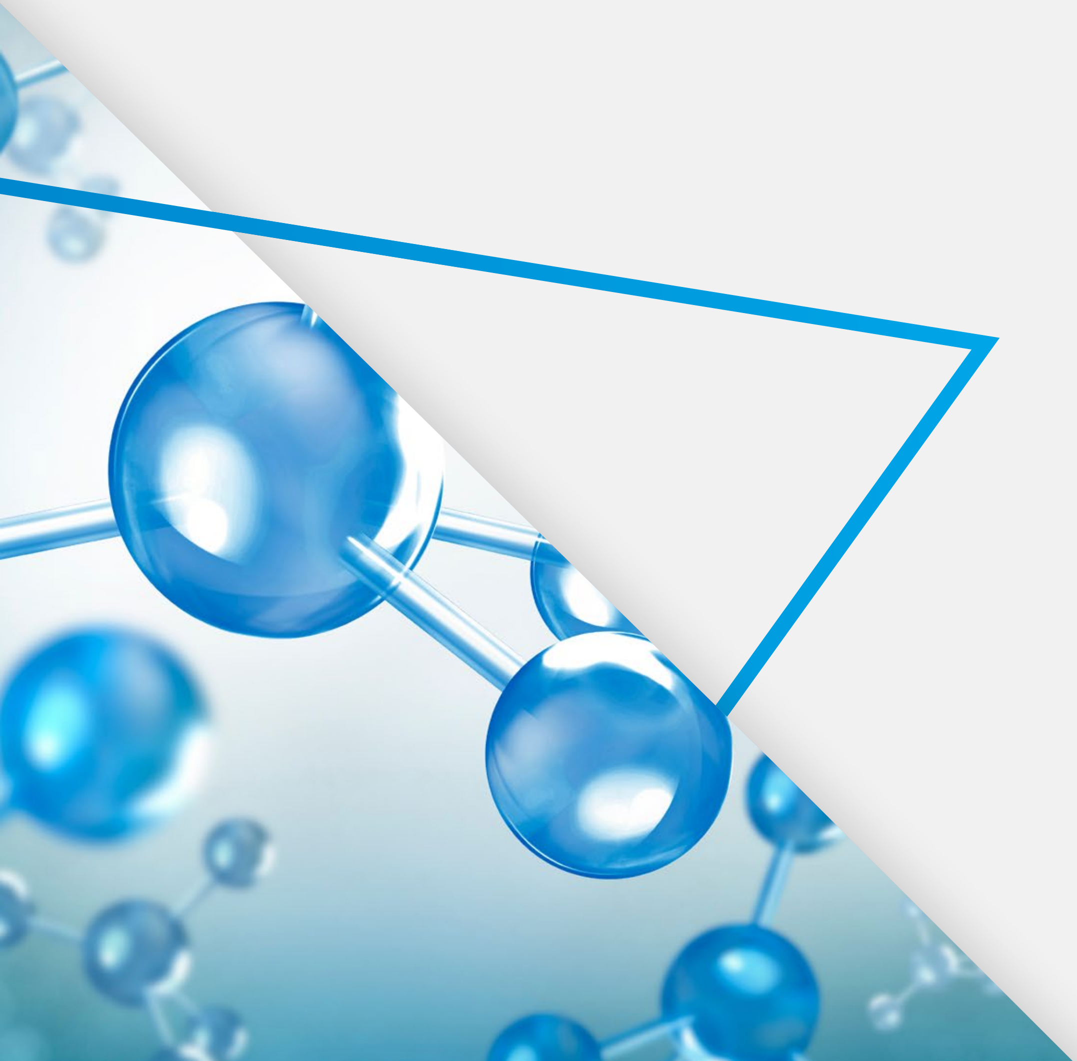
# Corporate Debt, Turnaround & Restructuring and Tax & Exchange Control

