.3 Requirements**

Once it is determined that activities are for an R&D purpose as described in paragraph (a) and (b) of section 11D(1), each item of expenditure must be separately considered.

#### **4.3.1 Carrying on any trade**

See paragraph 4 of Interpretation Note No. 33<sup>3</sup> for a discussion of this topic.

A taxpayer may begin a program of scientific or technological research and development before trading commences. Such so-called start-up expenditure would not qualify as a deduction under section 11D while trade is not underway.

Section 11A permits a deduction for R&D expenditure that would have qualified under section 11D but for the fact that it was incurred before the commencement of trade. The pre-trade R&D expenditure will be allowed as a deduction when the taxpayer commences to carry on trade [section 11A(1)]. However, under section 11A(2) the deduction is ring-fenced, that is, it is limited to the income less other allowable deductions from the particular trade. A taxpayer that abandons an R&D project before the commencement of trade will not be entitled to a deduction of the related R&D expenditure under section 11A. The latter provision requires that trade must commence before the qualifying pre-trade expenditure can be claimed as a deduction. However, once trade commences, the pre-trade R&D expenditure will

<sup>3</sup> 4 July 2005, “Assessed Losses: Companies: The Trade and Income from Trade Requirements”.

qualify for the 150% deduction provided the requirements of section 11D are complied with.

#### **4.3.2 Expenditure actually incurred by the taxpayer**

This phrase is used in other sections of the Act which have been considered by the courts. The general principle laid down by the courts is that expenditure is actually incurred not when it is paid (if paid in a subsequent year) but when the taxpayer incurs an unconditional legal liability.

In the field of R&D one company (A) will often commission another company (B) to conduct research on its (A's) behalf. Company A will usually pay a fee to Company B, while Company B will incur the actual R&D expenditure. In these circumstances both companies will qualify for a deduction under section 11D(1) – Company A for the fee it pays to Company B, and Company B for the actual R&D expenditure it incurs. Company B will, however, be subject to the deduction limitation provisions of section 11D(7) and (8) and the recoupment provisions of section 11D(9).

#### ***In the Republic***

The term “Republic” is defined in section 1 and means the territory of the Republic of South Africa, including the territorial waters, the contiguous zone and the continental shelf referred to respectively in sections 4, 5 and 8 of the Maritime Zones Act, No. 15 of 1994.

Activities which are conducted outside of the Republic, even if funded from within the Republic, are not eligible for the section 11D deduction.

#### ***Directly for the purpose of***

The activities eligible for a deduction must have been undertaken “directly” for an R&D purpose. In the case of an entire project having an R&D purpose, say the development of a computer program, not all activities are undertaken directly for the R&D purpose. Accordingly only activities relating directly to the listed statutory activities are eligible for a deduction.

For example, if an employee was not directly engaged in R&D activities in the year of assessment 100% of the time, the employee’s salary must be apportioned between R&D and non-R&D expenditure. For this reason, it is important that researchers’ timesheets, job cards, journals or diaries are kept.

The words “directly for the purposes 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:<sup>4</sup>

“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, ie 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

<sup>4</sup> 1976 (4) SA 500 (A), 38 SATC 126 at 148.

'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."

Activities which SARS considers directly for R&D purposes are listed in **Annexure A**, and activities excluded from eligibility are listed in **Annexure B**. These lists are not intended to be exhaustive.

### **Example 5 – Apportionment of R&D expenditure between eligible and non-eligible elements**

*Facts:*

During the year of assessment Research Co. conducted 40 research projects of which 25 qualified as R&D for purposes of section 11D, while 15 did not. The company has the following personnel:

- Two full-time researchers
- One clerk who is primarily responsible for administrative work but who also assists the researchers with their projects from time to time as and when needed
- One secretary exclusively responsible for administrative work

Are the salaries of the abovementioned personnel deductible for under section 11D?

*Result:*

The salary (cost to company) of the researchers will only be deductible under section 11D to the extent of their time spent on eligible research projects.

A portion of the salary of the clerk (cost to company) will be allowable under section 11D based on time spent in supporting the researchers directly with eligible research projects.

The salary of the secretary will not be allowable under section 11D as it is not incurred directly for the purposes of R&D.

### ***Of a scientific or technological nature***

While the words 'scientific or technological' are of wide import, they must be read with section 11D(5) which prohibits the deduction of R&D expenditure in relation to certain activities.

### ***Used by the taxpayer in the production of income***

For R&D expenditure to be incurred in the production of income, it must have been outlaid for the purpose of earning income as defined in section 1 and must be closely connected to the income-earning operations.<sup>5</sup> The income generated by the R&D expenditure will be in the production of income whether it is derived in the current or a future year of assessment.<sup>6</sup> The result of the activities might still be in a

<sup>5</sup> *Port Elizabeth Electric Tramway Co Ltd v CIR* 1936 CPD 241, 8 SATC 13; *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 113.

<sup>6</sup> *Sub-Nigel Ltd v CIR* 1948 (4) SA 580 (A), 15 SATC 381.

developmental phase or be completely unsuccessful, yet the expenditure will still qualify for the deduction.

The requirement that a taxpayer use the product of the research in the production of income would apply, for example, to a company that conducts the R&D itself with the intention of using the product of the research in its business. It would also apply to a company that pays another company a fee to conduct R&D on its behalf (that is, the company will use the product of the research in its business to produce income).

***For purposes of deriving income***

A taxpayer will also be entitled to the section 11D(1) deduction when the product of that taxpayer's R&D activities is discovered, devised, developed or created on behalf of someone else, provided that the taxpayer derives income from its R&D activities (for example, in the form of a fee paid to the taxpayer by the person on whose behalf the R&D is being conducted).

