IN THE INCOME TAX SPECIAL COURT
HELD IN CAPE TOWN

Before:

The Hon Mr Justice J G Foxcroft	**President**
Mr D M Fairbank	**Accountant Members**
Mr J B Dempers	**Commercial Members**

APPELLANT "A"

CASE NO 10956

[Heard at CAPE TOWN on 7 November 2003]

JUDGMENT

CAPE TOWN 30 January 2003

FOXCROFT J: This is an appeal against assessments issued by the South African Revenue Service ('SARS') for the 1993, 1994 and 1995 tax years. At the commencement of the hearing, my Assessors and I were provided with a statement of agreed facts which reads as follows:

> "WHEREAS it has been agreed and accepted by the Appellant and Respondent that following facts are common cause:
>
> 1. That the amounts as stipulated in the 'Statement of Case' in the dossier are the amounts as received by the Appellant in the years as indicated.
>
> 2. That the said amounts have all been received by the Appellant from the Industrial Development Corporation (IDC).
>
> 3. That the said amounts have all been received in terms of the programme administered by the IDC, as described in paragraph 1 on page 30 of the dossier.

4. That in order not to unnecessarily encumber the dossier it is agreed that the terms of all the agreements between IDC and the Appellant, relevant to the amounts received, are identical to the agreement as appears in the dossier on pages 29 – 37. Save for the clauses describing the 'milestones', 'expected dates' and 'amount of assistance'. (Copies of the agreements shall be available in Court in the event that the Honourable Court requires such.)

Signed in Cape Town on this 7th day of November 2002."

The document is signed by the representatives of the parties.

Appellant's case concerns amounts received in each of the relevant years from the Industrial Development Corporation ['IDC'] in terms of a programme instituted by the Department of Trade and Industry.

In essence, Appellant contended that the amounts received from the IDC represented a recovery or recoupment of scientific research expenditure incurred by Appellant and deducted in terms of s11(p)(i) of the Income Tax Act 58 of 1962 ('the Act'). It was further contended that since s 8(4)(a) of the Act deals with all recoupments and specifically excludes the recoupment of s 11(p) expenditure from inclusion in a tax payer's income, it follows that the amounts received from the IDC should not be included in Appellant's gross income.

The argument for the Respondent is that s 8(4)(a) is not applicable on the facts of this case and that the amounts received from the IDC form part of the gross income of Appellant by virtue of the general definition of 'gross income' as it appears in s 1 of the Act. It was further argued that the amounts are of a revenue nature and do not qualify for exclusion in terms of s 1 of the Act. Further arguments were also adduced by Counsel for the Respondent, which I will deal with at the end of this judgment.

The evidence of "B", company secretary of Appellant, was led.

He was referred to certain inconsistencies in tax returns for the respective years. The first reference is at p.6 of the dossier, where against para. 4.9 – Scientific Research – the 'No'-block is marked with an 'x'.
In obvious contradiction, an entry at p.8 of the dossier, in the 4th line from the top, reflects

"Research Expenditure s8(4)(a) R2 207 130,46".

"B" said that this was an obvious mistake. He referred to the same contradictory entries in later assessments at p.11 and 13, and again at pp.16 and 18 of the dossier.

Mr Jorge, for Respondent, indicated that the Commissioner had accepted that these were patent errors, and he conceded that the 'Yes" rather than the '*No*' blocks should have been marked with an 'x' on the appropriate pages.

"C" was then called to testify as an expert and witness on the facts. He said under oath that he was Chief Executive of Appellant from 1985 until 1998. He confirmed the information contained in an expect witness statement and confirmed that he had been a member of the State President's Scientific Advisory Council. He testified that during the transition period he was co-chairperson (together with "D") of the Scientific Liaison Committee. He testified to the effect that radio technology involving the propagation of electromagnetic waves is in the field of scientific research and that the ten kilowatt FM broadcast transmitter project undertaken by "A" and funded in part by the Industrial Development Council, involved research into a novel system and circuit design.

A letter had already been placed before me, being a copy of a facsimile transmission from Counsel for Respondent to Mr Clegg of Ernst & Young appearing for Appellant, that

> "It is not the Commissioner's intention to dispute whether the research was indeed 'scientific research" or not. Therefore, if I am correct in my summation of what the experts testimony will be, I do not believe that it will be necessary for you to call him as a witness."

It was therefore not surprising that Mr Jorge did not have ay questions for "C".

