DRAFT EXPLANATORY MEMORANDUM

ON THE

PROPOSED REFINEMENTS TO SECTION 11D OF THE INCOME TAX ACT

7 October 2022

TABLE OF CONTENTS

EXPLANATION OF MAIN AMENDMENTS

1. REVIEWING AND REFINING THE RESEARCH AND DEVELOPMENT TAX INCENTIVE

[Applicable provisions: Section 11D of the Income Tax Act]

I. Background

Research and technological development is a key factor for improved productivity, leading to new or improved products, processes or services. This enhanced productivity in turn leads to increased economic growth and international competitiveness. While South Africa offers a variety of direct subsidies aimed at the development phase of the innovation process, the R&D tax incentive is aimed at the earlier phases of research that are not catered for by other existing measures. Providing a tax benefit for the earlier phases of research and development ensures that local R&D is globally competitive.

The current R&D tax incentive came into operation on 2 November 2006 and has undergone various design changes to better tailor it to meet its objectives. The most significant of these changes was the introduction of a pre-approval process in 2012. The pre-approval process is administered by the Department of Science and Innovation (DSI), supported by an adjudication committee that evaluates applications and makes recommendations to the Minister of Higher Education, Science and Innovation. The R&D tax incentive allows for operating expenses incurred directly and solely for the purpose of conducting R&D to be deductible at 150 per cent if the R&D is approved by the Minister of Higher Education, Science and Innovation. This is the case even if those expenses could be characterised as being capital in nature, such as pilot plants.

II. Reasons for change

On 15 December 2021, Government published a discussion document titled *Reviewing the Design, Implementation and Impact of South Africa's Research and Development Tax Incentive.* This review sought to determine whether to extend the R&D tax incentive beyond its sunset date and, if so, in what form. Following the review, government has determined that the R&D tax incentive should continue, but sees it necessary to refine the definition of R&D.

A. Definition of R&D

Section 11D(1) of the ITA sets out a definition for "research and development" that determines eligibility for the R&D tax incentive. Currently, the wording "scientific or technological" is only found in the title of the section and in one of the paragraphs of the definition, even though the intention has always been that the incentive should only apply to activities with an aim of solving a scientific or technological uncertainty.

The definition contains a purpose test that requires not only an understanding of the concept of R&D, but also an understanding of various intellectual property statutes and the associated intellectual property characteristics, such as novelty and non-obviousness. In addition to this, several of the purposes focus on the end result of the R&D, which is difficult for taxpayers to explain or prove upfront and equally difficult for the adjudication committee to evaluate. This stands in contrast to the approach taken by many other countries in the design of their R&D tax incentives.

In addition, the “innovative” requirement linked to the creation of a functional design; the development of a computer program; or making significant improvements, has led to unintended consequences and complexity for taxpayers, as well as officials and technical experts assessing R&D tax incentive applications.

While the “innovative” requirement was intended to raise the bar in terms of the R&D activities that should qualify for the incentive, government recognises that innovation can happen without R&D, and that it does not necessarily encompass R&D.

To enhance the practical simplicity of applying for and adjudicating the incentive, it is considered that it would be more appropriate to move away from an “end-result” or IP statute approach. This is primarily because – while taxpayers may have a certain end-goal in mind, the reality of R&D is that it involves uncertainty and risk, and it is not practical to expect taxpayers to have detailed knowledge of how their envisaged R&D will unfold at the time of applying for the incentive.

Many other countries instead rely on the principles outlined in the OECD Frascati Manual (i.e. that activities should be novel, uncertain, systematic and transferable and/or reproducible) to design their legislation to test whether an activity should be considered R&D or not. Based on adjudicating experience, it is considered that this approach is preferable.

In addition to the principles outline above, the 2002 Frascati Manual explicitly refers to a person skilled in the art (someone familiar with the basic stock of common knowledge). This criterion is implied in the most recent Frascati Manual. To ensure this is explicit in the legislation and to ensure that R&D activities are non-obvious or inventive to qualify for the R&D tax incentive, the revised definition should include the test of whether a professional in the field with appropriate knowledge and skills, and having access to publicly available information, would resolve that scientific or technological uncertainty without undertaking any R&D activities (i.e. systematic investigative or systematic experimental activities).

It is envisaged that a revised definition will be simpler to understand and adjudicate, ensuring an easier application process. The proposed changes to simplify the legislation combined with moving to an online process and enhancing support for smaller businesses should enhance the uptake of the incentive.

