Reportable

IN THE TAX COURT
(CAPE TOWN)

Case No: IT13541

In the matter between:

ABC (PTY) Ltd Appellant

and

THE COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE Respondent

HEARD: 10 November 2014

DELIVERED: 20 April 2015

JUDGMENT

NDITA; J

[1] The issue in this appeal is whether the Appellant can claim 150 percent for the research and development expenditure incurred in respect of computer programs for its various customers in terms of the provisions of section 11D of the Income Tax Act, 58 of 1962 as it applied to its 2010 year of assessment.

[2] The Appellant, ABC (Pty) Ltd, is a wholly owned operating subsidiary of ABC Ltd, a Johannesburg Stock Exchange listed company. The facts as outlined in the Commissioner's Rule 10 statement on the grounds of assessment, reveal that ABC has been in the business of conducting software research and development for 27 years. It develops software programs for its customers in freight forwarding, customs clearing agents and cargo transport companies to control the clearance of consignments of goods, both imported and exported into the Republic of South Africa, from origin to the ultimate destination. The Respondent, the South African Revenue Services, Customs Division is one of Appellant's customers. The programs the Appellant develops are designed to meet the specific customer's particular needs. For this reason, it licenses its software to the users of the software developed for the specific customer, billing the customer on a monthly basis for the software utilized in the particular month, by the particular customer. The soft-ware enables its customers to comply with all the statutory requirements relating to the import and export of goods into the Republic as well as the requirements by the government agencies such as SARS Customs

Division, the Ports Authority and the Airports Company of South Africa. It also enables its customer's operating systems to interface with the SARS customs operating systems to verify data relating to the import and export of goods.

[3] According to the material facts germane to the determination of this appeal, the nature of the Appellant's business is such that research and software development is an integral part of its activities and is a major source of its income earned by way of license fees calculated on the number of transactions the software utilizes. To this end, all research and development processes commence with a request from a customer. The Appellant must then determine whether the particular request cannot be satisfied by its existing computer programs. Once the request is approved it is allocated a developer to perform the preliminary testing. The development programmer's development, duly informed by the preliminary testing is then subject to further testing by the project manager before the new computer program is released to the customer for use.

[4] In each year of tax assessment, ABC submits to the Minister of Science and Technology (Minister) in accordance with section 11D(11) of the Income Tax Act 58 of 1962 (the Act) all information required relating to the research and development undertaken. It is undisputed that in the 2010 year of assessment, the research and development was funded by Appellant in the course of its business operations, and it incurred expenses in the sum of R19 968 378. The income generated from the licence fees charged to clients amounted to R33 238 982. The Appellant submitted the relevant documentation to the Minister. Initially the Appellant claimed the actual expenditure incurred in respect of research and development which expenditure was allowed as a deduction by SARS on assessment. However, between the period September and December 2011, Appellant requested that the assessment be reopened, and claimed additional expenditure for research and development in terms of section 11D which allows for the deduction of 150% of the amount qualifying thereunder. The relevant expenditure in issue that was claimed in respect of research and development of computer programs amounted to R6 581 936 and the additional claim for deduction of 50% thereof, amounted to the sum of R3 290 968. The Commissioner

disallowed the additional 50% claimed for research and development on various grounds. I will revert to them later in this judgment. Suffice to state that it is that very disallowance which forms the subject matter of this appeal.

[5] The Respondent in its grounds of assessment readily acknowledges that the Appellant's activities for the 2010 year of assessment included software research and development and that it incurred expenditure of R6 581 936 for developing and creation of a computer program as defined in section 1 of the Copyright Act 98 of 1978. However, according to the Respondent, the 150% deduction for such expenditure is disqualified by section 11D(5)(b) because the research and development expenditure incurred by the Appellant for purposes of devising, developing or creating the computer programs relates to management or internal business processes. The Respondent further contends that the Appellant's research and development and the concomitant expenditure incurred by it is the development of software programs with its key business enabling features allowing freight forwarders, customs clearing agents and cargo transportation companies to conduct their core business more

effectively. The purpose of the programs therefore is to enhance a client's management of its assets and/or its internal business processes involving the optimal use of its resources. For this reason, so contends the Respondent, the Appellant's expenditure is not deductible in terms of section 11D(1) of the Act. In addition, whereas the appellant's expenditure does not qualify for the section 11D deduction of 150%, the appellant was entitled in terms of section 11(a) of the Act, to a deduction of the research and development expenditure actually incurred by it in the 2010 year of assessment, in the amount of R6 581 936 as reflected in the assessment which allowed the deduction.