Respondent the called "D", a department head in the IDC, to the witness stand. He referred to certain documents contained in Buddle '1', a copy of which had been served on Appellant in the same letter to which I referred above, from Mr Jorge to Mr Clegg. "D" described the document appearing at pp.29 to 37 of the dossier as the standard agreement between the IDC and any recipient, and explained that the purpose of the programme was to develop South African industry and to provide support for innovative products and processes. He explained that the amount agreed upon was calculated by estimating the costs to be expended by the recipient and then agreeing to pay half of those costs. Because the IDC had to make sure that the money was properly spent, the time of payment was based on the principle that the recipient company had to incur the costs first before any payment would be made. Technical checks referred to as '*milestones*' were conducted during the progress of any project and funds were only provided after actual costs were proved. "D" said a 10% leeway would be acceptable where an overspend had occurred, but that the accounts would be adjusted at the completion of the project so that only 50% of the actual cost incurred would be paid to the recipient.

On a question from the Court, "D" said that payments would be reduced at interim stages, and obviously at a final accounting, if the amount spent had been less than that estimated.

Certain section of the Act need to be set out, since the argument concerns their inter-relationship. The first is s11(a), which reads:

> "For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such persons so derived –
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature."

I interpose to mention that the legal representatives were agreed that the expenditure involved in scientific research in this case was of a revenue and not capital nature.

S 8 (4)(a) is as follows:

> "There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20, inclusive, section2 4D, section 24F, section 24G and section 27(2)(b) and (d) of this Act, except section 11(k), (p) and (q), section 11**quin**, section 12(2) or section 12(2) as applied by section 12(3), section 12A(3), section 13(5) or section 13(5) as applied by section 13(8), or section 13**bis**(7), or section 15(a), or section 15A, or under the corresponding provisions of any previous Income Tax Act, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment: Provided that the provisions of his paragraph shall not apply in respect of any such amount so recovered or recouped which has been included in the gross income of such taxpayer in terms of paragraph (eB) or (jA) of the definition of 'gross income'."

The third subsection of importance is s11(p). It allows as deductions,

> "expenditure (other than expenditure in respect of which any deduction or allowance has been or will be granted under any other provision of this Act) incurred during the year of assessment by any taxpayer –
>
> (i) for the purpose of scientific research undertaken by him for the development of his business, if such expenditure is not of a capital nature."

Subs (ii) is not relevant in the present matter.

Mr Clegg referred me to a comment by SILKE in his work on South African Income Tax, Vol 2 at para. 8.104, where it is noted that

> "Expenditure of a 'non-capital' or revenue nature incurred on scientific research would include the cost of materials and chemicals, the salaries payable to researchers and the rental payable for the hire of a laboratory or of machinery or equipment."

There is no dispute in the present matter that the scientific research expenditure was of a revenue and not capital nature.

Mr Clegg referred me to an unreported case in the Cape Income Tax Special Court in November 1987 in which TEBBUTT, J, as President of the Court, upheld the argument that expenses relating to scientific research, could be claimed under ss 11(a) and 11(p) of the Act, as was then provided, even though this resulted in a double deduction being allowed. Mr Clegg pointed out that the first response to this case [decided on 23 November 1987], was an amendment introduced in 1988 to the effect that s11(p) would be subject to the proviso that the deduction had not or would not be granted under any other provision of the Act. He contended that it was therefore apparent that the legislature did not then, nor today, intend s11(p) to supplement s11(a), but – and I quote from his Heads:

> "rather to provide relief in substitution for that section and in situations where that section would not apply."

He added that the 1988 amendment was followed in 1991 by the insertion of s 23B into the Act, which broadly prevents any double deduction. The effect of this, he argued, was that in the case of 11(p) it is clear that if expenditure could have fallen within the parameters of section 11(a), s23B(3) would override and a deduction would be allowed only in terms of s11(p). He concluded that operating expenditure, including salaries and consumables of a research project is deductible for income tax purposes only under section 11(p)(i), irrespective that it might otherwise be deductible under s11(a).

Mr Clegg then drew attention to s8(4)(a) of the Act, which provides for the inclusion in taxable income of

> "all amounts allowed to be deducted or set off under the provisions of ss11 to 20, inclusive … except s11(k), (p) and (q) … which have been recovered or recouped."

He submitted further that the amount received from the IDC was clearly a recoupment of actual expenses and referred to the decision in PINESTONE PROPERTIES in the Special Income Tax Court No ITC 1678,62 SATC 288, that

> "a recoupment can only be said to have occurred if there is a sufficiently close connection between the (expense) on the one hand, and on the other, the proceeds of the event giving rise to the alleged recoupment."

In the previously cited paragraph 8.104 of SILKE ***(supra)*** it is pointed out that

> "If the taxpayer recoups any of his expenditure incurred on scientific research, the recoupment is not taxable, since it is expressly excluded from the terms of s8(4)(a)."