## PART 2: DEPRECIATION ALLOWANCE

### 5. The law – section 11D(2), (3) and (4)

(2) There shall be allowed as a deduction by a taxpayer in respect of any building or part thereof, machinery, plant, implement, utensil or article which—

- (a) is owned by that taxpayer, or acquired by that taxpayer as purchaser in terms of an agreement contemplated in paragraph (a) of the definition of “instalment credit agreement” in section 1 of the Value-added Tax Act, 1991 (Act No. 89 of 1991);
- (b) is first brought into use by that taxpayer solely and directly for purposes contemplated in subsection (1); and
- (c) prior to first being brought into use by that taxpayer solely and directly for purposes contemplated in subsection (1), was not used by any person for any purpose;
- (d) . . . . .

an amount equal to 50 per cent of the cost to that taxpayer of that building, part, machinery, plant, implement, utensil or article in the year of assessment that it is bought into use for the first time by that taxpayer and 30 per cent in the first succeeding year of assessment and 20 per cent in the second succeeding year of assessment: Provided that no deduction shall be allowed to a taxpayer under this section in respect of any building, part, machinery, plant, implement, utensil or article if that taxpayer ceased to use that building, part, machinery, plant, implement, utensil or article, solely and directly for purposes contemplated in subsection (1) during any previous year of assessment.

(3) For the purposes of this section, the cost to the taxpayer of any building, machinery, plant, implement, utensil or article shall be deemed to be the lesser of—

- (a) the actual cost to the taxpayer in respect of the acquisition, installation and erection thereof;
- (b) the cost which a person would, if he or she had acquired, installed or erected that building, machinery, plant, implement, utensil or article under a cash transaction concluded at arm’s length on the date on which the transaction for the acquisition, installation or erection thereof was in fact concluded, have incurred in respect of the cost of such acquisition, installation or erection; or
- (c) . . . . .
- (d) where the building, machinery, plant, implement, utensil or article has been acquired to replace an asset which has been damaged or destroyed, such cost less any amount which has been recovered or recouped in respect of the damaged or destroyed asset and has been excluded from the taxpayer’s income in terms of section 8(4)(e), whether in the current or any previous year of assessment.

(4) Notwithstanding any other provision of this section, any building or any part thereof shall be deemed not to have been used for purposes contemplated in subsection (2) unless such building or part is regularly used for those purposes and is specifically equipped for such use.

#### 5.1 Eligible asset

A depreciation allowance is provided under section 11D(2) on the cost of any eligible asset used for an R&D purpose at the rate of 50% in the year of assessment in which the eligible asset was brought into use for the first time by the taxpayer, 30% in the first succeeding year of assessment and 20% in the second succeeding year of assessment.

Interpretation Note No. 47 dealing with deductions allowable under section 11(e) is useful in considering what constitutes an eligible asset.

For a deduction to be allowed under section 11D(2) the eligible asset must be –

- **Owned by the taxpayer, or acquired by that taxpayer as purchaser**

The expression “acquired by that taxpayer as purchaser” means acquired under an agreement contemplated in paragraph (a) of the definition of an “instalment credit agreement” in section 1 of the Value-Added Tax Act, No. 89 of 1991.

A lessee is accordingly not entitled to the deduction, but a co-owner may depreciate the eligible asset proportionately to his or her share in the eligible asset, provided that all other requirements are met.

- **First brought into use by that taxpayer**

The phrase “brought into use for the first time” was considered in ITC 1804<sup>7</sup> in the context of section 12C(1)(b). The court distinguished the letting of an asset by a lessor from the use of the asset by the lessee. Boruchowitz J stated the following:<sup>8</sup>

“The bringing into use of an asset is an act of a physical nature whereas letting or hiring is a jural or non-physical act. Only the user ... can bring the machinery or plant into use for the first time for the purposes of its trade and this is a factual question.”

If an asset was first used by a taxpayer for any purpose other than those in section 11D(1), it may not be depreciated under section 11D(2).

#### **Example 6 – Building brought into use**

*Facts:*

Company A erected a building in 2005. On completion it was occupied by senior management and fully used as their operational headquarters for the next two years. In 2007 management relocated to another building and the research and technical division moved into it.

Can Company A depreciate the building under section 11D(2)?

*Result:*

The building cannot be depreciated under section 11D(2) as it was not first brought into use by the company for R&D purposes.

- **Solely and directly for the purposes contemplated in section 11D(1)**

The words “solely and directly” are used to qualify the relationship between the expenditure and its purpose. The asset must be used exclusively and directly for the purposes contemplated in section 11D(1) in order to qualify for a deduction.

- **Prior to first being brought into use by the taxpayer was not used by any person for any purpose**

A used asset cannot qualify for the depreciation deduction under section 11D(2).

<sup>7</sup> (2005) 68 SATC 105 (G).

<sup>8</sup> At 109.

**Example 7 – Second-hand asset***Facts:*

An individual uses a machine in his business to conduct normal manufacturing. He started an R&D division and transferred the machine to that division.

Will the machine qualify for an allowance?

*Result:*

The machine will not qualify for an allowance under section 11D(2). The individual will have to seek an allowance under the normal allowance provisions such as section 11(e) or 12C.

- **In the year of assessment**

The term “year of assessment” is defined in section 1 as –

“any year or other period in respect of which any tax or duty leviable under this Act is chargeable, and any reference in this Act to any year of assessment ending the last or the twenty-eighth or the twenty-ninth day of February shall, unless the context otherwise indicates, in the case of a company be construed as reference to any financial year of that company ending during the calendar year in question”.

**Example 8 – Use of building***Facts:*

A new building is acquired at a cost of R10 million. Determine the section 11D(2) allowances for the next three years, assuming that 100% or 35% of the building is used for an R&D purpose.

