



**A lifeline for Small Business in South Africa: An evaluation of section 12J, Venture Capital Incentives**

**By**

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Signed: 

Signed by candidate
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Date: 18 January 2020

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# Abstract

This dissertation seeks to answer two questions. In the main it aims to answer *does the section 12J venture capital incentive advance government's original stated intention of incentivizing the provision of equity funds to the SME sector*. Based on the outcome of the primary research question the secondary question seeks to answer *whether section 12J should be extended beyond 2021*. In seeking to answer these questions the dissertation critically evaluates the section 12J legislation, researches the venture capital industry in South Africa including section 12J venture capital companies and investigates the role and success of targeted tax incentives in South Africa.

The VCC incentive targeted start-ups and SME's generally considered high growth and high-tech, or junior mining and exploration companies. SME's, especially entrepreneurial businesses, have the potential to be a catalyst for economic growth and job creation. *Inter alia*, access to finance is stunting the development of the SME sector with up to 70% of SME's failing due to a lack of funding. Venture capitalists can provide equity finance, management and technical support that could reduce some of the high risks associated with SME's. The advantage of equity finance is that it allows the SME's to better weather economic downturns and reinvest cash surpluses instead of servicing debt.

In the main, whether the section 12J tax incentive is successfully advancing government's original intention still remains to be seen. Although there has been significant uptake of the regime and evidence to suggest that jobs are being created and meaningful investments are occurring, it still needs to be assessed to what extent the jobs and investments would have occurred even without the incentive. There also remain some short-comings to the design of the incentive and uncertainty to the regime which affects the sustainability of VCC's and the type of investments being made. The VCC industry has evolved to be more conservative, investing into asset-backed businesses and generally providing more growth capital, meaning that start-ups and other industries such as high growth technological companies are benefitting to a lesser extent. As such, government's intention to provide equity finance to start-ups and high growth industries appears to not be being addressed. Due to the late uptake of the regime, it is further unlikely that sufficient data would be available to analyze the incentive before 30 June 2021, the current sunset date.

For these reasons, it is the writer's view that Treasury should appoint an external research organisation to prepare a thorough analysis of the incentive and whether it should be extended, but in any event, as a minimum the incentive should be extended for at least another six years (to make up for the years from its introduction to the year it began to show significant uptake, i.e. 2009 to 2015). Alternatively, the section 12J incentive should not be extended but rather replaced with a similar incentive taking into account the recommendations made in this dissertation.

# Table of contents

<b>Chapter 1 – Introduction and literature review</b> .....	1
<b>1.1. Background</b> .....	1
<b>1.2. Research Objective</b> .....	5
<b>1.3. Limitations</b> .....	5
<b>1.4. Research Method</b> .....	6
<b>1.5. Structure of the study</b> .....	6
<b>Chapter 2 – The legislation</b> .....	8
<b>2.1. Introduction</b> .....	8
<b>2.2. The VCC</b> .....	10
<b>2.2.1. The purpose of the VCC vehicle</b> .....	10
<b>2.2.2. The VCC approval process</b> .....	11
<b>2.2.3. The requirements for a registered VCC</b> .....	12
<b>2.3. The investee</b> .....	23
<b>2.4. The investor</b> .....	33
<b>2.5. Final remarks</b> .....	43
<b>Chapter 3 – The venture capital industry</b> .....	44
<b>3.1. Introduction</b> .....	44
<b>3.2. Distinguishing venture capital from other forms of funding</b> .....	44
<b>3.3. Venture capital in SA</b> .....	47
<b>3.4. Examples of the impact of section 12J venture capital companies</b> .....	52
<b>Chapter 4 – The role, success and failures of tax incentives</b> .....	63
<b>4.1. Introduction</b> .....	63
<b>4.2. A theoretical way of measuring the cost and success of a tax incentive</b> .....	67

<b>4.3. Measuring incentives in the South African context .....</b>	<b>69</b>
<b>4.4. VCC .....</b>	<b>74</b>
<b>Chapter 5 – Summary and conclusions .....</b>	<b>80</b>
<b>5.1. Summary .....</b>	<b>80</b>
<b>5.2. Conclusion.....</b>	<b>86</b>
<b>Bibliography .....</b>	<b>88</b>

# Glossary

DSBD	Department of Small Business Development
DTC	Davis Tax Committee
EBIT	Earnings Before Interest and Tax
GEM	Global Entrepreneurship Monitor
ITA	Income Tax Act 58 of 1962
NDP	South African National Development Plan
R&D	Research and Development
SA	South Africa
SARS	South African Revenue Service
SME	Small and Medium Enterprises
TLAB	Taxation Laws Amendment Bill
USA	United States of America
VC	Venture Capital
VCC	Venture Capital Company

# Chapter 1 – Introduction and literature review

## 1.1. Background

“A big business starts small.”

-Richard Branson

With the back-drop of historic economic exclusion, prevalent high unemployment rates (27.6%<sup>1</sup>) and very low economic growth (0.8%<sup>2</sup>), entrepreneurial businesses have the potential to be a catalyst for economic growth and job creation.<sup>3</sup> The South African National Development Plan indicated that small and developing businesses will be a significant driver behind job creation and undoing the legacy of apartheid. *Inter alia*, the NDP suggests that SME business is to be stimulated through access to finance.<sup>4</sup>

As per the Department of Small Business Development (“DSBD”), the five critical areas that are stunting the development of the SME sector are: public sector procurement, building access to market into the public sector value chain, regulatory constraints, access to finance; and support of township and rural enterprises.<sup>5</sup> The Global Entrepreneurship Monitor indicates similar results noting the three main constraints as access to finance, government policy, and education and training. As per its research, two-thirds of businesses that closed during 2016 did so for financial reasons.<sup>6</sup> In line with this, according to the presentation made by the DSBD to the National Council of Provinces, up to 70% of SMEs failed due to lack of funding.<sup>7</sup>

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<sup>1</sup> Department Statistics. 2019. *Key findings: P0211 - Quarterly Labour Force Survey (QLFS), 1st Quarter 2019*. Available: [http://www.statssa.gov.za/?page\\_id=1856&PPN=P0211&SCH=7619](http://www.statssa.gov.za/?page_id=1856&PPN=P0211&SCH=7619) [2019, 25 May]

<sup>2</sup> Department Statistics. 2019. *Economy edges up by 0,8% in 2018*. Available: <http://www.statssa.gov.za/?p=11969> [2019, 25 May]

<sup>3</sup> Toby Chance at page 52 of Herrington, M., Kew P. & Mwangi A., 2016/2017: *Global Entrepreneurship Monitor: South Africa Report Can Small Businesses Survive In South Africa?* (hereafter the 2016/17 GEMS SA report)

<sup>4</sup> South Africa: National Planning Commission ‘National Development Plan: Vision for 2030’ (11 November 2011). At 144

<sup>5</sup> Lester, M. & Padia N. 2016. *Second and Final Report on Small and Medium Enterprises for the Minister of Finance*. The Davis Tax Committee. At page 12

<sup>6</sup> The 2016/17 GEMS SA report. At 28:42

<sup>7</sup> NCOP Economic and Business Development. National Council of Provinces. *Department of Small Business 2018/19 Annual Performance Plan; with Minister & Deputy*. Available: <https://pmg.org.za/committee-meeting/26261/> [2019, 25 May]

The DTC split the range of SMEs into three parts: formal sector, missing middle and micro-enterprises. The formal sector consisted of 481 companies which contributed 64% of corporate tax. The missing middle, which is defined as entrepreneurial business with high growth potential, consisted of about 165,000 companies and contributed 36% of corporate tax.<sup>8</sup> Similar figures were reported by SARS in 2018, which relates to the 2014 to 2017 tax years, stating that 370 large companies contributed 57.7% of corporate tax amounting to R116 billion, while a further 185,913 companies which had taxable income contributed 40.8% of corporate tax amounting to R82 billion.<sup>9</sup> As an example, assuming total corporate tax collected was R220 billion<sup>10</sup>, on average a “formal” large company contributed R0.3 billion<sup>11</sup> compared to R500,000<sup>12</sup> per “missing middle” SME company. The potential tax revenue gain in assisting the missing middle SME companies to grow to the size of the “formal” large sector is clear.

There are many different ways in which government is trying to create an enabling environment for SMEs. These include grants and funds, special economic zones, tax incentives, preferential tax rates, the Treasury’s Jobs Funds and also legislation like the BBBEE codes. While this is very promising and shows government’s commitment to the cause, low economic growth and unemployment continue to plague the country, which is indicative of a lack of success of the policies. The problem does not necessarily lie with the policies themselves, but the successful implementation of the policies. It has been suggested that government should rather give proper incentives to business incubators to drive the economy and job creation, rather than trying to be a business incubator itself.<sup>13</sup>

The economy and the consumer continue to be under tremendous pressure. The South African budget deficit is pressuring government to increase its revenue, which is mainly received from taxes. It has reached the point that the risk to further increase the tax burden may actually result in

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<sup>8</sup> Lester, M. & Padia N. 2014. First Interim Report on Small and Medium Enterprises for the Minister of Finance. *The Davis Tax Committee* (here after the DTC First SME report). Figure 1 at page 9

<sup>9</sup> National Treasury and the South African Revenue Services. 2018. *2018 Tax Statistics*. At page 151 and 173

<sup>10</sup> National Treasury and the South African Revenue Services. 2018. *2018 Tax Statistics*. At page 158

<sup>11</sup>  $R220 \text{ billion} \times 64\% \div 481 = R0.29 \text{ billion}$

<sup>12</sup>  $R220 \text{ billion} \times 36\% \div 165,000 = R480,000$

<sup>13</sup> The 2016/17 GEMS SA report. At 46

less tax revenue. Arthur Laffer has developed a theory that illustrates the relationship between tax rates and tax revenue (“The Laffer Curve”). It advocates a tipping point where if tax rates are too high, it will discourage the taxed activities, such as business, to such an extent that tax revenue will decrease. Although the theory has been criticized for various reasons, it has been used in the USA to promote tax cuts which inevitably resulted in economic growth.<sup>14</sup> Raising taxes further is bound to have the opposite effect on SA’s economic growth, which was a mere 0.8% for 2018<sup>15</sup> and is predicted to be 0.5% in 2019.<sup>16</sup> The only remaining option is to increase the number of taxpayers and taxable income. This can only be done by allowing business to flourish in SA and stimulating the economy.