The Applicable Legislation

[6] The brief summary of substantial facts shows that the crisp issue between the parties is the interpretation of section 11D(1) read with section 11D(5). It must be mentioned from the outset that new Tax Court Rules were promulgated on 11 July 2014 in terms of section 103 of the Tax Administration Act, 28 of 2011, as amended, but they are not applicable in *casu* because Rule 66 (1) of the aforesaid Rules provides that:

"Subject to this Part, these rules apply to an act or proceedings taken, occurring or instituted before the commencement date of these rules, but without prejudice to the action taken or proceedings conducted before the commencement date of the comparable provisions of these rules."

Rule 34 reads thus:

"The issues in an appeal to the tax court will be those contained in the statement of the grounds of assessment and opposing the appeal read with the statement of the grounds of appeal, and, if any, the reply to the grounds of appeal."

It follows that, the issues in the present appeal are those defined in the Commissioner's Rule 10 statement of the grounds of assessment read with the Appellant's statement of the grounds of appeal. Both were filed in terms of the previous Rules.

[7] Section 11D(1) as it applied to the Appellant's 2010 year of assessment reads as follows:

"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 57 of 1978);

(ii) design as defined in section 1 of the Designs Act, 1993 (Act 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 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."

Section 11D(5) as it applied to the Appellant's 2010 year of assessment provided as follows:

"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."

The Copyright Act No 98 of 1978 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."

[8] It is necessary to refer to section 11(a) as the Appellant's statement of the grounds of appeal state as follows:

"13. ABC initially only claimed the actual expenditure in respect of research and development in terms of section 11(a) of the Income Tax Act 58 of 1962 in the sum of R19 968 378. The expenditure was allowed and an original assessment annexed as 'CC1'.

14. During the period between September and December 2011, ABC requested that the assessment be re-opened and claimed additional expenditure allowed for research and development in terms of section 11D of the Act.

15. The additional deduction amounted to the sum of R3 290 968.

16. The Commissioner disallowed the additional 50% claimed for research and development expenditure in terms of the provisions of section 11D and issued a revised additional assessment on 2 March 2012, a copy of which is annexed 'CC2'. Against this additional assessment, ABC objected. The Commissioner disallowed the objection in its entirety which is now the subject matter of this appeal."

Section 11(a) provides as follows:

“11 General Deductions allowed in determination of taxable income-

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 person 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;

. . .”

In order to determine whether a taxpayer is entitled to a general deduction, section 11(a) must be read with section 23B(3) of the Act, which provides that:

“No deduction shall be allowed under section 11(a) in respect of any expenditure or loss of a type for which a deduction or allowance may be granted under any other provisions of this Act . . .”.

[9] Although the dispute between the parties appears to be largely based on the interpretation of section 11D of the Act, the Appellant’s reference to section 11(a) as outlined above, must, nonetheless be considered. Counsel for the Respondent, Emslie SC, argued that the effect of section 23B(3) on the Appellant’s tax assessment is that if a deduction or allowance may be granted under any other provision of the Act, no deduction may be allowed under section 11(a) for the following reasons:

1. section 23(B)(3) prevents taxpayers from claiming a ‘double deduction’ for the same expenditure; and

2. section 23(B)(3) gives priority to any other provision of the Act in terms of which a deduction or allowance may be granted: where the other provision is applicable, no deduction may be allowed under section 11(a) and the expenditure can only be deducted under the other provision.