*Result:*

R&D building use	Allowances		
	50% R	30% R	20% R
100%	5 000 000	3 000 000	2 000 000
35%	1 750 000	1 050 000	700 000

**5.2 Meaning of “cost to the taxpayer” – section 11D(3)**

The depreciable cost to the taxpayer of an eligible asset is determined under section 11D(3) and is the lesser of –

- the actual cost to the taxpayer for the acquisition, installation and erection of the eligible asset;
- the cost which a person would have incurred under a cash transaction concluded at arm's length; or
- where an asset has been acquired to replace an eligible asset which has been damaged or destroyed, such cost less any amount which has been recovered or recouped in respect of the damaged or destroyed asset and has been excluded



from the taxpayer's income under section 8(4)(e), whether in the current or any previous year of assessment.

In *Hicklin v SIR*<sup>9</sup> Trollip JA said the following regarding the phrase "dealing at arm's length":

"For 'dealing at arm's length' is a useful and often easily determinable premise from which to start the enquiry. It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself. Indeed, in the Afrikaans text the corresponding phrase is 'die uiterste voorwaardes beding'."

Finance charges incurred on the acquisition of eligible assets are deductible under section 11(bB) (for finance charges incurred during the period before an asset is brought into use) or section 24J (for finance charges incurred during the period after an asset is brought into use). These charges are consequently not included in the cost of the assets concerned for the purposes of section 11D(3). "Cost" means the cost price of the asset excluding finance charges.

#### **Example 9 – Cost price**

##### *Facts:*

Researcher purchases a machine under an instalment credit agreement (paragraph (a) of the definition of an "instalment credit agreement" in section 1 of the VAT Act) for R100 000, with a 10% deposit at 12% interest per year repayable over a 54-month period. His monthly instalments are R2 165,09.

What are the income tax consequences?

##### *Result:*

The cost price of the machine for purposes of a deduction under section 11D(2) is R100 000. The interest payments will be deductible under section 24J over the period of the agreement, but will only qualify for a 100% deduction by virtue of section 11D(5B)(b).

#### **Replacement of damaged or destroyed assets qualifying for rollover relief**

Section 11D(3)(d) provides limited rollover relief for damaged or destroyed R&D depreciable eligible assets. For a detailed discussion on roll-over relief, see Chapter 13 of the *Comprehensive Guide to CGT* available on the SARS website. If the eligible asset is acquired as a replacement of another asset which was damaged or destroyed, the cost for purposes of claiming the allowance under section 11D(2) must be reduced by any amount which was recovered or recouped in respect of the damaged or destroyed asset that was excluded from the taxpayer's taxable income under section 8(4)(e), whether in the current or a previous year of assessment.

### **5.3 The building or any part thereof must be regularly used and specifically equipped – section 11D(4)**

Section 11D(4) imposes an ongoing requirement in the case of any building or any part thereof. It must be regularly used for an R&D purpose and be specifically equipped for that use. This requirement denies the allowance to a taxpayer that

<sup>9</sup> 1980 (1) SA 481 (A), 41 SATC 179.

acquires a building for an R&D purpose and then subsequently uses it for some other purpose.

The phrase "regularly used" is not defined in the Act, but since tax is an annual event, it is submitted that the building must be regularly used during a year of assessment. The regularity of use within each year of assessment depends in part on the nature of the R&D being undertaken. The facts and circumstances of each case must be taken into consideration in determining whether or not the building is regularly used.

The phrase "specifically equipped" is also not defined in the Act and again, the question of whether a building is specifically equipped depends upon the nature of the R&D and the facts and circumstances of the particular case.

## PART 3: EXCLUSIONS AND LIMITATIONS

### 6. The law – sections 11D(5), (5A), (5B) and (6)

(5) Notwithstanding any other provision of this section, no deduction shall be allowed in terms of subsection (1) or (2) in respect of expenditure or costs relating to—

- (a) exploration or prospecting;
- (b) management or internal business processes;
- (c) trade marks;
- (d) the social sciences or humanities; or
- (e) market research, sales or marketing promotion.

(5A) Notwithstanding any other provision of this section, no deduction shall be allowed in terms of subsection (1) in so far as that deduction is claimed in respect of expenditure incurred—

- (a) to acquire, install, erect, improve or add to any building, machinery, plant, implement, utensil or article;
- (b) to acquire, or for the right of use of, any invention, patent, design, copyright, work or knowledge; or
- (c) by any person carrying on any banking, financial services or insurance business.

(5B) Notwithstanding the provisions of subsection (1), the deduction to be allowed to a taxpayer in terms of that subsection in respect of expenditure incurred by that taxpayer shall, in so far as that expenditure—

- (a) is incurred to defray expenditure of any other person who is a connected person in relation to the taxpayer, be limited to an amount equal to 150 per cent of the amount of expenditure contemplated in subsection (1) incurred by that other person directly in respect of activities undertaken by that other person directly for purposes contemplated in that subsection; or
- (b) is incurred for the right of use of any property, or constitutes interest as defined in section 24J(1), be limited to the amount of the expenditure.

(6) The deductions contemplated in this section shall apply in lieu of any other deduction or allowance granted under any other provision of this Act, unless the taxpayer elects in the year of assessment that any deduction contemplated in subsection (2) is first allowable in respect of any building or part thereof, or any machinery, plant, implement, utensil or article, that the deduction or allowance granted under that other provision shall apply in respect of that building, part, machinery, plant, implement, utensil or article, in which case subsection (2) shall not apply in respect of that building, part, machinery, plant, implement, utensil or article, as the case may be.

#### 6.1 Excluded activities

Under section 11D(5) certain activities are expressly excluded from the R&D incentive scheme and any expenditure or costs relating to them are not deductible under section 11D(1) or (2). These activities are explored in more detail below.

##### 6.1.1 Exploration or prospecting

Exploration and prospecting have a wider meaning than that ascribed to these terms in paragraph 1 of the Tenth Schedule to the Act and in section 1 of the Mineral and Petroleum Resources Development Act, No. 28 of 2002 respectively. Exploration would for instance include space exploration.