A further concern is the low number of SMEs and entrepreneurs in SA compared to the rest of Africa and the world. Although the historic exclusion of the majority of the population from participation in the economy has resulted in SA having less SMEs,<sup>17</sup> there seems to be a reluctance in the South African public to start a new business. Entrepreneurial intentions<sup>18</sup> as per the 2016 GEMS SA survey was a mere 10.1%, compared to the 41.6% for Africa. However, 72.6% of the South Africans surveyed indicated that they strongly believed entrepreneurship to be a good career choice. The reason for this mismatch is that the risks associated with starting a new business is too high.<sup>19</sup> One way to address this is to have a mentoring equity partner that not only provides funding but also provides management and technical support. This may be in the form of venture capitalists.<sup>20</sup>

This dissertation will focus on the use of the venture capital tax incentive as contained in section 12J of the ITA. In 2008, Treasury proposed that a venture capital incentive be introduced. It cited that access to finance remained one of the main challenges to grow small business and junior

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<sup>14</sup> <https://www.washingtonexaminer.com/opinion/he-who-laffs-last>. Accessed 17 June 2019

<sup>15</sup> Department Statistics. 2019. *Economy edges up by 0,8% in 2018*. Available: <http://www.statssa.gov.za/?p=11969> [2019, 25 May]

<sup>16</sup> National Treasury. 2019. *Medium Term Budget Policy Statement 2019*. Available <http://www.treasury.gov.za/documents/mtbps/2019/mtbps/FullMTBPS.pdf> [2019, 25 May]

<sup>17</sup> TIPS. 2017. *Final Report Regulatory Burdens on Small Business: Options for Improvement*. Page 1

<sup>18</sup> Entrepreneurial intentions is defined as the percentage of the 18 – 64 year old population (individuals already engaged in any stage of entrepreneurial activity excluded) who intend to start a business within the next three years.

<sup>19</sup> The 2016/17 GEMS SA report. At 20:21

<sup>20</sup> Business Partners Limited. 2014. *What is venture capital*. Available: <https://www.businesspartners.co.za/en-za/entrepreneurs-growth-centre/useful-articles/venture/what-is-venture-capital> [2019, 26 October]

mining exploration companies. This proposal is in line with the suggestion that Government should seek to incentivize business incubators. Furthermore, a venture capital incentive would allow equity finance for this important sector. The advantage of equity finance would allow the businesses to better weather economic downturns and reinvest cash surpluses instead of servicing debt.<sup>21</sup>

The targeted enterprises were start-ups and small enterprises generally considered high growth and high-tech, or junior mining and exploration companies.<sup>22</sup> Due to the high investment risk associated with the targeted enterprises, an upfront tax deduction would increase the appetite for risk. Furthermore, the incentive was designed to ensure that a VCC would be required to diversify its portfolio as it would be limited to the percentage stake it may acquire in a qualifying company. The VCC would also be a pooling mechanism from different sources to channel funds into these businesses. This would further limit the exposure of the individual investors. The VCC itself would act as an ‘angel investor’, providing equity and supportive management services. The VCC buys and holds a major stake until the targeted enterprise reaches a certain level of maturity and growth (‘the incubation period’), and then exits the investment by selling it for a profit. It was believed that the incubation period would last for five to ten years.<sup>23</sup>

Although SARS’ mandate does not specifically include providing financial facilities to the SME sector,<sup>24</sup> SARS’ objective includes the efficient and effective collection of tax revenue.<sup>25</sup> It must do this by *inter alia* enforcing the ITA.<sup>26</sup> Accordingly, SARS is not primarily responsible for the stimulation of economic growth or job creation but it needs to enforce the tax incentives contained in the Act, which indirectly result in the aforementioned.

Tax, and with it, tax incentives, is but one factor and cannot solve all the problems in the SME sector.<sup>27</sup> Furthermore, this dissertation will not compare the merits of using tax law to assist SMEs

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<sup>21</sup> SARS. Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008. 67

<sup>22</sup> <http://www.treasury.gov.za/documents/national%20budget/2008/review/chap4.pdf> [2019, 25 May]

<sup>23</sup> SARS, Explanatory Memorandum on the Revenue Law Amendment Bill, 2011:75

<sup>24</sup> The DTC First SME report at page 24

<sup>25</sup> South African Revenue Service Act 34 of 1997, section 3

<sup>26</sup> South African Revenue Service Act 34 of 1997, section 4(a)(i) read with Schedule 1

<sup>27</sup> The DTC First SME report at page 24

with the other assistance measures. This is merely a study of whether the tax incentives, more specifically the venture capital incentive, are being used as envisioned by Treasury.

## **1.2. Research Objective**

This dissertation, in the main, aims to answer the following research question:

Does the section 12J venture capital incentive advance government's original stated intention of incentivising the provision of equity funds to the SME sector?

Based on the outcome of the research on the main research question, the secondary question to answer is:

Should section 12J be extended beyond 2021?

The following objectives will assist in answering the research questions:

- i) critically evaluate the section 12J legislation and suggest improvements to counter abuse, highlight unforeseen obstacles and suggest ways to remove them and to refocus the incentive to be in line with its original intention;
- ii) research and understand the need and role for venture capital in SA;
- iii) research current section 12J venture capital companies in order to establish if they are fulfilling that need and role in line with the original stated aim by government;
- iv) investigate the role and success of targeted tax incentives in the South African context; and
- v) combine all of the above to provide a recommendation on whether the incentive's sunset clause, 30 June 2021, should be extended.

## **1.3. Limitations**

This dissertation is limited by the information made available by VCCs, as these are private companies and they are not required to disclose financial information like listed companies must. A further limitation is the scarcity of academic literature specific to section 12J.

This dissertation does not seek to apply the SME definition as contained in different South African legislation but rather ascribes a broad meaning to the term in that it is an unlisted company that is still in the growth phase or has growth potential, with less than R50 million of assets, trades mainly within SA and is likely to yield improved contribution to the fiscus and/or create jobs.

#### **1.4. Research Method**

In order to achieve the stated objectives and answer the research questions, a literature review will be conducted focusing on the South African venture capital industry, covering past and present legislation, journals, articles, news reports, dissertations and VCC websites. The following steps will be followed:

- i) Interpretative research will be conducted regarding the venture capital industry in SA to understand the role and challenges of the industry, especially with regards to funding of businesses with high growth potential. The intention of this part of the research is to establish whether the VCC incentive could be conducive to addressing one or more of SA's socio-economic challenges;
- ii) An explanatory and critical evaluation will be made of the legislation and legislative changes made to section 12J since its insertion into the ITA to determine and describe whether these are conducive to the intention as determined in the interpretative research;
- iii) Exploratory research will be conducted and a descriptive analysis made of existing VCCs (where information is available) in order to establish whether these are fulfilling the original stated aim of government;
- iv) Applied research of journals, dissertations and international trends will be performed on the current VCC regime, and potential avenues for future research on how to improve investing into SMEs will be briefly discussed.

#### **1.5. Structure of the study**

The dissertation is structured in the following manner:

Chapter 1 provides a backdrop of the economic reasons why the venture capital incentive was introduced. It goes on to describe the research justification, providing the objectives of the

research, the research question and the methodology to be applied to achieve said objectives and to answer the research question.

Chapter 2 will evaluate the section 12J legislation. It will start by assessing the changes made to the original legislation and whether these either enhanced or diminished the incentive to address its original purpose. It will suggest improvements to counter abuse, highlight unforeseen obstacles and ways to remove them, and refocus the incentive to be in line with its original intention.

Chapter 3 will provide an introduction to the definition of a venture capital company and will reiterate the intention behind the tax incentive. It will investigate the venture capital industry in SA to understand the role and challenges of the industry, especially with regards to funding of small business. Lastly, it will look at existing VCCs by analyzing their financial data, ownership structure and general information available on their websites, news articles and journals. It will conclude by determining whether the VCCs are functioning in line with the original stated aim of government.

Chapter 4 will broadly discuss the success and failures of targeted tax incentives in the South African context. Tax incentives directly reduce government's tax revenue, which means they are a 'cost' to the fiscus.<sup>28</sup> If the success of a tax incentive is not measured, there is nothing to measure the cost of the incentive against. This will also hold true for the section 12J incentive. There has been academic research with regards to the success of other tax incentives. It is necessary to include this chapter due to the limited academic literature on section 12J specifically. The chapter will seek to identify ways to measure the success of section 12J and further conclude whether targeted incentives have a role to play in SA.

Chapter 5 will combine the conclusions and recommendations reached in each of the preceding chapters into a final conclusion on the research question: Does the venture capital incentive advance government's original intention and should the incentive's sunset clause, 30 June 2021, be extended.

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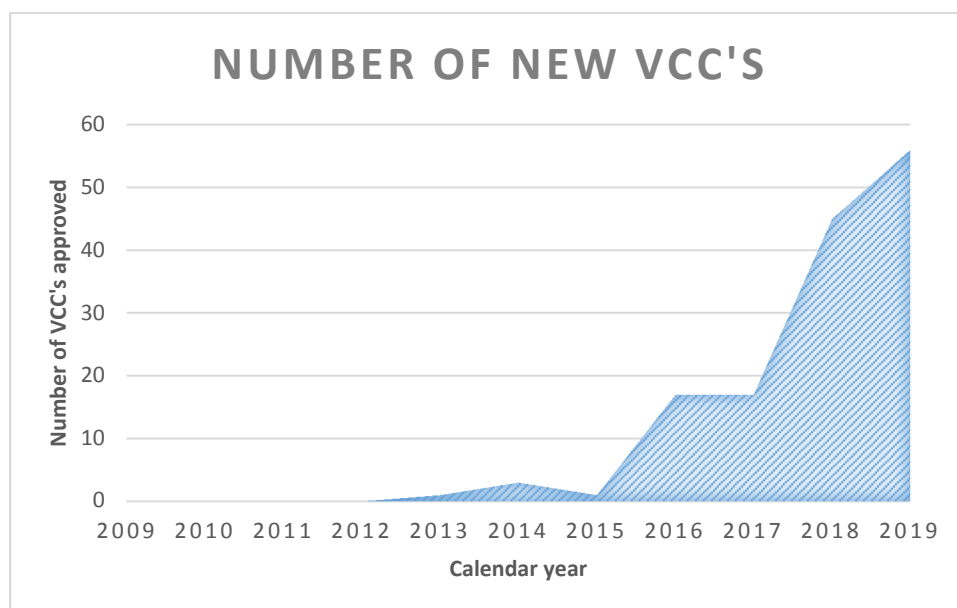
<sup>28</sup> Thuronyi V. 1998. Tax Law Design and Drafting (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. Page 3

# Chapter 2 – The legislation

## 2.1.Introduction

To address the challenges to the growth of the SME business and junior mining exploration sectors in the economy, a specific tax incentive for venture capital was introduced with effect from 1 July 2009 that would provide equity finance.<sup>29</sup> However, the initial uptake of the incentive was almost non-existent. By the end of 2011 not a single VCC had been successfully initiated,<sup>30</sup> and up to the start of 2014 only five companies were registered as VCC's, only three of which were active (and all registered in 2013).<sup>31</sup> From the start of 2015, a marked increase in new VCC is noted with 45 and 56 new VCC's being approved during 2017 and 2018, respectively.<sup>32</sup> This may be illustrated in the following graphs.