In line with government’s stance from the outset, the revised definition is shifted more towards a scientific or technological uncertainty and the systematic investigative or systematic experimental activities that are to be performed, with an added emphasis on novelty of products, processes or services, instead of the intellectual property outcomes e.g. invention or design that may occur after the R&D.

a. *Internal Business Process (IBP) exclusion*

   Certain activities are specifically excluded from the definition of R&D. The excluded activities extend to the development of internal business processes not mainly intended for sale or licensing that could be relevant to a range of sectors, such as manufacturing and software development. Over the years the interpretation and implementation of this exclusion has led to unintended consequences.

   Various interpretation notes have sought to provide clarity that routine learning associated with the management or enhancement of internal business processes will not be eligible for the incentive. However, based on the adjudication of multiple applications

and on feedback received, it is apparent that activities that fall under this exclusion have features and benefits that should allow the activities to be eligible.

A number of examples were included in the discussion document to highlight how the current interpretation of the internal business process exclusion potentially disqualifies what would otherwise be deemed eligible activities that encompass the benefits intended by the incentive. If an activity is systematic investigative or systematic experimental with an aim of resolving a scientific or technological uncertainty and it meets the proposed (revised) definition of R&D for the purposes of this incentive, it should be considered R&D – regardless of whether it is intended for sale or the use thereof is granted to connected parties.

One of the primary objectives of the incentive is to encourage spending on R&D to recognise that it has the potential to generate positive spillover effects in the economy – including by, for example, transferring knowledge, diffusing ideas and enhancing growth and employment prospects. These effects are possible even if the R&D is for internal use.

However, an exclusion will remain for business processes that are for management and administrative purposes to make clear that this is not considered R&D for the purposes of this incentive.

B. Software and computer programmes

In the context of software development, only those software development activities that are systematic investigative or systematic experimental of which the result is uncertain may be eligible. These types of systematic investigative/experimental development activities that exist under the R&D umbrella can at times be confused with high-level product development and pre-production development. This is due to both types of development having stages, such as experimental development, that can only form part of R&D if it is systematic and the result has (a scientific or technological) uncertainty. Thus, product development *per se* is not by definition the same as experimental development, and therefore not R&D.

When evaluating whether software development activities are eligible, the question to be considered is often whether a professional in the field (i.e. a software developer) with appropriate knowledge and skills, and having access to publicly available information, would conclude that software development can successfully be done. If the answer is yes and no systematic investigative or systematic experimental activities with scientific or technological uncertain results are required, it is unlikely that developing this computer program would be deemed R&D. Use of existing software for a new application or purpose does not, by itself, relate to a technological or scientific uncertainty, and is therefore generally excluded. Also excluded is the creation of a computer program using known methods of existing software tools.

C. Agrochemical products

Section 11D excludes routine testing, analysis, collection of information or quality control in the normal course of business; as well as financing, administration, compliance and similar costs from R&D expenditures. Additionally, regulations published in relation to clinical trials as they pertain to the R&D tax incentive excludes “research activities undertaken in preparation for the registration of a clinical trial”.

The Department of Agriculture, Land Reform and Rural Development (DALRRD) sets out pre-requisite registration requirements for products before they can be sold in the South African market. With such prerequisites, it cannot be said that an applicant is able to determine or alter the research methodology. Conducting activities to comply with such requirements is not deemed to fall within the scope of R&D in terms of section 11D. That being said, in the event that the testing required for registration indicates that a new formulation or reformulation is required for a product, such uncertainty identified by the testing and required for formulation/reformulation could form the basis for R&D.

D. Additional administrative issues

a. Introduction of a six-month grace period for receipt of pre-approval applications

In terms of section 11D, only expenditure incurred on or after the date of receipt of the application by the Department of Science and Innovation qualifies for the 150 per cent deduction. This has led to some taxpayers unfamiliar with the incentive (as well as smaller taxpayers) missing out on an opportunity to benefit from the incentive, or rushing to submit applications with insufficient information for the committee to adjudicate those applications.

Allowing applicants a grace period to gather more information regarding the intended R&D activities will allow smaller applicants, new applicants or applicants undertaking R&D in a new field to be in a better position to provide detailed information on the R&D project that has been undertaken.

b. Disclosure of information by the Commissioner of SARS

Currently, section 11D(12)(b)(iv) allows the committee to monitor all R&D approved to determine whether the objectives of the incentive are being met, and to advise the Minister of Finance and the Minister of Higher Education, Science and Innovation. Section 11D(14) states that the Commissioner may disclose information to the Minister of Science and Technology as is required for parliamentary reporting or if that information is material in respect of granting approval for the incentive. This does not appear wide enough to enable the committee and DSI employees to obtain information (data) from SARS to carry out a monitoring and evaluation function.

c. Sanctions for breach of secrecy

Every person involved in the administration of the R&D tax incentive is bound by confidentiality to preserve secrecy of the information that they may come across while performing their duties (section 11D(18)). However, section 11D does not include a sanction for contravening these sections of the Act.