Examples of activities excluded from the tax-incentive scheme include the sinking of exploratory drill-holes for geotechnical investigations or to evaluate the mineral resources of a site.

### **6.1.2 Management or internal business processes**

This exclusion is especially relevant to the inclusion of software as an R&D purpose (see 4.2.4). Accordingly the following software-related activities, whether or not they are of a routine nature, do not qualify for the deduction:

- Support for existing systems.
- Business application software.

### **6.1.3 Trade marks**

Any expenditure relating to trade marks, whether for the creation, development, protection, renewal or enforcement of a trade mark is not deductible under section 11D.

### **6.1.4 The social sciences or humanities**

Although scientific methods may be used in social science research, including quantitative and qualitative methods, such research does not qualify for the deduction. Examples of such social sciences include languages and literature, history, philosophy, religion, visual and performing arts (including music), psychology and economics.

### **6.1.5 Market research, sales or marketing promotion**

Activities associated with a project but not directly contributing to the resolution of scientific or technological uncertainty do not constitute eligible R&D. Examples include identifying or researching market niches in which R&D may be beneficial to a company, and the examination of a project's financial, marketing, and legal aspects.

## **6.2 Excluded expenditure – section 11D(5A)**

Section 11D(1) does not exclude expenditure of a capital nature. To avoid expenditure being deducted under the 150% deduction [section 11D(1)] and the depreciation deduction [section 11D(2)], section 11D(5A) prohibits a deduction under section 11D(1) claimed for expenditure incurred –

- to acquire, install, erect, improve or add to any building, machinery, plant, implement, utensil or article, or
- to acquire, or for the right of use of, any invention, design, copyright, work or knowledge.

The effect of section 11D(5A)(a) and (b) is that if expenditure is eligible for a 150% deduction and for the depreciation deduction under section 11D(2), the depreciation deduction takes precedence.

**Note:** With effect from years of assessment commencing on or after 1 January 2004, section 11(gC) allows as a deduction from income an allowance (5% or 10%) for expenditure incurred on the acquisition of certain incorporeal property provided that the expenditure actually incurred exceeds R5 000. It specifically excludes expenditure incurred by way of devising, developing or creating this intellectual property.

Under section 11D(5A)(b), expenditure incurred to acquire or for the right of use of any invention, design, copyright, work or knowledge is not allowable under section 11D(1). See 6.3 for clarity on the concept of “right of use”.

Under section 11D(5A)(c) the 150% deduction is also disallowed if expenditure is incurred by any person carrying on any banking, financial services or insurance business.

### 6.3 Limitation of expenditure – section 11D(5B)

Section 11D(5B)(a) contains an “anti-mark-up” rule when one connected person (A) pays another connected person (B) for R&D expenditure incurred on A’s behalf. A will only be entitled to the 150% deduction to the extent of B’s actual direct R&D expenditure. In other words, should B add a mark up to its actual costs in billing A, the mark-up portion will not qualify for the 150% deduction.

#### Example 10 – Non-qualifying rental expenditure

*Facts:*

R&D Co. hires a laboratory and purchases equipment for conducting a new research project.

What are the income tax consequences of the above transactions?

*Result:*

The rent will be deductible under section 11D(1) as it is payable for the right of use of the laboratory and is not excluded under section 11D(5A)(b) (see 6.3). However, under section 11D(5B)(b) the deduction for the rent will be limited to 100% instead of 150%.

The cost of the equipment will be deductible under section 11D(2).

#### Example 11 – Expenditure paid by a connected person – section 11D(5)(a)

*Facts:*

Huge Ltd is a listed company which has two wholly-owned subsidiaries, Subco and R&D Co, both of which operate in South Africa. All R&D activities for the entire group are carried out by R&D Co.

Under the agreement between Subco and R&D Co, Subco pays R&D Co a research fee based on R&D Co’s cost plus 10%. Subco is obliged to pay the fee even if the research is unsuccessful.

R&D Co charges Subco a fee of R990 000 for research on qualifying R&D projects during the year of assessment. The fee is made up as follows:

	R
Direct R&D expenditure	800 000
Indirect administration expenditure	<u>100 000</u>
Total expenditure	900 000
10% mark up	<u>90 000</u>
Research fee	<u><u>990 000</u></u>

Calculate the amount which Subco can claim as a deduction under section 11D.

*Result:*

Subco and R&D Co are connected persons in relation to each other by virtue of Huge Ltd (their common holding company) and Subco is thus governed by the limitation in section 11D(5B). Subco may deduct an amount of R800 000 x 150% = R1 200 000 of the R&D fee paid to R&D Co. The indirect expenditure and the profit margin do not qualify for the deduction.

Section 11D(5B)(b) limits the deduction under section 11D(1) to 100% in the case of expenditure on the right of use of any property and any interest contemplated in section 24J(1).

Amounts paid for the “right of use of any property” do not include the cost of purchasing property, including any acquisition under an agreement contemplated in paragraph (a) of the definition of an “instalment credit agreement” in section 1 of the Value Added Tax Act.

The ordinary meaning of the word “property” includes movable and immovable property and will thus include the right of use of any eligible asset used for an R&D purpose.

#### **Example 12 – Limitation of deduction for rent and interest – section 11D(5B)(b)**

*Facts:*

R&D Co. incurred the following expenditure in relation to its R&D activities:

	R
Rental – hire of laboratory from third party	50 000
Interest on bank loan used to finance purchase of R&D equipment	<u>150 000</u>
Total rent and interest incurred	<u>200 000</u>

Calculate the amount which R&D Co. can claim as a deduction under section 11D.

*Result:*

The rental comprises payment for the right to use property. Under section 11D(5B)(b) the deduction for interest and the right of use of property is limited to 100% of the cost incurred. R&D Co.’s deduction under section 11D(1) is therefore limited to R200 000.