ALERT | 6 February 2025



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SOUTH AFRICA

Leveraging innovation to stave off financial decline and promote growth

For more insight into our expertise and services

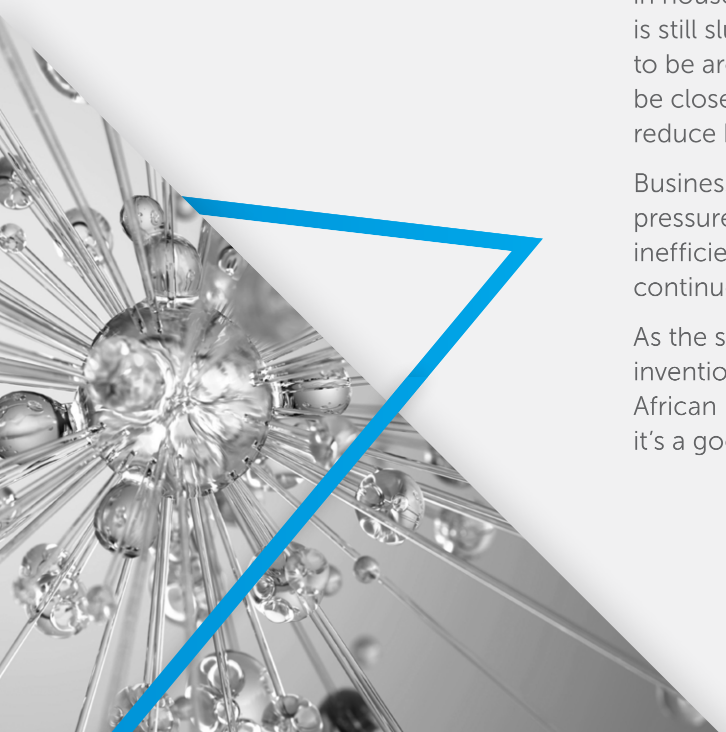
# Leveraging innovation to stave off financial decline and promote growth

South Africa, the 24th largest country by population and 25th by land area, has immense untapped potential. Our large labour market and significant immigrant population, combined with three major functional harbours along the 40th longest coastline in the world, create opportunities for considerable economic expansion.

Notwithstanding these encouraging factors, the South African economy is facing strong headwinds and businesses are currently navigating a challenging landscape. Despite some positive developments, such as the government of national unity that was established in the weeks following South Africa's May 2024 National Election, reduced load shedding and a slight recovery in household spending, the overall economic growth is still sluggish. The GDP growth rate was projected to be around only 1,3% in 2024, but it turned out to be closer to 0,8%. This is not sufficient to significantly reduce high levels of unemployment and poverty.

Businesses in South Africa continue to face financial pressures. Additionally, structural issues such as operational inefficiencies in postal services, freight rail and ports continue to disrupt economic activity.

As the saying goes – necessity is the mother of invention. There's no getting around it. South African businesses must innovate to survive – so it's a good thing innovation is incentivised.



Innovation should be an important part of any South African company's survival (turnaround) plan, because the South African government encourages innovation through tax incentives, particularly for research and development (R&D). Companies that qualify for these tax benefits will see a reduction in their tax liabilities and may as a result enjoy improved cashflows.

## Tax incentives for research and development

Section 11D of the Income Tax Act offers tax deductions for investments in *"scientific or technological research and development."* These deductions are designed to incentivise innovation, which is critical to driving South Africa's economic growth.

R&D, as defined under Section 11D, includes systematic investigative or experimental activities aimed at addressing scientific or technological uncertainties. Qualifying activities include discovering new scientific or technological knowledge, creating or significantly improving products, processes, or services, and developing multisource (generic) pharmaceutical products that meet the World Health Organization's guidelines. However, the outcomes of these activities should not be obvious to someone skilled in the relevant field.

This definition is incredibly broad, and every South African company is (or should be) involved in significantly improving their products, processes, or services. And, as long as the intended outcomes are not obvious, the associated costs may qualify for a tax deduction.

# Leveraging innovation to stave off financial decline and promote growth

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### Exclusions from the Definition of R&D

However, not all activities qualify as R&D under the Income Tax Act.

Market research, product testing, and sales promotions, while valuable for business growth, are not considered R&D under this section. Studies in social sciences, arts, and humanities are also excluded, as they fall outside the technical scope.

Oil, gas, and mineral exploration do not qualify unless they involve new technology specifically related to extraction. Additionally, developing financial products, trademarks, and goodwill doesn't meet the R&D criteria, as these focus more on business assets than on advancing scientific knowledge.

R&D expenses funded by the government, public entities, or municipalities are also not eligible for deduction, and any grants or allowances must be subtracted from the total expenditure for tax purposes.