**Figure 2.1**



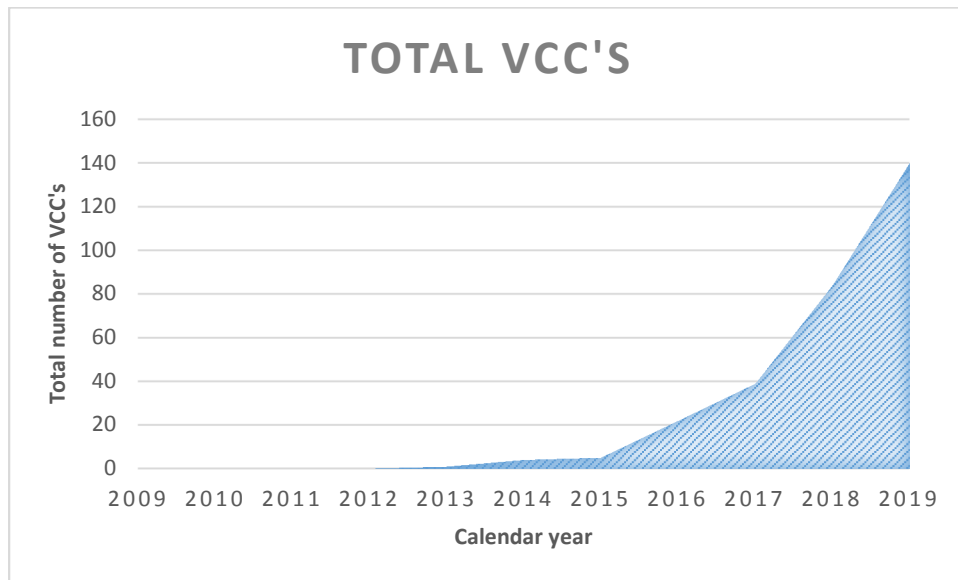
<sup>29</sup> SARS. Explanatory Memorandum on the Revenue Law Amendment Bill (hereafter 'Explanatory Memorandum on the TLAB'), 2008:67

<sup>30</sup> [https://www.saica.co.za/integritax/2012/2093.\\_The\\_venture\\_capital\\_tax\\_regime.htm](https://www.saica.co.za/integritax/2012/2093._The_venture_capital_tax_regime.htm)

<sup>31</sup> SARS, Explanatory Memorandum on the TLAB 2014:50

<sup>32</sup> Analysis of the List of Approved Venture Capital Companies ("VCC") available at <https://www.sars.gov.za/ClientSegments/Businesses/Pages/Venture-Capital-Companies.aspx> [2019, 25 February]

**Figure 2.2**



Some reasons ascribed to the slow start were that the investment benefits were too small and the three sets of criteria (1- investor-level requirements, 2- qualifying VCC requirements, 3- qualifying investee company requirements) were too restrictive and complex.<sup>33</sup> What followed were numerous changes to the legislation, in which Treasury needed to balance creating an appealing incentive and countering abusive schemes. This Chapter will evaluate the section 12J legislation and the amendments. This will include considering the reason for the changes, the proposed impact for each of them and whether the changes were a step toward addressing the incentive's original purpose, or not. The intention is to consider whether the current legislation is still in line with the original purpose of the incentive.

The Chapter will comprises of the following sections:

- i) The requirements for a VCC;
- ii) The requirements for an investee to be a 'qualifying company';
- iii) The incentive for the investor and the investor requirements;
- iv) Final remarks.

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<sup>33</sup> SARS, Explanatory Memorandum on the TLAB 2011:75

As part of this Chapter, suggestions will be made to refine the section 12J regime, where these become apparent.

## **2.2. The VCC**

The stated intention is that the VCC is a marketing vehicle which brings together small investors, and concentrates investment expertise in favor of the small business sector.<sup>34</sup>

A VCC is taxed as a normal company with no additional special tax benefits. It further needs to be approved by the Commissioner in terms of section 12J(5) of the ITA, and the approval must not have been withdrawn.<sup>35</sup> The intention is that the approval requirement and the fact that there is no added tax incentive for a VCC would lead to only true venture capitalists registering VCC's to source additional investment funds. With reference being made to the 'financing of own projects', Treasury recently indicated that the incentive is still being used by taxpayers in a way that undermines the objectives and principles of the VCC incentive to benefit from excessive tax deductions.<sup>36</sup> Treasury's comments suggest that some VCC vehicles are not being used by true venture capitalists.

In order to more fully comprehend this, it is necessary to understand how the legislation provides for the VCC's role, purpose, approval and anti-avoidance requirements, while identifying any shortcomings.

### **2.2.1. The purpose of the VCC vehicle**

The purpose of the VCC is to provide key commercial benefits. Firstly, it provides equity finance to qualifying companies (SME's and junior mining companies). As stated in Chapter 1, one of the main reasons SME's fail is due to limited access to finance. Equity finance allows the investee to weather economic downturns and to reinvest cash surpluses rather than being forced to service debt and interest.<sup>37</sup>

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<sup>34</sup> SARS, Explanatory Memorandum on the TLAB, 2008:68

<sup>35</sup> Section 12J(1) of the ITA definition of 'venture capital company'

<sup>36</sup> SARS, Explanatory Memorandum on the TLAB, 2019:36

<sup>37</sup> SARS, Explanatory Memorandum on the TLAB, 2008:67

Secondly, as noted above, it brings together small investors, and concentrates investment expertise in favor of the small business sector. The VCC is to provide equity but also supportive management services for these small businesses and junior mining companies.<sup>38</sup>

### **2.2.2. The VCC approval process**

The VCC application requires that the company submits a VCC001 form (available on the SARS website) together with:

- i) A tax clearance certificate to verify that the company's tax affairs are in order.
- ii) A certificate from the Companies and Intellectual Property Commission (CIPC) confirming the company's registration number.
- iii) A copy of the company's Memorandum of Incorporation and, if applicable, the Certificate of Confirmation that the amendment of the memorandum of incorporation was accepted by CIPC to confirm that the sole object of the company is the management of investments in qualifying companies.
- iv) A copy of the Financial Services Board license certifying that the VCC is licensed as a financial service provider.

There are no specific guidelines as to how long the approval process takes once the application is sent to SARS.

Obtaining a financial service provider license takes a number of weeks, with some sources indicating a turnaround time of between 6 to 12 weeks.<sup>39</sup> The qualifying criteria impose other requirements on a VCC that first need to be in place, some of which are noted in section 2.2.3 of this chapter.

With this in mind, the time period for a prospective VCC to be set up can be extensive, after which it still needs to source enough investors. As such, it would be almost impossible for the prospective VCC to start identifying or negotiating with qualifying companies before it has both its VCC approval and funding in place. This takes away the initiative and adaptability of VCC's to a large

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<sup>38</sup> SARS, Explanatory Memorandum on the TLAB, 2011:75

<sup>39</sup> [http://www.fais-compliance.co.za/enquiry\\_form\\_2.html](http://www.fais-compliance.co.za/enquiry_form_2.html), [2019, 8 June]

extent as the timeframe implies that investees identified on commencement of the process may no longer be available.

### **2.2.3. The requirements for a registered VCC**

Up to 2019, but mainly in 2009, 2011 and 2014, there were various changes to the VCC regime which included a general relaxation of the VCC requirements. Some of the reasons noted for the changes were that:<sup>40</sup>

1. the VCC criteria were too restrictive which meant that the VCC could not operate in accordance with the private equity model upon which the regime was founded; and
2. the regime was too complex, making the operation of a VCC unsustainable.

The following paragraphs track the VCC requirements and the changes through the years and provides insight into whether the requirements are in line with the objective of the regime.

#### *SA tax resident company*

For South African income tax purposes the definition of ‘company’ includes, among others, companies incorporated outside of SA, co-operatives, public benefit organisations, portfolios of foreign collective investment schemes in participation bonds or securities, portfolios of collective investment schemes in property qualifying as REITs and close corporations.<sup>41</sup>

The definition of ‘resident’ includes companies that are incorporated in SA and also whose place of effective management is in SA, but excludes any person who is deemed to be exclusively a resident of another country due to the application of an avoidance of double taxation treaty entered into by SA and that country.<sup>42</sup> With this in mind, it stands to reason that a VCC may be incorporated overseas as long as its place of effective management is in SA and it is not deemed to be exclusively resident in that other country due to the application of a double tax treaty.

#### *Controlled company*

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<sup>40</sup> SARS, Explanatory Memorandum on the TLAB 2011:75

<sup>41</sup> Section 1 of the ITA, definition of ‘company’

<sup>42</sup> Section 1 of the ITA, definition of ‘resident’

The requirement that a VCC is not controlled by another company was removed.<sup>43</sup> This was however coupled with introduction of anti-avoidance provisions one of which would disallow the deduction available to an investor where that investor becomes a connected person to the VCC. Originally this was just aimed at the investor. Subsequent to 1 January 2017 however, the anti-avoidance provision was amended and the presence of a connected person investor would lead to the VCC approval being withdrawn after 36 months after first issuing VCC shares.<sup>44</sup> In respect of a company, the definition of connected person *inter alia* includes where another company has more than 50% equity shares or voting rights (or at least 20% if no other shareholder has more), or a person other than a company holds individually or jointly with its connected persons 20% equity shares or voting rights.<sup>45</sup> Effectively, it means that a VCC cannot form part of a group after a 36 month deferral period.

Industry at the time commented that the amendment does not allow for a connected person investor to invest into the VCC on the basis that it doesn't benefit from the section 12J deduction as this would lead to the VCC approval being withdrawn. Treasury's response was that there are other investment vehicles available for those investors and they ought to invest in those other investment structures.<sup>46</sup> What was not considered is that this would prohibit anchor investors from investing into a VCC, which would mean it would be less likely that smaller investors would come onboard.