[10] The Respondent’s contention in this regard is correct because the provisions of section 23B(3) clearly seek to prevent claims under the general deduction provisions contained in section 11(a) for expenditure or loss or allowance which may be granted under section 11D. In other words, where section 11D is applicable, the Appellant may claim only under section 11D, but if section 11D is not applicable, a deduction can be claimed under section 11(a), if it applies. The effect of section 23B(3) therefore is that 100% expenditure incurred by the Appellant can be deducted in terms of section 11(a) but the additional deduction of 50% cannot be claimed under section 11D. As rightly contended by Counsel for the Respondent, either section 11D applies to justify a deduction of 150%

of the expenditure in question or if section 11D does not apply at all, section 11(a) applies. However, I am not inclined to dismiss the appeal on this basis as it clear from the nature of the Appellant's claim, as well as argument that the real issue is a claim lodged under the provisions of section 11D.

The Findings of the Commissioner

[11] In disallowing the Appellant's objection in respect of additional deductions amounting to R3 290 968, the Commissioner considered that expenditure related to management and internal business processes is not eligible for a deduction regardless of whether the software is developed for use in-house or is developed for the purpose of sale to end-users. The Commissioner reasoned as follows:

"'SARS' view is that internal business processes are not restricted to ABC internal processes, but apply to business processes generally. This is supported by the following extracts from IN 50:

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.

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.

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."

The Commissioner concluded that the Appellant is not entitled to the research and development allowance claimed under section 11D as these activities are prohibited by 11D(5)(b).

It is these findings that are assailed before this court. That said, I now turn to consider the interpretation of section 11D.

Analysis

[12] The crucial question in this appeal is whether the expenditure incurred by the Appellant as contemplated in section 11D(1)(b)(iii) is precluded by section 11D(5)(b) because it related to management or internal business processes. The Appellant contends that the management or internal business processes envisaged in section

11D(5)(b) are, in the context of this appeal, limited to the management or internal business processes of the Appellant and excludes the users of the computer programs for which the computer programs were developed. To this end, the Appellant states that:

> "In particular, the expenses were incurred in the research and development of computer programs for its various clients, including the South African Revenue Services customs division and were not related to the management or internal business process of Compu-Clearing."

Counsel for the Appellant, Ms Dreyer, assailed the findings of the Respondent on the basis that it misconstrued the meaning and application of sections 11D(5) and 11D(1). According to Appellant, when section 11D(5) is read with section 11D(1), it is clear that the restriction intended by the legislature in 11D(5) relates to expenditure incurred by the taxpayer in the production of its income. As a result, so contends the Appellant, the limitations set out in section 11D(5) relate to expenditure incurred by a taxpayer in the course of its own business operations which cannot be considered for the section 11D deduction, where the expenditure was incurred by the taxpayer itself. In a nutshell, the Appellant's argument is that the expenditure in question can only be the expenditure of the Appellant, for this is the expenditure which is either deductible in terms of section 11D(1) or

prohibited in terms of 11D(5)(b), and therefore the words *'expenditure relating to management or internal business processes'* can only refer to the Appellant's management or internal business processes. In addition, the interpretation advanced by the Respondent is restrictive and would place the very development intended by the legislature through section 11D(1) at a disadvantage in comparison with legislation of other countries. Stated differently, the legislature in enacting section 11D was mindful of the high cost of research and development, as well the fact that both are continuous, and wanted to ensure that research and development in the country is at a global competitive level.

[13] Counsel for the Respondent concedes that the expenditure referred to in section 11D(5) can only be the expenditure of the Appellant, but does not agree that it follows that the *'management or internal business processes'* referred to can only be those of the Appellant. According to the Respondent, *the 'management or internal business process'* referred to in section 11D(5)(b) are those of users of the computer programs, in this case, the Appellant's customers, including the Appellant itself. The ambit of section 11D(5) is

according to the Respondent, not limited in the way contended for by the Appellant, and may well include the users for which the computer programs were developed by the Appellant on a customised basis.