### The Tax Deduction

But, for those R&D activities that do qualify, a significant deduction equal to 150% of expenditure incurred directly for R&D, and an accelerated depreciation deduction (that is, 50:30:20 as per section 12C(gA)) for capital expenditure incurred on machinery or plant used for R&D, may be allowed, provided that the expenditure was incurred in the production of income and in carrying on a trade. Furthermore, the R&D activity must be approved by the Minister of Science and Innovation; and the expenditure must be incurred within six months before, or after, the application was received by the Department of Science and Innovation.

### Tax Allowance for Buildings

Under Section 13 of the Income Tax Act, companies may claim a 5% tax allowance on buildings used for R&D purposes, subject to certain conditions being met, including that the building was erected (or construction commenced) on or after 1 January 1989.

Furthermore, the building must be bought or constructed specifically for R&D as part of the company's trade. The building must also be predominantly used by the taxpayer for R&D activities during the year of assessment. Buildings leased to tenants for R&D purposes are eligible for this allowance as well.

# Leveraging innovation to stave off financial decline and promote growth

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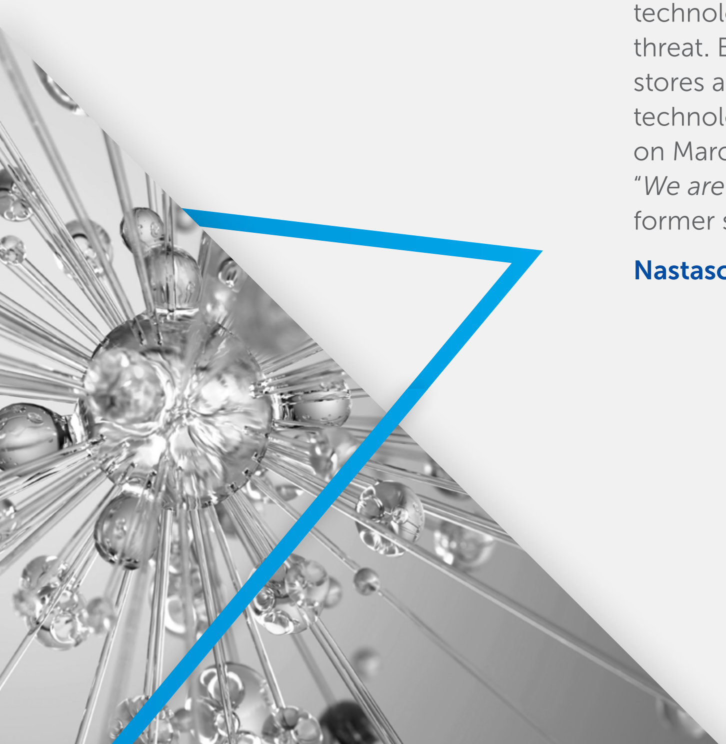

## The importance of innovation for growth

The largest and most stable economies in the world are also leading innovators. For example, countries like Switzerland, Sweden, the United States of America, Singapore and Germany ranked highest amongst the World Intellectual Property Organization's Global Innovation Index (GII) on their innovation capabilities.

Historically, innovation has been driven by curiosity, necessity, and crises. For companies, innovation is essential for staying competitive and adapting to market changes.

Failure to innovate can lead to stagnation, decline, and eventually corporate demise.

An oft cited example of innovation inertia is Blockbuster. During the 1990s it had over 9,000 stores and massive brand recognition. But Blockbuster did not adapt well to technological change. The rise of on-demand streaming video services threatened its business model. Blockbuster tried imitating Netflix's DVD-by-mail service in 2004, while Netflix and others kept innovating their streaming technology and content. Blockbuster's CEO famously dismissed Netflix as no threat. Blockbuster did not evolve with industry changes. It clung to physical stores and did not embrace the digital shift - underestimated disruption from new technologies. Almost all of its stores worldwide were closed by 2014. However, on March 23, 2023, the Blockbuster web page was re-activated, with the message "*We are working on rewinding your movie*" – who knows…a tiny slither of its former self may be innovating now…