### *Tax compliant*

The company must comply with all its tax obligations as required under the laws administered by the Commissioner. This requirement includes, for example, complying with all registration requirements, the timely submission of all tax returns and the payment of any tax liability, interest or penalties.<sup>47</sup>

The VCC status may be withdrawn if the VCC has, during a year of assessment, failed to comply with the requirements. As such, the VCC will need to remain tax compliant throughout. This ought

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<sup>43</sup> SARS, Explanatory Memorandum on the TLAB 2011:76

<sup>44</sup> SARS, Explanatory Memorandum on the TLAB 2016:50

<sup>45</sup> Section 1 of the ITA, definition of 'connected person'

<sup>46</sup> SARS, National Treasury: Final Response Document on Taxation Laws Amendment Bill, 2016 and Tax Administration Laws Amendment Bill, 2016:39

<sup>47</sup> SARS. 2018. Draft guide on venture capital companies (hereafter "the VCC guide"). At page 7

to provide a means for SARS to review the VCC's financial information on an ongoing basis to ensure VCC's do not operate without all the VCC requirements being satisfied.

#### *Unlisted company*

As part of the general relaxation of the VCC requirements, effective 1 January 2012, there is no longer a requirement that a VCC must be an unlisted company. The purpose of the VCC is to be a marketing vehicle that brings together small investors and as such there seems to be no reason why this cannot be done via a listed vehicle.<sup>48</sup> By being listed, it might be easier to reach and attract investors. Furthermore, an investor that uses debt financing may be able to add one third of the finance cost, which would most likely have been non-deductible for income tax purposes, to the base cost of the VCC shares (only available for listed shares).<sup>49</sup> This provides a future capital gains tax benefit on eventual sale of the VCC shares which would not have been available had the investor invested into an unlisted VCC. To date no VCC has however been listed. Nonetheless, removing unnecessary restrictions remains a positive step in ensuring the incentive is not overly cumbersome and remains viable.<sup>50</sup>

#### *Connected person to qualifying company*

The ownership prohibition was relaxed with effect from 1 January 2012<sup>51</sup> so that the VCC can own up to 70% of a qualifying company.<sup>52</sup> This was done by removing this VCC requirement and including a new qualifying company requirement which required that a qualifying company is not a controlled group company in relation to a group of companies.<sup>53</sup> The remaining 30% ensures that the small business attracts independent players. This is in line with the private equity model on which the VCC incentive was based.<sup>54</sup> In an earlier explanatory memorandum, it was noted that a VCC should rather act as a financier (e.g. 'angel investor'<sup>55</sup>) and not a controlling owner.<sup>56</sup> These

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<sup>48</sup> SARS, Revenue Laws Amendment Act 2011:76

<sup>49</sup> See 2.5 *Investor*

<sup>50</sup> SARS, Explanatory Memorandum on the TLAB, 2011:76

<sup>51</sup> SARS, Explanatory Memorandum on the TLAB, 2011:77

<sup>52</sup> Section 12J(1) par (b) of the definition of 'qualifying company'

<sup>53</sup> SARS, Explanatory Memorandum on the TLAB, 2011:77

<sup>54</sup> *Ibid*

<sup>55</sup> See Chapter 3, subsection 3.2

<sup>56</sup> SARS, Explanatory Memorandum on the TLAB 2008:70

statements are somewhat contradictory. It thus seems that there is a lack of policy certainty on what model the incentive is based on.

Only following comments by the public, was the legislation changed in 2018 (effective 1 January 2019) to specifically note that the controlled company test pertained only to the VCC.<sup>57</sup> Prior to this, if another company held 70% or more equity shares in the investee, the investee would not be a qualifying company. This might have prevented companies, whose shareholders wished to maintain significant ownership and not relinquish control, to miss out on VCC funding. Although the explanatory memorandum noted that the amendment was administrative in nature, to correct unintentional practical uncertainty and to clarify policy intent that the controlled company test is only applied within the VCC frame-work, the VCC Guide clearly states that the controlled company test was to be applied to the VCC *or any other company*.<sup>58</sup> This may be another indicator of policy uncertainty.

#### *Classes of shares*

Of interest is that the controlled company test pertains specifically to the percentage equity shares, i.e. the number. An equity share is defined as “any share in a company excluding any share that neither as respects dividends nor respects returns of capital, carries any right to participate beyond a specified amount in a distribution.”<sup>59</sup> As such, a share needs to be restricted on both rights to dividend distributions *and* return of capital before it will not be an “equity share”. There is no restriction on the issue of different classes of shares by a qualifying company or a VCC. As long as the shares issued to the VCC are not third-party backed shares as defined in section 8EA(1) or hybrid equity instruments (but for the three year period requirement) as defined in section 8E(1), different classes of shares at different subscription prices may be issued, where certain classes of shares carry preferential rights to dividends.<sup>60</sup>

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<sup>57</sup> SARS, Explanatory Memorandum on the TLAB 2018:29

<sup>58</sup> SARS. 2018. The VCC Guide. At page 6

<sup>59</sup> Section 1 of the ITA, definition of ‘equity share’

<sup>60</sup> [https://www.accountancysa.org.za/wp-content/uploads/2018/05/Integritax\\_Jan\\_2017\\_Issue\\_208.pdf](https://www.accountancysa.org.za/wp-content/uploads/2018/05/Integritax_Jan_2017_Issue_208.pdf) [2019, 8 June]; BPR 205; BPR 242;

This allows for example that a VCC could contribute more in monetary/ economic value but receive a smaller qualifying interest which means it would not exceed the 70% threshold.<sup>61</sup> This could occur for example where different classes of shares are issued to enable a BBBEE partner to enjoy similar qualifying interest although contributing less financially. Where for example three classes of shares exist, two of which are entitled to an additional distribution of profits, after which all three classes of shares rank *pari passu* in all respects, the share classes will not be considered hybrid equity instruments, but rather ‘equity shares’ as defined.<sup>62</sup>

Treasury has identified that the issuing of different classes of shares was being used in schemes abusing the incentive<sup>63</sup> and considered limiting the regime so that VCC’s and qualifying companies can only issue one class of share. This was heavily opposed by stakeholders, stating that it would guarantee the premature end of the VCC incentive and that there were various paramount and internationally accepted reasons for justifying the use of more than one class of share. In respect of a VCC, different classes of shares were being used:<sup>64</sup>

- within the VCC for the carried interest purposes of VCC management (no VCC deduction obtained for it) after receiving a pre-determined return on investment for VCC shareholders;
- for different rounds of capital raising by the VCC to ensure a cash flow waterfall for qualifying companies; and
- to channel investments into different industrial sectors within a single VCC.

In respect of the qualifying company different classes of shares were being used:

- to ensure a preferent right to recovery for the VCC;
- for assurance of governance control in the qualifying company;
- that existed before the VCC investment;
- to avoid the dilution of the original entrepreneur’s shareholding.

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<sup>61</sup> Ibid

<sup>62</sup> Section 8E(1), definition of “hybrid equity instrument”, subparagraph (b)(ii)(aa). See also SARS Binding Private Ruling 264.

<sup>63</sup> See Chapter 3, subsection 3.4

<sup>64</sup> SARS, National Treasury: Final Response Document on Taxation Laws Amendment Bill, 2018 and Tax Administration Laws Amendment Bill, 2018:29

Following this, Treasury did not impose the restriction on different classes of shares. It did however introduce the following:

- The VCC's status must be withdrawn and the VCC penalized if, after a 36 month deferral period, any investor holds more than 20% of any class of venture capital shares.
- No shares issued by the VCC solely for services rendered in respect of the incorporation, marketing, management or administration of the VCC or qualifying company will qualify as VCC shares and no deduction may be claimed.

#### *FSP license*

A VCC is required to obtain authorization as a financial service provider. In order to obtain and maintain the license, some of the key aspects a VCC must continuously adhere to are:

- It needs a key individual that meets the fit and proper requirements as listed;<sup>65</sup>
- It must at all times be satisfied that every director, who is not a key individual in the provider's business, complies with the requirements in respect of personal character qualities of honesty and integrity.<sup>66</sup>
- Its representatives are competent to act and comply with the fit and proper requirements.<sup>67</sup>
- It is required to submit audited financial statements to the registrar within four months after year end<sup>68</sup>. The auditor is required to report any irregularity in the affairs of the FSP that it became aware of and that is material.<sup>69</sup>
- The registrar may by notice in the Gazette declare a particular business practice as undesirable. If so, a representative may not on or after that date carry on that business practice. The registrar may give notice to a FSP who carries on the practice to rectify it, after which the FSP must comply within 60 days.

Failure in respect of the above will not only mean that the VCC status may be withdrawn but also that a fine not exceeding R10 million or imprisonment not exceeding 10 years (or both) be applied.<sup>70</sup>

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<sup>65</sup> Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002). Section 8(1A)

<sup>66</sup> Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002). Section 8(10)(a)

<sup>67</sup> Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002). Section 13

<sup>68</sup> Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002). Section 19(2)

<sup>69</sup> Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002). Section 19(4)

<sup>70</sup> Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002). Section 36

The 'fit and proper' requirements ought to provide some surety that the VCC management is up to the task and will do so in an ethical and honest way. A requirement that the VCC be audited provides further assurance. As noted above, the registrar may declare a business practice as undesirable, which could prevent certain schemes that are abusing the section 12J regime.

#### *Thresholds and 36 month deferral*

Originally the 36 month deferral period started from the date of application for VCC approval as opposed to the first date of issue of VCC shares.<sup>71</sup> With reference to section 2.2.2. of this dissertation, the approval process takes some time and a VCC can only start sourcing investors and investee's afterward. The change to the provision relating to the first issue of VCC shares allows a VCC more time to satisfy the requirements and is viewed by the writer as an improvement to the legislation.

The 2009 amendments also allowed for a slight relaxation of the requirements subject to the 36 month deferral period. A requirement that 10% of funds were allocated to qualifying companies with a book value of less than R5 million, was removed. The requirement that no more than 10% of gross income may be derived from sources other than financial instruments or services rendered to a qualifying company in which the VCC holds shares, was amended to not more than 20% of gross income from investment income as defined in section 12E(4)(c) other than dividends from qualifying shares and proceeds from investment in qualifying shares. This was considered to be more in line with the 80% qualifying investments requirement.<sup>72</sup> There was however a mismatch due to the change. The initial requirement was aimed at ensuring that substantially all of the gross income of a VCC must be derived from financial instruments or services rendered to qualifying companies<sup>73</sup> whereas the amendment only addressed investment income. As such there was no specific monetary restriction on non-investment income, which source may not be in line with the purpose of the VCC. The 2011 amendments<sup>74</sup> removed this requirement entirely and is discussed further below.