#### **Right of use**

The personal servitude of *usus* (right of use) is a lesser right than usufruct, but, like usufruct, it is a real right and attaches to the asset rather than the person. It entitles a person to use another’s property but not to appropriate its fruits.<sup>10</sup> The right of use can be acquired over land, a house or animals, and in each of these the user may

<sup>10</sup> C G van der Merwe and M J de Waal *The Law of South Africa* 24 (First Reissue Volume) [CD-ROM] (*My LexisNexis*: 31 July 2000) LexisNexis Butterworths, Durban in para 441 under Servitudes / Personal Servitudes / Usus.

use the thing without becoming the owner of the fruits of the thing or the thing itself.<sup>11</sup> Lease rentals and lease premiums paid will be regarded as payments for the “right of use of any property”<sup>12</sup> as well as rental paid for the use of any movable or immovable property.

The effect of this paragraph is that the deductions for leases and rental payments will be limited to 100% and not 150%.

#### **Interest as defined in section 24J**

“**interest**” includes the–

- (a) gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
- (b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and
- (c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party,

irrespective of whether such amount is–

- (i) calculated with reference to a fixed rate of interest or a variable rate of interest; or
- (ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement;

Any finance charges, rental or lease payments will therefore not qualify for the 150% allowance, even if they are deductible under section 11D(1). Note that the limitation applies even if the rent or interest is paid to an unconnected third party.

#### **6.4 Option/election – section 11D(6)**

Section 11D(6) provides the taxpayer with an option to use a depreciation allowance under another section instead of the 50:30:20 deduction under section 11D(2). For this election to be effected –

- it must be exercised in the year of assessment that the eligible asset is brought into use for the first time, that is, the year of assessment in which a deduction under section 11D(2) is first allowable; and
- once an election is made to depreciate a particular eligible asset under another section, the taxpayer cannot later depreciate it under section 11D.

For example, a taxpayer can opt for a more favourable deduction of 100% under section 12E(1) for the cost of plant or machinery owned or acquired if the taxpayer qualifies as a small business corporation. Another example is the 100% write-off for small items costing R7 000 or less under section 11(e).

<sup>11</sup> James Lamprecht “Usufruct, Usus and Habitatio – Say what you mean and get what you want” (16 March 2006) available online at <[http://www.cm.law.za/article\\_print.aspx?id=35](http://www.cm.law.za/article_print.aspx?id=35)> [Accessed 25 August 2008].

<sup>12</sup> See, for example, *C: SARS v BP South Africa (Pty) Ltd* 2006 (5) SA 559 (SCA), 68 SATC 229 at 238.

## 6.5 Amount other than government grant received or accrued to fund expenditure – section 11D(7)

### 6.5.1 The law – section 11D(7)

(7) Where any amount (other than a government grant) is received by or accrues to a taxpayer to fund expenditure that is otherwise eligible for deduction under subsection (1), the deduction for that expenditure shall be limited to 100 per cent in lieu of 150 per cent to the extent of that amount, unless that amount is not deductible by any other person in terms of this Act.

Section 11D(7) applies when a taxpayer (A) pays another taxpayer (B) to conduct qualifying R&D on A's behalf. In this scenario, both A and B meet the income-generation requirements of section 11D(1) in that A will use the product of the R&D to produce its income, while B will derive income in the form of the funding it receives. However, section 11D(7) limits B's deduction to 100% of the cost incurred to the extent that the R&D expenditure is funded.

The type of amount envisaged in section 11D(7) is in the nature of a fee or grant, rather than a loan.

The deduction-limitation rule does not apply if the amount of the grant –

“is not deductible by any other person in terms of this Act”.

This means that the recipient of the grant will not be limited to a 100% deduction if the payer of the grant is not entitled to a deduction under the Act. This would apply, for example, if the payer of the grant was an approved public benefit organisation exempt from income tax under section 10(1)(cN) or not a resident of the Republic that does not receive income from a source within or deemed to be within the Republic.

The limitation applies only “to the extent” that the R&D expenditure claimed by the recipient is funded by way of grant. Any unfunded expenditure will thus not be subject to the 100% limitation.

It is submitted that section 11D(7) envisages that the funding will be received or accrued before the relevant R&D expenditure is incurred. A grant received or accrued after the expenditure has been incurred would represent a recovery or recoupment to be dealt with under section 11D(9).

#### **Example 13 – Expenditure funded by taxable entity**

*Facts:*

Company A and Company C are residents of the Republic. Company C received R1 000 from Company A to finance R&D expenditure. Company C incurred qualifying R&D expenditure of R1 200. The research results are intended to be for the production of Company C's income.

Calculate the amount which Company C is entitled to claim under section 11D(1).



*Result:*

Company C is entitled to the following deduction under section 11D(1):

	R
100% of R1 000 [section 11D(7) limitation]	1 000
150% of R200 (no limitation)	<u>300</u>
Total deduction under section 11D(1)	<u>1 300</u>

The portion of the expenditure funded by the grant is limited to 100%.

**Example 14 – Expenditure funded by non-resident***Facts:*

Foreign Holdco, which is not a resident, owns all the shares in SA Subco. SA Subco carries on qualifying R&D activities. During the year of assessment SA Subco incurred R&D expenditure of R1 000. In the same year of assessment SA Subco received an amount of R400 from Foreign Holdco for the purpose of funding this expenditure.

*Result:*

SA Subco will be entitled to a deduction of R1 500 (150% of R1 000) under section 11D(1). Since Foreign Holdco is not entitled to a deduction under the Act for the amount paid to SA Subco, SA Subco's deduction is not limited to 100% under section 11D(7).

**6.6 Government grant received or accrued to fund R&D expenditure – section 11D(8)****6.6.1 The law – section 11D(8)**

(8) Where any government grant is received by, or accrues to, a taxpayer to fund expenditure that is otherwise eligible for a deduction under subsection (1), the deduction for that expenditure shall be limited to 100 per cent in lieu of 150 per cent to the extent of twice that amount (except to the extent that expenditure is disallowed in terms of section 23(n)).