**Nastascha Harduth, Jerome Brink and Kagiso Mokaleng**

Chambers TOP RANKED Global 2024 Cliffe Dekker Hofmeyr

# OUR TEAM

For more information about our Corporate Debt, Turnaround & Restructuring sector and services in South Africa and Kenya, please contact:

**Nastascha Harduth**
Sector Head: Corporate Debt, Turnaround & Restructuring
Director
T +27 (0)11 562 1453
E nastascha.harduth@cdhlegal.com

**Chris Charter**
Practice Head & Director:
Competition Law
T +27 (0)11 562 1053
E chris.charter@cdhlegal.com

**David Thompson**
Deputy Practice Head & Director:
Corporate & Commercial
T +27 (0)21 481 6335
E david.thompson@cdhlegal.com

**Albert Aukema**
Director:
Competition Law
T +27 (0)11 562 1205
E albert.aukema@cdhlegal.com

**Eugene Bester**
Director:
Dispute Resolution
T +27 (0)11 562 1173
E eugene.bester@cdhlegal.com

**Peter Hesseling**
Director:
Corporate & Commercial
T +27 (0)21 405 6009
E peter.hesseling@cdhlegal.com

**Sammy Ndolo**
Managing Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E sammy.ndolo@cdhlegal.com

**Mashudu Mphafudi**
Practice Head & Director:
Banking, Finance & Projects
T +27 (0)11 562 1093
E mashudu.mphafudi@cdhlegal.com

**André de Lange**
Sector Head: Agriculture, Aquaculture & Fishing
Director: Corporate & Commercial
T +27 (0)21 405 6165
E andre.delange@cdhlegal.com

**Gerhard Badenhorst**
Director:
Tax & Exchange Control
T +27 (0)11 562 1870
E gerhard.badenhorst@cdhlegal.com

**Jerome Brink**
Director:
Tax & Exchange Control
T +27 (0)11 562 1484
E jerome.brink@cdhlegal.com

**Dane Kruger**
Director:
Corporate & Commercial
T +27 (0)21 481 6362
E dane.kruger@cdhlegal.com

**Emil Brincker**
Practice Head & Director:
Tax & Exchange Control
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

**Aadil Patel**
Practice Head & Director:
Employment Law
Sector Head:
Government & State-Owned Entities
T +27 (0)11 562 1107
E aadil.patel@cdhlegal.com

**Tim Smit**
Sector Head: Consumer Good, Services & Retail Sector
Director: Dispute Resolution
T +27 (0)11 562 1085
E tim.smit@cdhlegal.com

**Timothy Baker**
Director:
Dispute Resolution
T +27 (0)21 481 6308
E timothy.baker@cdhlegal.com

**Petr Erasmus**
Director:
Tax & Exchange Control
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com

**Nomlayo Mabhena-Mlilo**
Director:
Dispute Resolution
T +27 (0)11 562 1743
E nomlayo.mabhena@cdhlegal.com

## OUR TEAM*...continued*

For more information about our Corporate Debt, Turnaround & Restructuring sector and services in South Africa and Kenya, please contact:

**Imraan Mahomed**
Director:
Employment Law
T +27 (0)11 562 1459
E imraan.mahomed@cdhlegal.com

**Richard Marcus**
Director:
Dispute Resolution
T +27 (0)21 481 6396
E richard.marcus@cdhlegal.com

**Howmera Parak**
Director:
Tax & Exchange Control
T +27 (0)11 562 1467
E howmera.parak@cdhlegal.com

**Lucinde Rhoodie**
Director:
Dispute Resolution
T +27 (0)21 405 6080
E lucinde.rhoodie@cdhlegal.com

**Njeri Wagacha**
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E njeri.wagacha@cdhlegal.com

**Deon Wilken**
Director:
Banking, Finance & Projects
T +27 (0)11 562 1096
E deon.wilken@cdhlegal.com

**Sentebale Makara**
Director:
Dispute Resolution
T +27 (0)11 562 1181
E sentebale.makara@cdhlegal.com

**Yvonne Mkefa**
Director:
Employment Law
T +27 (0)21 481 6315
E yvonne.mkefa@cdhlegal.com

**David Pinnock**
Joint Sector Head: Private Equity
Director: Corporate & Commercial
T +27 (0)11 562 1400
E david.pinnock@cdhlegal.com