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<sup>71</sup> SARS, Explanatory Memorandum on the TLAB 2008:67

<sup>72</sup> SARS, Explanatory Memorandum on the TLAB 2009:72

<sup>73</sup> SARS, Explanatory Memorandum on the TLAB 2008:69

<sup>74</sup> SARS, Explanatory Memorandum on the TLAB 2011:76

The prohibition against having more than 20% passive income in a single year was removed so that temporary cash build-ups do not undermine the regime. The VCC must, however, still spend at least 80% of its funds in acquiring shares in qualifying companies within the 36 month deferral period. It was thought that the 80% requirement would be sufficient by itself to ensure (by applying objective principles) that the VCC is directed to its objective.<sup>75</sup>

A potential stumbling block on the 80% deployment of the VCC's capital is that the measurement is 36 months from the first issue of any VCC share and not each separate VCC share, or class of share. This makes it less likely that a VCC will be able to enter into multiple fund raises. As such, a VCC manager might need to create new VCC's for each round of funding.<sup>76</sup> This may provide some explanation as to the number of VCC's on the SARS database that appear to be connected to the same venture capital managers. The 2019 TLAB, once promulgated, will provide that a VCC can take up to four years to make suitable investments, with an effective date from 21 July 2019.<sup>77</sup> Treasury has tried to protect the fiscus by imposing a cap on the amount a person can claim as a deduction each year<sup>78</sup> but this is counterintuitive to allowing a VCC an additional year to invest into qualifying companies.<sup>79</sup> If the incentive is based on the premise that a short term loss to the fiscus is offset against the long term growth of the economy which will increase tax revenues, allowing another full year for VCC's to find suitable investment will increase the timing delay between the initial loss to the fiscus and future tax revenue growth.<sup>80</sup>

With effect from 1 January 2012, the minimum monetary investment requirement was removed. The reasons cited were that it was contradictory to the regime.<sup>81</sup> The diversification requirement was also eased to some extent so that the VCC can invest up to 20% of its capital in a qualifying

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<sup>75</sup> Ibid

<sup>76</sup> Smal R. 2018. Thorts – Section 12J – Overview, developments and obstacles. *InceConnect*. Available <http://www.inceconnect.co.za/article/thorts-section-12j-overview-development-and-obstacles-2018-09-14> [2019, 17 August]

<sup>77</sup> SARS. Taxation Laws Amendment Bill 2019. At page 12

<sup>78</sup> See section 2.4

<sup>79</sup> Whitfield B. 2019. Balancing retirement annuities (RAs) and Section 12J investments. *Capetalk*. Available <http://www.capetalk.co.za/podcasts/201/the-best-of-the-money-show/261894/balancing-retirement-annuities-ras-and-section-12j-investments> [2019, 17 August]

<sup>80</sup> Ibid

<sup>81</sup> SARS, Explanatory Memorandum on the TLAB 2011:76

company (increased from 15%). Hence, a VCC can satisfy the criteria by investing in a minimum of five qualifying companies. Although the increase should provide some relief, the 20% threshold limits the scope of qualifying companies that a VCC can invest in. The investee may require substantial investment and 20% of a VCC's funds might not be enough. This may lead to the qualifying company missing out on funding, or require it to negotiate with more than one party.<sup>82</sup> Although this requirement is subject to the 36 month deferral period, which means a VCC may invest more than 20% initially, the penalties of not satisfying the requirement is so severe that it would be high risk for a VCC to invest a very high percentage of its capital in a particular qualifying company without having the certainty that it will be able to source both sufficient investors and other qualifying companies before the expiry of 36 months.

Other amendments have increased the assets limit imposed on qualifying companies and junior mining companies from R20 million<sup>83</sup> (R10 million prior to 2012) and R300 million<sup>84</sup> (R100 million prior to 2012) to R50 million and R500 million respectively<sup>85</sup>. Notably these further increases were initially proposed by industry in 2011,<sup>86</sup> but only in 2014 did Treasury decide to increase the levels.

The 2014 TLAB also proposed that the 20% and 80% rules be amended by including capital gains with the total subscription monies received, or expenditure incurred, on which the percentage limit is to be applied. Industry was concerned about the unintended consequences this would have and it was decided to withdraw this amendment.<sup>87</sup> It stands to reason that where a VCC realizes a gain on exiting an investment, the original subscription monies go back into the pool and will be required to satisfy the 20 and 80% tests. However, the gain is now “untainted” and may be used to by the VCC as it deems fit as long as it does not mean that the VCC will fail the sole object test (see below).

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<sup>82</sup> Smal R. 2018. Thorts – Section 12J – Overview, developments and obstacles. *InceConnect*. Available <http://www.inceconnect.co.za/article/thorts-section-12j-overview-development-and-obstacles-2018-09-14> [2019, 17 August]

<sup>83</sup> SARS, Explanatory Memorandum on the TLAB, 2011:77

<sup>84</sup> Ibid

<sup>85</sup> SARS, Explanatory Memorandum on the TLAB, 2014:51

<sup>86</sup> SARS, National Treasury: Final Response Document on Taxation Laws Amendment Bill, 2011:26

<sup>87</sup> SARS, National Treasury: Draft Response Document on Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill, 2014:28

### *Sole object*

The 2009 TLAB also introduced one additional requirement on VCC's- that the sole object of the VCC must be the management of investments in qualifying companies.<sup>88</sup> The relevant explanatory memorandum notes that, with regards to the sole object of the company, the VCC can still engage in other activities ancillary to its sole purpose (such as the leasing of excess office space or investing in short-term debt instruments or preference shares for temporarily liquid capital). The VCC Guide advises that whether a VCC is renting out excess space as opposed to that it has acquired extra space with the purpose of renting it out can only be determined on a case-by-case basis.<sup>89</sup> A similar comment is made in respect of investment of surplus funds into anything other than qualifying companies and that the terms of the investment and the relevant facts will need to be considered on a case-by-case basis in order to determine whether this transgresses the sole object test. It should further be noted that neither the explanatory memorandum nor the draft SARS guide are part of SA law. These documents are merely of persuasive nature.<sup>90</sup>

The purpose of the sole object test is to ensure that only eligible companies are approved to be VCC's. It is an anti-avoidance measure and as such should be construed in such a way that it will advance the remedy provided thereby and suppress the mischief against which it is directed.<sup>91</sup> The ordinary meaning of 'sole object' is that there is only one object. Notwithstanding the comments made in the explanatory memorandum and the VCC Guide, on a strict interpretation this would mean that any ancillary objective will be in contravention of the sole object test. However, it stands to reason, based on the documents available at the time that the legislation was being prepared, such as the explanatory memorandum, that this would be nonsensical. What remains apparent is that there appears to be no exact answer as to when the sole purpose test is failed, as each case will need to be decided on a case-by-case basis. This leads to uncertainty in the industry. It will likely also be difficult for SARS to effectively monitor when this requirement is breached.

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<sup>88</sup> Here after referred to as the 'sole object test'

<sup>89</sup> SARS. 2018. The VCC Guide. At page 2

<sup>90</sup> De Koker AP, Williams RC. 2019. Silke on South African Income Tax. Chapter 25 Interpretation. 25.16 Sars' interpretation

<sup>91</sup> (1995) 59 SATC 126 at 136-7. See also Natal Joint Municipal Pension Fund v Endumeni Municipality 2012 (4) SA 593 (SCA) (16 March 2012) at 18

Furthermore, there is already a requirement that 80% of capital should be invested in qualifying companies, and prior to 1 January 2012 there was also a percentage-based limit on the income from non-qualifying investments. Both these requirements were determined in monetary terms, which leaves little room for uncertainty and, to a large extent, is aimed to achieve the same result as the sole object test. The requirements were however deferred for 36 months which might still require a test from day one, i.e. the sole purpose test.

#### *Final comments on the VCC*

VCC's find it challenging to continually modify their business models to remain compliant with the regular changes to the tax law. The industry would benefit from policy certainty and stability going forward.<sup>92</sup>

There appears to be no relief from the VCC requirements at a stage when the VCC has to exit from a qualifying company. This could lead to the VCC, if only temporarily, breaching the VCC requirements. Except for section 12J(3B), discussed below, it is however noted that SARS would generally notify and provide opportunity for the VCC to take corrective steps before withdrawing its VCC approval.<sup>93</sup> 'Corrective steps that are acceptable to SARS' is not defined and would likely just require the company to satisfy the VCC requirements within the required period. The ITA does not specifically provide for how long the period is that the Commissioner must grant the company to comply. Generally a taxpayer is allowed 21 days to respond to requests from SARS, which is likely to apply in this case.

The VCC needs to monitor its investors to ensure that no single investor becomes a connected person or holds more than 20% of any class of share. The retrospective withdrawal of the VCC status is concerning to fund managers.<sup>94</sup> Notably, in terms of section 12J(3B), there does not appear to be opportunity provided for the VCC to even correct the 20% shareholding in any class of share

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<sup>92</sup> MoneyMarketing. 2019. Industry body responds to the draft Section 12J changes. Available <https://www.moneymarketing.co.za/industry-body-responds-to-the-draft-section-12j-changes/> [2019, 3 August]

<sup>93</sup> Sections 12J(3A), 12J(6), 12J(6A) of the ITA

<sup>94</sup> Smal R. 2018. Thorts – Section 12J – Overview, developments and obstacles. *InceConnect*. Available <http://www.inceconnect.co.za/article/thorts-section-12j-overview-development-and-obstacles-2018-09-14> [2019, 17 August]

within a reasonable time, which the Commissioner does allow in terms of section 12J(3A), the connected person test. This is discussed further in section 2.4.

### **2.3. The investee**

Incentives are generally very specific and focused on particular areas of the economy. In this sense section 12J defines the type of companies that may be invested into by the VCC, i.e. the ‘qualifying companies’. This section discusses each of the qualifying company requirements, how these have been amended and the additional requirements that have been imposed.

#### *SA tax resident company*

Similar to a VCC, a qualifying company may be incorporated overseas, but which has its place of effective management in SA as long as it is not exclusively considered a resident of the other country in terms of the double tax treaty.

As will be discussed later on, a qualifying company must mainly conduct its trade in SA. As such, as long as its trade overseas accounts for less than 50% of its business, a qualifying company can conduct its trade overseas.

#### *Controlled group company*

2011 saw a general relaxation of the regime, including the requirements for a qualifying company. This included the removal of the reference to the connected person definition in respect of a controlled group company, which had the effect of increasing the ownership percentage that a VCC may have from 50% to 70%. Please refer to the discussion under section 2.2.