**Section 1 – Definition of a “government grant”**

“**government grant**” means an appropriation, grant in aid, subsidy or contribution, in cash or kind, paid by a department listed in Schedule 1 to the Public Service Act, 1994 (Proclamation No. 103 of 1994), (other than a provincial administration), but does not include any amount paid in respect of the supply of any goods or services to that department;

**Section 23(n)**

**23. Deduction not allowed in determination of taxable income.**—No deduction shall in any case be made in respect of the following matters, namely—

(a) – (m) . . .

(n) any deduction or allowance in respect of any asset or expenditure to the extent that amount—

- (i) is granted or paid to the taxpayer and is exempt from tax in terms of section 10(1)(y) or (yA); and
- (ii) is so granted or paid for purposes of the acquisition of that asset or funding of that expenditure:

Provided that the provisions of this paragraph shall not apply if the grant or payment is in respect of programmes or schemes that the Minister has identified by notice in the *Gazette* for purposes of this paragraph;

### **Section 10(1)(y) and (yA)**

**10. Exemptions.**—(1) There shall be exempt from normal tax—

(a) – (x) . . .

(y) any government grant or government scrapping payment received or accrued in terms of any programme or scheme which has been approved in terms of the national annual budget process and has been identified by the Minister by notice in the *Gazette* with effect from a date specified by the Minister in that notice (including any date that precedes the date of such notice) for purposes of this paragraph, having regard to—

(i) whether the programme or scheme meets government policy priorities and objectives with respect to—

(aa) the encouragement of economic growth and investment;

(bb) the promotion of employment creation;

(cc) the development of public infrastructure and transport;

(dd) the promotion of public health;

(ee) the development of innovation and technology;

(ff) the provision of housing and basic services; or

(gg) the provision of relief in the case of natural disasters;

(ii) the extent to which the programme or scheme will support the policy priorities and objectives contemplated in subparagraph (i);

(iii) the financial implications for government should government grants or government scrapping payments in terms of that programme or scheme be exempt from tax; and

(iv) whether the tax implications were taken into account in determining the appropriation or payment in respect of that programme or scheme;

(yA) any amount received by or accrued to any person in respect of goods or services provided to beneficiaries in terms of an official development assistance agreement that is binding in terms of section 231(3) of the Constitution of the Republic of South Africa, 1996, to the extent—

(aa) that amount is received or accrued in relation to projects that are approved by the Minister after consultation with the Minister of Foreign Affairs;

(bb) that agreement provides that those receipts and accruals of that person must be exempt; and

(cc) the Minister announces that those receipts and accruals are exempt by notice in the *Gazette*;

**[Note:** At the time of release of this Note, no schemes had been approved.]

The whole or a portion of the deduction under section 11D(1) is limited from the usual 150% to 100% if a government grant is received by or accrues to a taxpayer to fund qualifying R&D expenditure.

The portion of the expenditure that will be limited to a 100% deduction is equal to twice the amount of the government grant. The balance of the expenditure (if any) will qualify for the 150% deduction. If “twice the grant” exceeds the R&D expenditure, the deduction under section 11D(1) will simply be limited to 100% of the R&D expenditure.

To the extent that R&D expenditure has been disallowed under section 23(n), the “twice the grant” limitation rule does not apply. This will occur when the taxpayer receives a government grant that is exempt from tax which triggers a disallowance of expenditure under section 23(n). The Minister can exclude certain government grants that are exempt from tax from triggering section 23(n), and in that event the “twice the grant” limitation rule will apply to expenditure funded by such a grant which is exempt from tax.

#### **Example 15 – Taxable government grants**

*Facts:*

Company Z receives a government grant of R4 000 which is not exempt from tax to finance its R&D activities. The company spent the R4 000 and an additional R10 000 on qualifying R&D activities.

Calculate the amount which Company Z is entitled to claim as a deduction under section 11D.

*Result:*

	R
Total R&D expenditure (R4 000 + R10 000)	14 000
Less: Grant received (R4 000 X 2)	<u>(8 000)</u>
Amount eligible for 150% allowance	<u>6 000</u>
	R
R6 000 X 150%	9 000
Amount subject to 100% deduction (R14 000 - R6 000)	<u>8 000</u>
Deduction under section 11D	<u>17 000</u>

#### **Example 16 – Government grant which is exempt from tax**

*Facts:*

ABC (Pty) Ltd receives a government grant of R10 000 that is exempt from tax under section 10(1)(y). The company incurs R&D expenditure of R110 000. The Minister has not exempted the grant from the application of section 23(n).

Calculate the amount which Company Z is entitled to claim as a deduction under section 11D.

<i>Result:</i>	
	R
R&D expenditure incurred	110 000
Less: Portion disallowed under section 23(n)	<u>(10 000)</u>
Allowable expenditure	<u>100 000</u>
Allowable deduction under section 11D	<u>150 000</u>

## 6.7 Recoupment of amounts allowed under section 11D(1)

### 6.7.1 The law – section 11D(9)

(9) Where a taxpayer during any year of assessment recovers or recoups any expenditure in respect of which a deduction was allowed in terms of subsection (1) during that year or any previous year, such deduction shall be included in the income of that taxpayer.

Section 8(4)(a) specifically excludes any recoupment of an amount that was allowed as a deduction under section 11D(1). This is because the recoupment of amounts allowed under section 11D(1) is dealt with under section 11D(9).

If a taxpayer disposes of an asset for value for which a deduction was allowed under section 11D(1), the amount which was previously allowed as a deduction and which is recovered or recouped is included in taxable income under section 11D(9). The recoupment equals the deductions previously allowed.