[14] The approach to statutory interpretation is stated in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012(4) SA 593 SCA at 603 - 604 as follows:

"[18] The present state of the law can be expressed as follows: Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose for which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of these factors. The process is objective, not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document. Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. To do so in regard to a

statute or statutory enactment is to cross the divide between interpretation and legislation; in a contractual context, it is to make a contract for the parties other than the one they in fact made. 'The inevitable point of departure is the language of the provision itself', read in context and having regard to the purpose of the provision and the background to the preparation and production of the document."

[15] Against this backdrop, I turn to examine section 11D(5) in the context of its setting and surrounds keeping in mind the purpose of section 11D(1). First, the clear intent of section 11D is to provide an incentive in respect of research and development in the field of science and technology. Second, when examining the ambit of the exclusion of *'management or internal business processes*' from eligibility for the incentive in the context of computer program development, the phrase must *'take its colour, like a chameleon, from its settings and surrounds in the Act',* as correctly submitted by Counsel for the Respondent. (See *Standard General Insurance Co Ltd v Commissioner for Customs and Excise* 2005 (2) SA 166 (SCA) at paragraph 25).

[16] It must be accepted that the legislature sought to incentivise the development of innovative computer programs, but not where these relate *inter alia* to '*management or internal business processes'*. The Respondent does not dispute that research and development was conducted by the Appellant in the devising of the computer programs. In fact it acknowledges that:

1. the Appellant incurred expenditure;
2. in the sum of R6 581 936.00;
3. in the 2010 year of assessment;
4. in respect of activities undertaken in the Republic;
5. for the purpose of devising, developing or creating of a computer programme as defined in section 1 of the Copyright Act 98 of 1978.

The Act contains no definition of the phrase *'expenditure relating to management and internal processes'*. That being the case, the words in the phrase must be given their ordinary meaning, unless such a meaning is contrary to the intention of the legislature. This approach as correctly submitted by counsel for the Appellant, is in line with the principles of statutory interpretation set out in *Public Carriers*

Association and Others v Toll Road Concessionaries (Pty) Ltd and Others 1990 (1) SA 925 (A) in the following manner:

1. the primary rule in the construction of a statutory provision is to ascertain the intention of the legislature. To do so, words, words must be given their ordinary grammatical meaning unless this would lead to absurdity so glaring the legislature could not have contemplated it;
2. where the words in question are susceptible to only one meaning, effect must be given to this meaning;
3. it is only where, on literal interpretation, a word is capable of bearing different meanings which are linguistically feasible, the question arises as to how to resolve the resultant ambiguity. In such an instance, it is necessary to consider the legislature's intention. This is known as the purposive construction.
4. The literal interpretation principle is firmly entrenched in South African law and it is only where the application results in ambiguity where more than one meaning can be ascribed to the word that may have view to the purpose of the provision under construction to achieve its objects.

[17] The New Oxford Dictionary of English defines *'management'* to mean:

'the process of dealing with or controlling things or people'. *'Process'* is defined as *'a series of actions or steps taken in order to achieve a particular end*'. There is no dispute between the parties with regard to the above definitions. What is of significance in my view is the meaning of the words *'expenditure . . . relating to'*. The New Oxford Dictionary of English defines the verb *'relate'* to mean:

'make or show a connection between'. It defines the noun *'relation'* to mean:

'the way in which two or more people or things are connected; a thing's effect on or relevance to another'. It follows that what is prohibited is expenditure *'which is connected with'* the items listed in 11D(5) as provided in paragraphs (a) to (e). Ms Dreyer strenuously argued that there is no ambiguity in the language used in section 11D(1), read with section 11D(5). According to the interpretation the Appellant proffers, it is the nature of the expenditure that is excluded in section 11D(5) and not the capacity of the software.