#### *Tax compliant*

The company must comply with all its tax obligations as required under the laws administered by the Commissioner. This requirement includes, for example, complying with all registration

requirements, the timely submission of all tax returns and the payment of any tax liability, interest or penalties.<sup>95</sup>

However, as noted in Chapter 1, the cost for SME's to administer and comply is significant. As much as 23% of companies that were expected to submit tax returns for 2016 had not been assessed by 30 June 2018.<sup>96</sup> In a recent news article, Treasury was quoted as saying that of an estimated 2.8 million SME's only 1 million were formally registered.<sup>97</sup> For a number of reasons, there is a high probability of start-ups and SME's not being fully tax compliant. This ranges from reasons such as not having registered for all the types of tax as required due to a lack of know-how, not paying taxes on time and the high cost of being compliant relative to a SME's income. Once a person has been non-compliant for tax for a number of years, penalties and interest start to accumulate. Although there are various SARS processes available to regularize a company's tax affairs, reduce exposure to penalties and enter into payment arrangements, applying them requires some level of know-how and time. One of the processes, the voluntary disclosure program, has a turnaround time of about 10 months.<sup>98</sup>

A suggestion may be made that the 'tax compliant' requirement should be satisfied within a reasonable time to allow the VCC to invest in and then assist the investee in becoming tax compliant, through funds and also skills. There is however a significant risk of investing into a non-compliant company. The VCC would run the risk of the non-compliance not being rectified in time, which would likely mean the investee will not satisfy the qualifying company criteria which would impact on whether the VCC satisfies all of its criteria and would then impact the investor. It is also likely that the non-compliance could indicate mismanagement and potentially unethical behavior. These are however business risks which may be addressed by an in-depth due diligence and risk assessment. The writer is of the view that cases where taxpayers, especially SME's, are seeking to regularize their tax affairs should be prioritized and expedited. The following three benefits are apparent:

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<sup>95</sup> SARS. 2018. The VCC Guide. At page 7

<sup>96</sup> National Treasury and the South African Revenue Services, December 2018, 2018 Tax Statistics. At page 151

<sup>97</sup> Girnun D. 2019. How to feed the funding life-cycle of a small business. Available <https://www.sowetanlive.co.za/sebenza-live/2019-09-09-how-to-feed-the-funding-life-cycle-of-a-small-business/> [2019, 9 September]

<sup>98</sup> <https://www.sars.gov.za/Legal/VDP/Pages/default.aspx> [2019, 1 July]

- i) More companies (as much as 23%) would be considered qualifying companies as defined, allowing for a larger reach for the VCC regime;
- ii) SME companies that were previously not tax compliant, will now become tax compliant leading to an increased tax base and potential tax revenue; and
- iii) The success rate of SME's might increase slightly, due to investments received, reduced tax penalty exposure and management experience.

#### *Unlisted or junior mining company*

An unlisted company as defined in section 41(1)<sup>99</sup> means any company that is not a listed company as per section 41(1), which in turn refers back to the listed company definition in section 1(1)(a). As such a qualifying company cannot be a company that is listed on an exchange as defined in the Financial Markets Act and licensed under section 9 of that Act unless it is a junior mining company as defined.

A junior mining company means any company that is solely carrying on a trade of mining exploration or production which is either an unlisted company as defined in section 41 or listed on the alternative exchange division of the JSE Limited (i.e. the AltX). As noted in the VCC Guide, the AltX caters specifically for small and medium sized companies.

The writer is of the opinion that allowing all qualifying companies in general to list on the AltX broadens the scope of qualifying investments and allows the companies to source funds via the AltX while not impairing their ability to obtain VCC funding.

#### *Impermissible trade*

On introduction, both the requirement pertaining to investment income not exceeding 20% and trade that is not an impermissible trade, allowed for a delay of 18 months (36 months for junior mining companies). This created problems for SARS due to their predictive nature. To address this, the requirements were amended during 2009. It is now merely required that a qualifying company is not carrying on any impermissible trade i.e. from day one. The overall requirement

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<sup>99</sup> Section 12J refers to the definition of "unlisted company" as defined in section 41.

that the company should be trading would be addressed by imposing the limitation on investment income and is further discussed below.

Before the amendment, the requirement was that the company should mainly carry on a trade that is not an impermissible trade, whereas the amended requirement states that it must not carry on *any* impermissible trade. As such, prior to the amendment the qualifying company could arguably have conducted impermissible trade as long as it was subsidiary to its main trade. This amendment ensures that the funds are not misdirected.

The definition of impermissible trade includes any trade carried on in respect of:

- i) immovable property, other than a trade carried on as an hotel keeper;
- ii) a bank as defined in the Banks Act, a long-term insurer as defined in the Long-Term Insurance Act, a short-term insurer as defined in the Short-Term Insurance Act, and in respect of money-lending or hire-purchase financing;
- iii) financial or advisory services, including trade in respect of legal services, tax advisory services, stock broking services, management consulting services, auditing or accounting services;
- iv) gambling;
- v) liquor, tobacco, arms or ammunition; and
- vi) any trade carried on mainly outside the Republic;

The only significant change to this definition since the introduction of section 12J is that a trade as a franchisee used to be included as an impermissible trade. Small businesses of this nature often need outside equity support to initiate or expand operations.<sup>100</sup> From 1 January 2012, VCC can now also invest into franchisees.

In order to more meaningfully interpret the impermissible trade requirement, it is necessary to consider relevant case law regarding interpretation. The word ‘any’ may be restricted by the

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<sup>100</sup> SARS, Explanatory Memorandum on the TLAB 2011:77

subject matter or the context, but *prima facie* it is unlimited.<sup>101</sup> Trade should be given a wide interpretation<sup>102</sup> and is intended to embrace every profitable activity<sup>103</sup>.

The context in which the words ‘in respect of’ are used is of vital importance.<sup>104</sup> The purpose of listing the impermissible trades is to ensure that the section 12J incentive is not extended to these trades. ‘In respect of’ does not necessarily mean that a direct or causal relationship is required. It may have a wide meaning and may be compared with such expressions as ‘in connection with’, ‘arising out of’, ‘with reference to’, ‘in relation to’ and ‘touching and concerning’.<sup>105</sup> As such, in the context of the current provision, ‘in respect of’ should be interpreted more widely and include trades that are loosely connected to impermissible trades. In binding private ruling 333 SARS appears to have applied a more restrictive interpretation.<sup>106</sup> The ruling states that the taxpayer would either acquire or rent vacant land on which he will undertake farming operations. This would include establishing fencing, netting, irrigation, cold rooms, equipment and planting.<sup>107</sup> It appears as if SARS accepts that in cases where there is no direct link between the business and the immovable property there is no “impermissible trade”.<sup>108</sup>

As such, determining whether a particular trade is ‘in respect of’ an impermissible trade can only be done on a case-by-case basis.<sup>109</sup> Some examples that may assist taxpayers in determining whether their trades will be considered impermissible trades were the subject of the VCC Guide, and will be discussed below.

### *Immovable property, other than a trade carried on as a hotel keeper*

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<sup>101</sup> Rv Hugo 1926 AD 268 at 271; CIR v Ocean Manufacturing Ltd 1990 (3) SA 610 (A) at 618

<sup>102</sup> Burgess v Commissioner for Inland Revenue 55 SATC 185(A) at 196

<sup>103</sup> ITC 770 (1953) 19 SATC 216(T) at 217

<sup>104</sup> ITC 1340 (1980) 43 SATC 210 at 213

<sup>105</sup> SBI v Raubenheimer 1969 (4) SA 314 (A), 31 SATC 209 at 216

<sup>106</sup> Strauss B. 2019. Venture capital companies and trades in respect of immovable property. *Cliffe Dekker Hofmeyr*. Available <https://www.cliffedekkerhofmeyr.com/en/news/publications/2019/Tax/tax-alert-21-november-2019-venture-capital-companies-and-trades-in-respect-of-immovable-property.html> [2019, 22 November]

<sup>107</sup> SARS. 2019. Binding Private Ruling: BPR 333

<sup>108</sup> Strauss B. 2019. Venture capital companies and trades in respect of immovable property. *Cliffe Dekker Hofmeyr*. Available <https://www.cliffedekkerhofmeyr.com/en/news/publications/2019/Tax/tax-alert-21-november-2019-venture-capital-companies-and-trades-in-respect-of-immovable-property.html> [2019, 22 November]

<sup>109</sup> SARS. 2018. The VCC Guide. At page 11

Immovable property comprises of things which cannot be moved from one place to another without damage or a change of form.<sup>110</sup> An incorporeal thing could also be classified as immovable dependent on the nature of the object to which it pertains.<sup>111</sup>

The explanatory memorandum expressly noted that this requirement included development and renting of immovable property.<sup>112</sup> Trading in immovable property, for example real estate, would also clearly be included under this category. Although development was specifically mentioned in the explanatory memorandum, it is not clear whether refurbishment or repairs will be considered an impermissible trade. It is likely to depend on the degree of the work performed. Arguably, interpreting that repairs that are minor compared to the value of the property as an impermissible trade would be too restrictive and unintended, and the writer submits this should not be adopted.<sup>113</sup> For example, taking the purpose and context of the section into account, the work of an electrician or a plumber performing repairs on a building, although being work on immovable property, would not be considered an impermissible trade.<sup>114</sup>

The trade of a hotel keeper is excluded from being an impermissible trade. Hotel keeper is defined to mean any person carrying on a business of hotel keeper or boarding or lodging house keeper where meals and sleeping accommodation are supplied to others for money or its equivalent.<sup>115</sup> As such meals and accommodation must be provided on the same premises. A bed-and-breakfast will satisfy the definition of hotel keeper even though only one meal is provided. The VCC Guide however notes that where a portion of the premises of a hotel is let to a restaurateur, and the restaurateur is entirely responsible for providing meals, the trade is not that of a hotel keeper as defined. The hotel will in this case not receive income from meals but rather rental income from the restaurateur.<sup>116</sup>

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<sup>110</sup> Van der Merwe CG. 2014. "Movables and Immovables" 27 (Second Edition Volume) LAWSA [online] (My LexisNexis: 31 January 2014) in paragraph 51

<sup>111</sup> Van der Merwe CG. 2014. "Incorporeal movables and immovables" 27 (Second Reissue Volume) LAWSA [online] (My LexisNexis: 31 January 2014) in paragraph 52.

<sup>112</sup> SARS, Explanatory Memorandum on the TLAB 2008:71

<sup>113</sup> Natal Joint Municipal Pension Fund v Endumeni Municipality 2012 (4) SA 593 (SCA)

<sup>114</sup> SARS. 2018. The VCC Guide. At page 12

<sup>115</sup> Section 1(1) of the ITA definition of 'hotel keeper'

<sup>116</sup> SARS. 2018. The VCC Guide. At page 11

Notably, where the hotel also sells alcohol with its meals, it is likely that its trade will be an impermissible trade in respect of a trade carried on in respect of liquor.<sup>117</sup> Please refer to below.

*Banks, a long-term insurer, a short-term insurer, and any trade carried on in respect of money-lending or hire-purchase financing*

Banks and insurers, as defined in their respective legislation, are conducting impermissible trades and this leaves little room for uncertainty. What however needs to be considered is what is meant by ‘any trade in respect of money-lending or hire-purchase financing’.