#### Example 17 – Recoupment

##### *Facts:*

R&D Co. spends R100 000 on a researcher's salary and claims a deduction of R150 000 under section 11D(1) for the amount expended. R&D Co. subsequently receives R100 000 from its holding company in reimbursement of the salary expense.

Determine the amount to be included in the income of R&D Co. under section 11D(9).

##### *Result:*

Under section 11D(9) R&D Co must include R150 000 in its income.

The mere cessation of an R&D project does not trigger a recoupment.

The waiver or prescription of a debt used to incur R&D expenditure will also give rise to a recoupment under section 11D(9) (see ITC 1704,<sup>13</sup> ITC 1634<sup>14</sup> and *Omnia Fertilizer Ltd v C: SARS*<sup>15</sup>).

<sup>13</sup> (1997) 63 SATC 258 (C).

<sup>14</sup> (1997) 60 SATC 235 (T).

<sup>15</sup> (2003) 65 SATC 159 (SCA).

## 6.8 Recoupment of allowances allowed under section 11D(2)

### 6.8.1 The law – section 11D(10)

(10) The provisions of section 8(4)(a) and 11(o) shall not apply to so much of the amount of any allowance contemplated in subsection (2) as has been included in the taxpayer's income under the provisions of subsection (9), whether in the current or any previous year of assessment.

Section 11D(9) provides for the recoupment of any expenditure allowed under section 11D(1), but not section 11D(2).

Amounts allowed under section 11D(2) are subject to recovery or recoupment under section 8(4)(a). Any loss will be allowable under section 11(o).

It is accordingly submitted that section 11D(10) is superfluous.

#### Example 18 – Recoupment

*Facts:*

Company X buys a machine for R45 000 and uses it for R&D activities for two years of assessment. At the end of the second year of assessment the company sells it for R40 000.

*Result:*

Allowances claimed under section 11D(2):

	R
Year 1    R45 000 x 50%	22 500
Year 2    R45 000 x 30%	<u>13 500</u>
Total allowances claimed on machine	<u>36 000</u>

*Recoupment under section 8(4)(a):*

	R
Cost of machine	45 000
Less: Amounts allowed under section 11D(2)	<u>(36 000)</u>
Tax value	<u>9 000</u>
Proceeds	40 000
Less: Tax value	<u>(9 000)</u>
Recoupment – section 8(4)(a)	<u>31 000</u>

## **PART 4: OTHER PROVISIONS**

### **7. The law – sections 11D(11), (12), (13), (14), (15), (16), (17) and (18)**

(11) In respect of each year of assessment during which any taxpayer is eligible for any deduction contemplated in subsection (1) or (2), whether or not that deduction is limited in terms of this section, that taxpayer must submit to the Minister of Science and Technology such information as that Minister may require in such form and manner (including electronically) and at such place and within such time as that Minister may from time to time prescribe.

(12) 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.

(13) Other than as may be required by subsection (12), the Minister of Science and Technology and every person employed or engaged by him or her in carrying out the provisions of this section shall preserve and aid in preserving secrecy with regard to all matters that may come to his or her knowledge in the performance of his or her duties in connection with those provisions, and shall not communicate any such matter to any person whatsoever other than the Commissioner or the taxpayer concerned or his or her lawful representative nor suffer or permit any such person to have access to any records in the possession of that Minister or person except in the performance of his or her duties as required by the laws of the Republic or by order of a competent court.

(14) Every person employed or engaged as contemplated in subsection (13) shall, before acting under this section, take and subscribe before a magistrate or justice of the peace or a commissioner of oaths, such oath or solemn declaration, as the case may be, of fidelity or secrecy as may be prescribed as contemplated in section 4(2)(a).

(15) The provisions of subsection (13) shall not apply in respect of information relating to any person, where that person has consented in writing that such information may be published or made known to any other person.

(16) Any person who contravenes the provisions of subsection (11) shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding 24 months and any person who has been so convicted shall, if he or she fails within any period deemed by the Minister of Science and Technology to be reasonable and of which notice has been given to him or her by that Minister, to submit the information in respect of which the offence was committed, be guilty of an offence and liable on conviction to a fine of R50 for each day during which such default continues or to imprisonment without the option of a fine for a period not exceeding 12 months.

(17) Any person who contravenes the provisions of subsection (13) shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding 24 months.

(18) Any person employed or engaged as contemplated in subsection (13) who carries out any of the provisions of this section before he or she has taken the prescribed oath or solemn declaration shall be guilty of an offence and liable on conviction to a fine not exceeding R500.

### **8. Reporting requirements**

#### **8.1 Reporting by the taxpayer to the Minister of Science and Technology**

Each year of assessment in which a taxpayer, claiming the 150% deduction or the 50:30:20 depreciation allowances, was eligible for a deduction (whether or not that deduction is limited under section 11D), information about the R&D project must be submitted to the Minister of Science and Technology in the form and manner

(including electronically) and at the place as the Minister may from time to time prescribe.

Further information about the reporting requirements can be obtained directly from the Department of Science and Technology's website. [www.dst.gov.za](http://www.dst.gov.za).

## **8.2 Reports from the Minister of Science and Technology to Parliament**

The Minister of Science and Technology must annually report to Parliament about the direct benefits for the activities in section 11D(1) in terms of –

- economic growth;
- employment; and
- other broader government objectives; and
- the aggregate expenditure for such activities.

This report will be compiled based on the information submitted as discussed in **9.1**.

## **8.3 Preservation of secrecy**

Section 11D(13) requires the Minister of Science and Technology and every person employed or engaged by him or her in carrying out the provisions of section 11D to preserve and help in preserving secrecy with regard to all matters that may come to his or her knowledge in performance of his or her duties in connection with the section.

Both the Department of Science and Technology and SARS understand that certain R&D activities and results may be secret and confidential and that the taxpayer relies on such confidentiality to protect its commercial interests. Under section 11D(13), officials in the Department of Science and Technology (including the Minister of that department) are required to preserve and aid in preserving the secrecy of information disclosed to them. The secrecy of information disclosed to SARS is protected under section 4.