[18] If this interpretation is correct, the relevant words must be read to mean *'expenditure relating to the management or internal business processes of the taxpayer'*. But that is not what the words say. In my view, a proper interpretation is to be found in the words *'expenditure . . . relating to'.* To my mind this make sense because what is prohibited is the expenditure *'which is connected with'* any of the items listed in paragraphs (a) to (e) thereof. On this score, I agree with submissions made by Counsel for the Respondent, the *'connectedness'* arising from *'relation to'* must be determined with reference to the use for which the computer program resulting in the expenditure incurred by the developer was developed. To my mind, this a sensible approach.

[19] The setting of section 11D(5) is that what is prohibited in the context of computer programs is the deduction of expenditure which is connected with:

(a) exploration or prospecting; or

(b) management or internal business processes; or

(c) trademarks; or

(d) the social sciences or humanities; or

(e) market research, sales or marketing promotion.

For example, the *'expenditure relating to exploration and prospecting'* can only refer to expenditure which is connected with exploration and prospecting in the sense of this being the use for which the computer program was developed. In the same vein, *the 'expenditure . . . relating to the social sciences or humanities'* can only refer to expenditure which is connected with the social sciences or humanities in the sense of this being the use for which the computer program was developed. Therefore *'the expenditure . . . relating to management or internal business processes'* can only refer to expenditure which is connected with management or internal business processes in the sense of the use for which the computer program was developed. In my view, the interpretation contended for by the Appellant is wrong for two reasons:

1. The words *'of the taxpayer'* after 'management and internal business processes' have been specifically excluded by the legislature and cannot be read into the prohibition.
2. Such an interpretation would render the prohibition so narrow that it would be nugatory and that could not have been intended by the legislature.

[20] It follows from this reasoning that I agree with the interpretation of the Respondent to the effect that the internal business processes are not restricted to the Applicant's internal business processes, but apply to the nature of the computer program.

[21] It remains to be said that Counsel for the Appellant in persuading the court that a sensible interpretation is that the activities which are excluded from the research and development deduction are activities which relate to the management and internal business activities of the developer of the software, referred to similar legislation in other countries. Whereas it is permissible to have recourse to foreign jurisprudence when interpreting a statutory provision, this should be done cautiously as foreign dicta may at times be at odds with an express purpose of the Act the result of which would lead to an interpretation which is at war with the express words of the section. (See *Federal-Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission and another* [2005] 1 CPLR 50 (CAC). In the matter at hand, I am satisfied the intention of the legislature is discernable from the setting and surrounds in the

Act .I am fortified in this view by the dictum in *Western Platinum Limited v Commissioner for the South African Revenue Service 67* SATC 1 (SCA) para [1] at 6B-C:

"The fiscus favours miners and farmers. Miners are permitted to deduct certain categories of capital expenditure from income derived from mining operations. Farmers are permitted to deduct certain defined items of capital expenditure from income derived from farming operations. These are class privileges. In determining their extent, one adopts a strict construction of the empowering legislation. That is the golden rule laid down in *Ernst v Commissioner for Inland Revenue* 1954 (1) SA 318 (A) at 323 C-E and approved in *Commissioner for Inland Revenue v D & N Promotions (Pty) Ltd* 1995 (2) SA 296 (A) at 305 A-B."

By parity of reasoning, it must be accepted that section 11D creates a class privilege for certain categories of research and development expenditure, by permitting the deduction of 150% thereof, whereas the norm is that only the actual amount of qualifying expenditure can be deducted. I see no reason why in principle such an approach should not be applied in a matter such as the present. Section 11D(5) places a curb on the class privilege available to such categories of research and development expenditure. In my judgment, section

11D(5) must be interpreted as I have done, in the manner set out by Conradie J, in *D & N Promotions, supra*.

[22] For all these reasons, the following order is issued;

The appeal is dismissed.

_____

T. C. NDITA

JUDGE OF THE HIGH COURT

I agree **I agree**

_____ _____

Ms K A LAGLER **MR T PASIWE**

ASSESSOR **ASSESSOR**

HEARD ON THE : 10 NOVEMBER 2014

DATE OF JUDGMENT : 20 APRIL 2015