The term ‘Money lender’ is not defined but has been considered in case law. What is required is that there is a certain degree of system and continuity to the lending, and that the money-lender is ready and willing to lend to all.<sup>118</sup> As noted earlier, trade should be given a wide meaning. However, it has been held that a person which is not a financing company and merely earns interest on surplus funds advanced to a subsidiary does not carry on a trade.<sup>119</sup> It appears as if SARS considers this to be passive income and it does not constitute a trade as a money-lender.<sup>120</sup> For this reason, only where a company is an active money-lender would it be considered an impermissible trade. The company will not be disqualified if it merely receives interest income, ancillary to its main business, on for example surplus funds it lent to a group company as this will not be considered a trade in respect of money-lending. This is further supported by the fact that the definition of qualifying company includes a company where the sum of investment income such as interest does not exceed 20% of the company’s gross income. This requirement is further discussed below

Hire-purchase relates to a specific way of financing, for example in terms of instalment payments. Even if this is ancillary to a company’s main business, SARS will view the company as conducting an impermissible trade. This could arise for example where a company’s main business is the sale of machinery and some of its clients have bought the machines on credit, subject to credit

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<sup>117</sup> SARS. 2018. The VCC Guide . At page 13

<sup>118</sup> *Sentra-oes Kooperatief BPK v Kommissaris van Binnelandse Inkomste*. 1995. 57 SATC 109. At 112. *Solaglass Finance Company (Pty) Ltd b Commissioner for Inland Revenue*. 53 SATC 1. At 15

<sup>119</sup> ITC 496 (1941) 12 SATC 132 (U) at 132

<sup>120</sup> Practice note 31. 3 October 1994. Income Tax: Interest paid on moneys borrowed

agreements.<sup>121</sup> However, this could be debated as, recently, SARS seems to accept that an indirect link between an impermissible trade and the qualifying company will not disqualify said company.<sup>122</sup>

### *Gambling*

This would include operations such as a casino or national lottery. The VCC Guide notes that the development of a new game of chance which is patented and is sold to a casino would also be an impermissible trade due to being inextricably linked to and facilitates gambling.<sup>123</sup> Similar to above this could be contested as the link to gambling is indirect, and the VCC regime was targeted to provide equity finance to high-tech companies.<sup>124</sup>

### *Liquor, tobacco, arms or ammunition*

Manufacturing, buying or selling of liquor, tobacco, arms or ammunition is included under this category. The VCC Guide notes that a company's trade does not have to primarily involve these activities, for example where a hotel keeper sells liquor with its meals it would be considered an impermissible trade.<sup>125</sup> However, SARS does seem to accept situations where the liquor is being sold in the hotel by another person, not the hotel keeper. The person that provided the liquor may bill the hotel keeper, which can recover the bill, at no additional mark-up, from the guest.<sup>126</sup>

### *Mainly outside the Republic*

The word 'mainly' establishes a purely quantitative measure of 'more than 50%'.<sup>127</sup> As such, a company is not prohibited from conducting a trade outside of SA as long as it does not exceed 50%. Considering that a resident company also includes a company that is not incorporated in SA but has its place of effective management in SA provides for some opportunity and flexibility for growing a business across borders.

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<sup>121</sup> SARS. 2018. The VCC Guide . At page 14

<sup>122</sup> SARS. 2019. Binding Private Ruling: BPR 333

<sup>123</sup> SARS. 2018. The VCC Guide . At page 15

<sup>124</sup> <http://www.treasury.gov.za/documents/national%20budget/2008/review/chap4.pdf> [2019, 25 May]

<sup>125</sup> Ibid

<sup>126</sup> SARS. 2019. Binding Private Ruling: BPR 314

<sup>127</sup> De Koker AP, Williams RC. 2019. Silke on South African Income Tax. Chapter 25 Interpretation. 25.7E 'Solely or mainly'

### *Investment income limited to 20%*

As noted above, the investment income limit was amended from initially only applying after 36 and 18 months for junior mining company or any other qualifying company respectively, to applying immediately. It was however noted that a qualifying company's business could be both time and infrastructure intensive and that the qualifying company is only able to generate income, other than investment income, upon completion of the infrastructure. This could lead to a company losing its status as a qualifying company which will negatively impact both the VCC and investor. Accordingly, 2018 saw an amendment that once again introduced an element of deferral for this test. This required that after 36 months from the first date on which a qualifying company issued shares to a VCC, the sum of investment income may not exceed an amount equal to 20% of gross income of that company for that year.<sup>128</sup>

Notably, this requirement would prevent a VCC from investing into a group of companies at the holding company level, where the holding company mainly receives investment income from the operating companies it holds.

### *New requirements*

2018 saw further amendments specifically aimed at abusive schemes. This included 'targeted' VCC structures that allowed an investor the ability to invest in their own businesses with the benefit of both the participation and voting rights in the underlying qualifying company. It was proposed that a qualifying company is only allowed to issue a single class of shares to address this. Industry however convinced Treasury otherwise. Please refer to section 2.2.3 regarding the 'Classes of shares' discussion. Measures to counter abuse were also included and the following amendments were introduced.

### *Trade with investor*

With effect from 24 October 2018, not more than 50% of amounts in aggregate received by the company from carrying on a trade, may be directly or indirectly derived from a person, or a connected person to that person, who holds a share in a VCC.

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<sup>128</sup> SARS, Explanatory Memorandum on the TLAB 2018:29

This limits a qualifying company from obtaining income from investors of a VCC. It however does not limit investors from obtaining income from a qualifying company, whether by means of for example salary, service fees or sale of goods.

*No control*

No person holding shares in a VCC (note that this does not refer to VCC shares (see below)), alone or together with connected persons, may hold more than 50% participation rights or voting rights in the qualifying company.

Notably, the requirement specifically includes any share issued by a VCC and not just VCC shares as defined. As such, shares issued by the VCC for services rendered solely in respect of services rendered or to be rendered for the incorporation, marketing, management or administration of the VCC or any qualifying company in which the VCC holds shares will be included. Considering the wide ambit of the definition of connected person, where, for example, a VCC holds a controlling interest in a qualifying company, and a director of the VCC is considered to be a connected person to the VCC while also holding shares in the VCC, this particular qualifying company requirement will not be met.

*Business not acquired from investor or connected person*

A company cannot carry on a trade that is a venture, business, undertaking or part thereof that was also acquired, directly or indirectly, from a person, or its connected person, that holds a share in a VCC, and that company issued shares to that VCC. This ought to prevent a taxpayer from selling his business to a qualifying company, and then subscribing for shares in a VCC that subscribes for shares in that qualifying company.

Arguably, if a natural person however trades through or sold his business to a company before 1 January 2019, and now exits the company by a way of a share buy-back with a VCC subscribing for new qualifying shares, this provision may be by-passed in that the VCC did not “acquire” the business from the investor. It should be noted that other tax implications could arise due to a share buy-back. The investor may then re-invest into the VCC and reduce his capital gain tax liability. Nothing prevents the natural person from still playing an active role in the underlying business and

receiving compensation (for example, a salary). Since many businesses are conducted through companies and not as sole proprietors, this may require further consideration in future. Furthermore, where a company buys back shares (in aggregate exceeding R10 million) and then issues shares within 12 months, it will constitute a “reportable arrangement”.<sup>129</sup>

## **2.4. The investor**

### *The type of investor and removing the monetary limitations*

Generally, an equity investment is not tax deductible. However, section 12J allows for an upfront tax deduction of the amount invested by the investor into a VCC. Initially only natural persons (and to some extent listed companies) qualified for the tax deduction if investing into VCC’s. Furthermore, each natural person was limited to a maximum investment of R750,000 per year (and R2.25 million cumulatively). The deduction was not permanent but rather subject to a recoupment occurring on eventual sale of the investment held. The monetary limits were however replenished following such a recoupment. Other income tax rules, like capital gain tax, still applied as per usual.<sup>130</sup>

To prevent natural persons from by-passing the R750,000 and R2.25 million limits by making investments through controlled entities juristic persons, such as unlisted companies and trusts, did not qualify for the tax deduction.<sup>131</sup> Listed companies, and their 70% owned group companies, could qualify for the deduction. There was no fixed monetary threshold but no deduction was allowed for the part of the investment that exceeded a 10% equity shareholding into a VCC.<sup>132</sup> It appears to the writer that it was considered that, due to the nature of a listed company and that its shares are publicly traded, it was considered to be less likely that a listed company would be controlled by a single individual natural person and there was thus no reason to impose a fixed monetary figure to the 10% available tax deduction.

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<sup>129</sup> South African Revenue Service. 2016. *Government gazette* 608(39650). 3 February. Government notice no. 140. Page 5

<sup>130</sup> SARS, Explanatory Memorandum on the TLAB, 2008:68

<sup>131</sup> Ibid

<sup>132</sup> Ibid

The purpose of the 10% requirement was to ensure diversification in VCC ownership.<sup>133</sup> However, considering that a VCC would further diversify its investment in different qualifying companies it becomes less relevant to diversify between different VCC's. The 10% was increased to 40%, effective from 1 July 2009,<sup>134</sup> with the purpose to cater for anchor company investors. This could provide a level of security, acting as a catalyst for attracting smaller retail investors.<sup>135</sup> However, anti-avoidance provisions promulgated in 2011 required that no deduction would be allowed where an investor into a VCC is a connected person to that VCC.

A connected person, *inter alia*, includes a company that holds at least 20% of the voting rights or equity shares in a company and no holder of shares holds the majority voting rights in that company.<sup>136</sup> None of the Explanatory Memoranda indicate whether it was intended to also limit listed companies that were supposed to be anchor investors.

At the initial stages of a VCC finding investors, large investors could hold more than 20%. As such several large investors opted out of the VCC initiative which made it less likely that smaller investors would come on board as well.<sup>137</sup> From 1 January 2017 the application of the connected person test was thus deferred by 36 months after the first issue of VCC shares.<sup>138</sup> The amendments did go further and required the withdrawal of the VCC status if the connected person test was failed after the 36 deferral period.<sup>139</sup>

Another anti-avoidance provision, effective from 24 October 2018, requires that no shareholder holds more than 20% of VCC shares in any class of shares after the 36 month deferral period.<sup>140</sup> This would mean that after 36 months a listed entity (or any other person for that matter) holding more than 20% equity shares or voting rights in a VCC will be disqualified from claiming the deduction (not even in part). The legislation is specifically worded in that the investor will not be

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<sup>133</sup> SARS, Explanatory Memorandum on the TLAB, 2009:73

<sup>134</sup> Ibid

<sup>135</sup> Ibid

<sup>136</sup> Section 1 definition of 'connected person' paragraph (d)(v)

<sup>137</sup> SARS, Explanatory Memorandum on the TLAB, 2016:49

<sup>138</sup> SARS, Explanatory Memorandum on the TLAB, 2016:49

<sup>139</sup> SARS, Explanatory Memorandum on the TLAB 2016:50

<sup>140</sup> SARS, Explanatory Memorandum on the TLAB, 2018:30

allowed a deduction in respect of “that year”. Furthermore, tax is an annual event.<sup>141</sup> As such there ought to be no recoupment for investors that claimed the deduction in prior years, although the VCC will be subject to the 125% inclusion of amounts claimed by the investors- see below.