III. Proposal

Based on the above, Government proposes the following:

A. Adjustments to the R&D definition

It is proposed that changes be made to the current definition of R&D as follows:

i. The definition of R&D should be amended to clarify that the intention has always been that the incentive should only apply to activities with an aim of solving a scientific or technological uncertainty. By referring to activities that are aimed at solving a scientific or technological uncertainty in the words of subsection (1) preceding paragraph (a), this intent is made clear. Amongst other things, this requirement will clarify the type of computer software activities that will be deemed to form part of R&D. Further, the words "scientific or technological" should be included before the words "research and development" throughout the section.

ii. The definition should also be amended to clarify that activities will not qualify for the incentive if knowledge to resolve a scientific or technological uncertainty is deducible by a competent professional in the relevant scientific or technological field, having regard to information that is publicly available to such professional. In other words, a test for obviousness (or lack of inventiveness) should be brought into the definition.

iii. The "non-obvious" requirement for scientific or technological knowledge in section 11D(1)(a) should be replaced with "new" in line with the proposal that a test for non-obviousness be included in the definition (to ensure that research and development does not include an activity if knowledge to resolve the scientific or technological uncertainty is deducible by a person skilled in the relevant scientific or technological field, having regard to information that is publicly available to such professional).

iv. The intellectual property purpose test in the first part of the definition should be deleted to move away from a focus on the end-result at the time of applying to recognise the uncertainty inherent in R&D. The approach will shift to testing for R&D by considering some of the principles in the OECD Frascati Manual. In line with this, it is proposed that s11D(1)(b) and (c) be replaced with a purpose test aligned with the OECD Frascati principles that an R&D activity must be carried on for the purpose of creating or developing new knowledge, or new or improved products, processes or services. The OECD Frascati manual provides an internationally accepted definition on R&D activities based on five core criteria being met; i.e. the activity must be novel, creative, uncertain, systematic and transferable and/or reproducible. In summary, R&D eligibility should be assessed in the context of the type of activities proposed to be performed; the uncertainty being addressed and the new knowledge being sought; or products, processes or services being created.

B. Exclusions from the definition of R&D

a. Certain internal business processes

It is proposed that the part of the exclusion for internal business processes relating to the for-sale requirement and granting of right/use to a non-connected party be deleted, so that the activities are measured against the requirements set out in the definition of R&D, rather than whether they are intended for sale / licensing or not. An exclusion will remain for management and administrative business process to ensure clarity that these types of activities are not eligible for this incentive.

b. Agrochemical products

It is proposed to specifically exclude research activities undertaken solely in preparation for the registration of products as required by the Department of Agriculture, Land Reform and Rural Development (DALRRD) from the incentive.

C. Additional administrative issues

a. Introduction of a six-month grace period for receipt of pre-approval applications

It is proposed that applicants be allowed a six-month grace period to submit pre-approval applications.

For example, if a company has started spending on exploratory R&D activities on 16 June 2022, they will have up until 16 December 2022 to submit their application if they would like to be eligible to claim the expenditure on qualifying R&D activities.

b. Disclosure of information by the Commissioner of SARS

It is proposed that the circumstances under which the Commissioner of SARS discloses information to the Minister of Higher Education, Science and Innovation be extended to include anonymized information (data) from tax returns that may require fulfilling of duties insofar as they relate to monitoring R&D approved under the incentive and the consideration of proposed amendments and adjustments to the R&D tax incentive, beyond reporting to Parliament. As such, it is proposed that amendments be made in section 11D(14) by introducing a new subsection (c) dealing with the requirement.

c. Sanctions for breach of secrecy

With respect to any breaches of secrecy, it is proposed that a sanction in line with those provided under section 12I(23) be included in section 11D. As such, it is proposed that any person who contravenes the secrecy provisions is guilty of an offence and be liable on conviction to a fine or imprisonment for a period not exceeding two years.

D. Sunset clause

It is proposed that the revised R&D tax incentive be extended for a period of 10 years and apply in respect of amounts incurred on or after 1 January 2024 and up to and including 31 December 2033.

E. Other technical amendments

Additional technical amendments include:

i. Updating the names of the Department and the Minister in line with the new names throughout the section.
ii. Updating the applicable regulations throughout.

IV. Effective date

The proposed amendments will come into effect on 1 January 2024 and will apply in respect of amounts incurred on or after that date.