## **8.4 Oath or solemn declaration**

Section 11D(14) directs every person employed or engaged as contemplated in section 11D(13), to take and subscribe before a magistrate or justice of the peace or commissioner of oaths, an oath or solemn declaration of fidelity or secrecy as may be prescribed, as contemplated in section 4(2)(a). Before any official of the Department of Science and Technology may act under section 11D that official must take or subscribe to the oath or solemn declaration.

If a taxpayer has consented in writing that such information may be published or made known to any person, the secrecy provisions of section 11D(13) shall not apply [section 11D(15)].

## **9. Offences and fines**

### **9.1 Offences relating to submission requirements – section 11D(16)**

Any taxpayer contravening the submission requirements of section 11D(11) will be subjected to the following:

- On conviction the taxpayer shall be liable to a fine or to imprisonment for a period not exceeding 24 months.
- After being convicted, a notice will be sent to the taxpayer by the Minister of Science and Technology requiring the taxpayer to submit the information for which the offence was committed. The taxpayer will be given a period, which the Minister of Science and Technology deems reasonable, to submit the information. A taxpayer that fails to submit the information after a notice was given to him or her, will be –
  - guilty of an offence and liable on conviction to a fine of R50 for each day during which such default continues; or
  - to imprisonment without the option of a fine for a period not exceeding 12 months.

## **9.2 Offences relating to breach of secrecy provisions – section 11D(17)**

The Minister of Science and Technology and every person employed or engaged by him or her in carrying out the provisions of section 11D shall be guilty of an offence and liable on conviction to a fine or to imprisonment for a period not exceeding 24 months if he or she fails to comply with section 11D(13) (the preservation of secrecy provision).

## **9.3 Failure to take prescribed oath or make solemn declaration – section 11D(18)**

Before carrying out the provisions of section 11D, the Minister of Science and Technology and every person employed or engaged by him or her is required under section 11D(14) to take a prescribed oath or subscribe to a solemn declaration of secrecy or fidelity. If the Minister or that person fails to do so he or she shall be guilty of an offence and liable on conviction to a fine not exceeding R500.

## **10. Record-keeping**

Under section 73A all records relevant to a tax return must be retained by the taxpayer for a period of five years from the date on which that return was received by SARS. In the context of this Note, taxpayers claiming expenditure under section 11D will need to keep amongst other things –

- records of R&D expenditure claimed under section 11D(1);
- details of assets for which a 50:30:20 allowance has been claimed under section 11D(2), such as dates of acquisition and disposal, description, cost and allowances claimed, copies of instalment sale agreements supporting purchase price;
- details of grants (including government grants) received or accrued to fund R&D expenditure;
- details of related recoupments;
- records which monitor the technical progress of the research and development activities; and
- copies of returns of information submitted to the Department of Science and Technology under section 11D(11).



In the event of a tax audit being conducted, taxpayers may be asked detailed questions regarding the research and development activities conducted and records must show that a particular activity has indeed been carried out. The following are typical questions which may be asked:

- What is the R&D activity which has been carried out?
- Who identified the need for carrying out the activity?
- Were any searches or investigations conducted to determine whether such an R&D exercise was necessary in that the results were not available elsewhere?
- Was any professional advice obtained?
- How are the R&D activities being coordinated and by whom?
- Who carried out the R&D activities and at which stages of the project?
- Is there a separate cost centre keeping account of the R&D expenditure?

#### **Project-by-project v departmental allocation of R&D expenditure**

SARS's preference is for R&D costs to be accounted for on a project-by-project basis rather than on a departmental basis. A taxpayer that adopts a departmental basis of allocation will not automatically be precluded from claiming a deduction under section 11D, but should bear in mind that a problem may arise if a particular project does not qualify for the allowances under section 11D. In such event the onus rests squarely on the taxpayer under section 82 to make a logical, fair and reasonable allocation of expenditure between qualifying and non-qualifying projects. It is therefore imperative for taxpayers to identify non-qualifying projects at the outset and to put measures in place which will enable them to make a sound allocation. Such measures would include, for example, the maintenance of time sheets.

#### **11. Conclusion**

The information contained in this Interpretation Note provides broad principles in interpreting the legislation pertaining to the deduction for scientific or technological research and development. As the facts and circumstances pertaining to specific R&D activities or projects differ, each case must be considered on its own merits.

**Annexure A – Examples of activities directly eligible for R&D purposes**

- Activities to create or adapt software, materials or equipment needed to resolve a scientific or technological uncertainty provided that the software, material or equipment is created or adapted solely for use in R&D.
- Scientific or technological planning activities.
- Scientific or technological design, testing and analysis undertaken to resolve the scientific or technological uncertainty.
- Design and construction of apparatus used directly for experiments, such as a pilot plant. Pilot plants and prototypes qualify for deduction under section 11D(1).
- Data collection for use in experiments.
- Mathematical modelling used to analyse the results of experiments.
- Design, construction and operation of prototypes used in experiments.
- Phase I, II and III clinical trials.

**Annexure B – Examples of activities excluded from eligibility for R&D purposes**

- Commercial, legal and financial activities necessary for research and development and for marketing of the new intellectual property created.
- Manufacturing and distribution of goods and services.
- Administration and general support services (such as human resources costs, transportation, storage, cleaning, repair, maintenance – including maintenance of R&D equipment - and security).
- Scientific and technical information services, insofar as they are conducted for the purpose of R&D support (such as the preparation of the original report of R&D findings).
- Training required to direct and support an R&D project.
- Research (including related data collection) to devise new scientific or technological testing, survey, or sampling methods, when this research is not R&D in its own right.
- Phase IV clinical trials.
- Feasibility studies to inform the strategic direction of a specific R&D activity.
- Tooling up and industrial engineering.