**Belinda Scriba**
Director:
Dispute Resolution
T +27 (0)21 405 6139
E belinda.scriba@cdhlegal.com

**John Webber**
Director:
Real Estate Law
T +27 (0)11 562 1444
E john.webber@cdhlegal.com

**Vincent Manko**
Director:
Dispute Resolution
T +27 (0)11 562 1660
E vincent.manko@cdhlegal.com

**Desmond Odhiambo**
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E desmond.odhiambo@cdhlegal.com

**Vivek Ramsaroop**
Director:
Corporate & Commercial
T +27 (0)11 562 1015
E vivek.ramsaroop@cdhlegal.com

**Tamarin Tosen**
Director:
Corporate & Commercial
T +27 (0)11 562 1310
E tamarin.tosen@cdhlegal.com

**Emily West**
Director:
Trusts & Estates
T +27 (0)11 562 1182
E emily.west@cdhlegal.com

# OUR TEAM

For more information about our Tax & Exchange Control practice and services in South Africa and Kenya, please contact:

**Emil Brincker**
Practice Head & Director:
Tax & Exchange Control
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

**Gerhard Badenhorst**
Director:
Tax & Exchange Control
T +27 (0)11 562 1870
E gerhard.badenhorst@cdhlegal.com

**Jerome Brink**
Director:
Tax & Exchange Control
T +27 (0)11 562 1484
E jerome.brink@cdhlegal.com

**Petr Erasmus**
Director:
Tax & Exchange Control
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com

**Dries Hoek**
Director:
Tax & Exchange Control
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

**Alex Kanyi**
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E alex.kanyi@cdhlegal.com

**Heinrich Louw**
Director:
Tax & Exchange Control
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com

**Lena Onyango**
Partner | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E lena.onyango@cdhlegal.com

**Howmera Parak**
Director:
Tax & Exchange Control
T +27 (0)11 562 1467
E howmera.parak@cdhlegal.com

**Stephan Spamer**
Director:
Tax & Exchange Control
T +27 (0)11 562 1294
E stephan.spamer@cdhlegal.com

**Tersia van Schalkwyk**
Tax Consultant:
Tax & Exchange Control
T +27 (0)21 481 6404
E tersia.vanschalkwyk@cdhlegal.com

**Varusha Moodaley**
Senior Associate:
Tax & Exchange Control
T +27 (0)21 481 6392
E varusha.moodaley@cdhlegal.com

**Abednego Mutie**
Senior Associate | Kenya
T +254 731 086 649
+254 204 409 918
+254 710 560 114
E abednego.mutie@cdhlegal.com

**Nicholas Carroll**
Associate:
Tax & Exchange Control
T +27 (0)21 481 6433
E nicholas.carroll@cdhlegal.com

**Mariska Delport**
Associate:
Tax & Exchange Control
T +27 (0)11 562 1574
E mariska.delport@cdhlegal.com

**Puleng Mothabeng**
Associate:
Tax & Exchange Control
T +27 (0)11 562 1355
E puleng.mothabeng@cdhlegal.com

**Sophie Muzamhindo**
Associate:
Tax & Exchange Control
T +27 (0)11 562 1729
E sophie.muzamhindo@cdhlegal.com

**Savera Singh**
Associate:
Tax & Exchange Control
T +27 (0)11 562 1575
E savera.singh@cdhlegal.com

**BBBEE STATUS:** LEVEL ONE CONTRIBUTOR
Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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**JOHANNESBURG**
1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa.
Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

**CAPE TOWN**
11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

**NAIROBI**
Merchant Square, 3rd floor, Block D, Riverside Drive, Nairobi, Kenya. P.O. Box 22602-00505, Nairobi, Kenya.
T +254 731 086 649 | +254 204 409 918 | +254 710 560 114
E cdhkenya@cdhlegal.com

**NAMIBIA**
1st Floor Maerua Office Tower, Cnr Robert Mugabe Avenue and Jan Jonker Street, Windhoek 10005, Namibia
PO Box 97115, Maerua Mall, Windhoek, Namibia, 10020
T +264 833 730 100 E cdhnamibia@cdhlegal.com

**STELLENBOSCH**
14 Louw Street, Stellenbosch Central, Stellenbosch, 7600.
T +27 (0)21 481 6400 E cdhstellenbosch@cdhlegal.com



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