I agree with Mr Clegg's submission that it would be absurd to suggest that the legislature, having gone out of its way to exclude recoupments of "revenue" scientific research expenditure under s8(4)(a) would envisage the taxation of the same amount in terms of the gross income definition.

Mr Jorge's answer to this argument was that one was here not concerned with a recoupment at all. Despite the evidence of his own witness, who made it quite clear that money would only be paid on the basis of actual money spent by the recipient of the funds, he submitted that the purpose behind the payment of the money was all important and was decisive of the issue before the Court. He submitted that the purpose of the program is to promote local design and manufacture of innovative electronic products and that this is done through the provision of financial assistance. He contended that it was incorrect for Appellant to attempt to bring the facts within the purview of s8(4)(a), since he contended that a recoupment can only occur where an expense has been previously allowed. He submitted that "the amount of the grant", as he put it, was determined prior to payment and at the stage when the application for the 'subsidy' was approved by the Support Programme for Industrial Innovation ('SPII') panel. He submitted further that

> "the fact that payment occurs after expenditure has been incurred merely reflects the manner in which payment is made and is not a reflection of the purpose thereof, i.e. it is done on a re-imbursive principle."

Obviously, the IDC did not want to actually hand over the money until it was satisfied that the work had been done, but this does not after the fact that payment would not be made until work was done.

"D" did not classify the agreement as a grant in aid, which was a phrase use by Mr Jorge on a number of occasions, although he did concede that "D" had not used that phrase. Mr Jorge said that there was reference to a grant in aid in the brochure which he had placed before the Court. He did not refer me to any specific reference, but the brochure does not, in my view, amount to evidence which is dispositive of this appeal. Further, and as Mr Clegg submitted, the question of

the tax liability of Appellant in this matter must be seen from Appellant's point of view, not that of the IDC.

Labelling of the provision of funds does not assist in determining whether it is subject to tax or not. Whatever the purpose might have been in the mind of the donor, the question remains one to be determined from the point of view of the recipient. The fact that money may be offered as an incentive – which was not in issue – does not detract from the fact that once provided, the money legally constitutes a recoupment of 50% of actual expenditure.

Mr Jorge advanced further arguments, suggesting that the money provided to Appellant amounted to a subsidy and that it was not a recoupment.

I disagree with these submissions. On the facts, it was quite that a recoupment of an expenses had occurred and that s8(4)(a) allows for the deduction to be made.

Mr Jorge submitted that one should look at this money as income under the definition of gross income in section 1 of the Act and somehow ignore the fact that it was deductible under s8(4)(a).

The argument reappeared as an alternative where it was submitted that if the amounts paid to Appellant did constitute a recoupment or recovery as provided for in s8(4)(a),

> "it nevertheless does not render the said amounts excluded or excludable from gross income."

He submitted further that the purpose of s8(4)(a) is to serve as an additional inclusion provision in circumstances where an amount is not caught in the net of the general definition of 'gross income'. His answer to the exclusion of the recoupment of s11(p)(i) expenses from the effect of this inclusory subsection was that all that it meant was that a recovery of s11(p)(i) expenses cannot be included in gross income by virtue of s8(4)(a) or paragraph (n), in other words by way of 'special

inclusion'. He went on to submit that this does not save the amount in question from being included in gross income by virtue of the general definition if it passes the requisite test.

I cannot accept that argument, since it defies logic. It would render meaningless the exclusion of scientific research recoupments in s8(4)(a).

Mr Jorge put up a final argument to the effect that s23(c) of the Act was applicable on the basis that deductions would not be allowed to the extent to which they were recoverable under any contract of insurance, guarantee, security or indemnity. He submitted that the agreement with the IDC effectively indemnifies the Appellant against 50% of his expenses and therefore only 50% of the Appellant's s1(p)(i) expenses are deductible.

I also do not accept that argument, because I do not accept that the contract is concerned at all with insurance, guarantee, security or indemnity.

Finally, Mr Jorge drew attention to programmes specially exempted in the Act (see e.g. sections 10(1)(z)(zA), (zB), (zC). These are a random number of special situations dealing with economic expansion which would not readily fall under the 'scientific research' category. They would therefore need to be specified for a tax benefit to apply in such situations.

Moreover, the situation with which we are concerned is squarely covered by section 11(p)(i) of the Act and no further specific categorisation is required.

In the premises, I consider that the appeal should be allowed and that the assessments be reversed insofar as they concern the question of recoupments of scientific expenses. The matter is referred back to the Commissioner for revised assessments in the light of this judgment.

Mr M D L Jorge represented the Commissioner, South African Revenue Service.
Mr D J M Clegg instructed by Ernest & Young appeared on behalf of the Appellant.