After 36 months a new investor would be disallowed from claiming a new section 12J deduction and the VCC will be subject to income tax on 125% of the investment. As a result the difference between the incentive being utilized and the application of the anti-avoidance provision is an increase in taxable income of 225% (100% non-deductibility for the investor and 125% inclusion of the VCC).

The reasoning behind the 125% inclusion rate was because it translated roughly back to the benefit an individual would have had from the deduction if he had a marginal tax rate of 40%.<sup>142</sup> 40% used to be the maximum marginal tax rate. Since then, the marginal rate has now increased to 45%. Furthermore, any taxpayer may now invest into a VCC and obtain the deduction, not just individuals.<sup>143</sup> The reasoning behind the 125% inclusion is thus outdated and the writer is of the view that it might require re-assessment.

It should be noted that the test would not apply to any shares issued before 24 October 2018. Notably, the response document stated that the limit is to be applied to all shares issued by the VCC whereas the ITA specifically notes that the test is to be applied on VCC shares only, i.e. shares issued in respect of incorporation, marketing, management or administration of the VCC or qualifying company, third-party backed and hybrid equity shares should likely not be taken into account when determining the 20% test.

Holding more than 20% of any class of VCC share would have the same effect. The 36 month deferral period was introduced as a measure to prevent investors in the initial stages of unintentionally breaching the requirements while the VCC is still raising funds.<sup>144</sup> As such it is not a measure to attract anchor investors and will prevent anchor investors that intended to hold a

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<sup>141</sup> Caltex Oil (SA) Ltd v Secretary for Inland Revenue 1975 (1) SA 665 (A) at 677H-678A

<sup>142</sup> SARS, Explanatory Memorandum on the Revenue Law Amendment Bill, 2008:71

<sup>143</sup> SARS, Explanatory Memorandum on the Revenue Law Amendment Bill, 2011:75

<sup>144</sup> SARS, Explanatory Memorandum on the TLAB, 2016:49

major stake throughout the VCC life cycle, such as an investment of 40% by a listed company, from investing. Anchor investors were to be a catalyst. With less incentive for such investors it will arguably lead to less retail, or smaller, investors coming onboard.<sup>145</sup>

The monetary limitations on natural persons were ultimately removed. As such there was no reason to exclude controlled entities from the investor pool. With this in mind a further amendment was made to allow any taxpayer to qualify for the incentive, to the extent that the other provisions were adhered to.<sup>146</sup> Not only did this mean a much wider investor pool being allowed to invest into a VCC, but they were incentivized to contribute as much as they wanted. Arguably, natural persons in their personal capacities may not have control over significant funds whereas a juristic person, which is controlled by for example boards, members and trustees, furthering the interest of any number of natural persons, could have material capital at its disposal.

The inclusion of all taxpayers and removing the monetary limitation on deductions are seen as positive steps towards the intention of the incentive. It increases the pool of potential investors, as well as the amount they are likely to invest. The higher these are, the larger the eventual investments into SME's are likely to be. Due to the connected person test, and the 20% limit on any class of VCC share, there is however no incentive for long-term anchor investors which would likely mean that these will opt out of the regime and, as a result, that smaller investors are less likely to come on board.

#### *Re-introducing of the monetary limitation*

Treasury has however indicated that it plans on re-introducing a deduction limitation of R2.5 million per annum per taxpayer to counter abuse in the form of excessive tax deductions. It is proposed that this change will be effective from 21 July 2019.<sup>147</sup> This is likely to reduce the number of new investors but especially anchor investors. In turn, this increases the risk for, and thus is likely to reduce, the number of smaller investors. Industry notes that Treasury indicated the reason

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<sup>145</sup> Ibid

<sup>146</sup> SARS, Explanatory Memorandum on the TLAB, 2011:75

<sup>147</sup> SARS, Explanatory Memorandum on the TLAB, 2019:36

for the caps were to protect the fiscus from excessive tax deductions.<sup>148</sup> The draft bill also does not take into account that those that intend to abuse the incentive can merely introduce further legal entities that will qualify for a further R2.5 million deduction (which was previously prevented by only having natural persons and listed entities qualify for the deduction).<sup>149</sup> With this said, no distinction is being made between different types of taxpayers, for example listed companies, unlisted companies, trusts and natural persons. Different capital gains tax inclusion rates and tax rates are applicable to different taxpayers. The loss to the fiscus is significantly less when a company invests into a VCC as opposed to a natural person taxed at the maximum marginal rate. The below example illustrates this:

**Example 2.4.1.**

*A taxpayer invests R2.5 million into a VCC during the year. The reduction in tax payable: for an Individual, taxed at the marginal rate of 45%, is*

$$R2,500,000 \times 45\% = R1,125,000;$$

*and for a Company, taxed at 28%, is*

$$R2,500,000 \times 28\% = R700,000.$$

*Assuming the same taxpayers as per above, if the VCC shares are sold after 5 years for R2.5million. The increase in tax payable (capital gains tax) is calculated as:*

$$\text{Individual: } R2,500,000 \times 40\% \times 45\% - R40,000 = R410,000$$

$$\text{Company: } R2,500,000 \times 80\% \times 28\% = R560,000$$

*Accordingly, after 5 years the direct net loss to the fiscus is:*

$$\text{Individual: } R1,125,000 - R410,000 = R715,000$$

$$\text{Company: } R700,000 - R560,000 = R140,000$$

The cost to the fiscus, but also the incentive for the investor, is further reduced if a capital gain arises. The effect is compounded when both the VCC and its shareholders dispose of their

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<sup>148</sup> Whitfield B. 2019. Balancing retirement annuities (RAs) and Section 12J investments. *Capetalk*. Available <http://www.capetalk.co.za/podcasts/201/the-best-of-the-money-show/261894/balancing-retirement-annuities-ras-and-section-12j-investments> [2019, 17 November]

<sup>149</sup> Subject to general anti-avoidance rules, section 80A to 80L

respective investments for a capital gain since capital gains is triggered on two levels as opposed to a direct investment made by the investor.<sup>150</sup> Continuing on from the previous example, the next example illustrates the effect of the capital tax gain across both the investor and VCC levels:

**Example 2.4.2.**

*For explanatory purposes, the VCC realizes a profit of R1million on each of the R2.5 million originally invested by the individual and the company (i.e. total profit of R2 million). The capital gains tax payable by the VCC per R2.5 million is:*

$$\text{VCC: } R1,000,000 \times 80\% \times 28\% = R224,000$$

*The investors immediately dispose of their VCC shares. The capital gains tax paid by the VCC reduces the net asset value (“NAV”) of the VCC, which reduces the proceeds on disposal of the VCC shares for the investors.*

$$\text{Proceeds for individual and company: } R3,500,000 - R224,000 = R3,276,000$$

*The following capital gains tax consequences arise for the investors:*

$$\text{Individual: } R3,276,000 \times 40\% \times 45\% - R40,000 = R549,680$$

$$\text{Company: } R3,276,000 \times 80\% \times 28\% = R733,824$$

*If there was no VCC interposed and the investors invested directly into the investee, the capital gains tax would have been:*

$$\text{Individual: } (R3,500,000 - R2,500,000) \times 40\% \times 45\% - R40,000 = R140,000$$

$$\text{Company: } (R3,500,000 - R2,500,000) \times 80\% \times 28\% = R224,000$$

*Accordingly, the net cash inflows for the investors after five years, based on the two scenarios, are:*

$$\text{Individual through VCC: } R1,125,000 + R3,276,000 - R549,680 = R4,851,320$$

$$\text{Individual without VCC: } R3,500,000 - R140,000 = R3,360,000$$

$$\text{Additional section 12J benefit: } R4,851,320 - R3,360,000 = R1,491,320$$

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<sup>150</sup> Budget Review 2019. National Treasury. At page 118

*Company through VCC: R700,000 + (R3,276,000 – R733,824)= R3,242,176*

*Company without VCC: R3,500,000 – R224,000 = R3,276,000*

*Detriment due to section 12J investment: R3,242,176 – R3,276,000 = - R33,824*

The above example further illustrates why corporates are less likely to benefit from the section 12J incentive. Treasury has however indicated that the proposed R2.5 million cap will be increased to R5 million for companies.<sup>151</sup>

Industry noted in 2011 that the VCC incentive is wrongfully premised on the intermediary being a company. Rather, a trust would allow for the conduit principle which would increase the incentive for investors. Treasury stated that this would require that the whole incentive be re-considered.<sup>152</sup> It may improve the incentive if the VCC regime is extended to partnerships or trusts, treating the VCC as fiscally transparent or providing an exemption for capital gains tax at either the level of the VCC or the investor.<sup>153</sup>

Whether R5 million is invested by one person, or two persons invest R2.5 million each does not make a difference to the total amount claimed as a tax deduction nor to what is intended to be invested back into the South African economy. The only difference would be the loss of tax revenue where different tax rates would apply as illustrated in Example 2.4.1. As such, it may be suggested that the tax deduction limit be geared for different taxpayers.

Furthermore, only where the taxpayer is subject to a different marginal tax rate, would the limitation have a different result within the same type of taxpayer. For example, a natural person can reduce his/ her marginal tax rate. The writer is of the view that the incentive could rather be limited to the extent that a reduced marginal tax rate would apply due to the section 12J deduction, instead of imposing an overall limit per taxpayer. This may be done by reducing the deduction by a ratio of the change in tax rates. As an example, where a taxpayer would have been taxed at 45%

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<sup>151</sup> SARS. Taxation Laws Amendment Bill 2019. At page 12

<sup>152</sup> Standing Committee on Finance (SCOF): Report-Back Hearings Taxation Laws Amendments Bills, 2011 Response Document from National Treasury and SARS [Final] page 26

<sup>153</sup> Linington, M. 2016. Funding for small and medium-sized enterprises. *Cliffe Dekker Hofmeyr*. Tax and Exchange Control Alert

but for the tax deduction, and is now being taxed at 40%, the said deduction is limited to 40/45 of the amount paid for the VCC shares. However, an optimal tax structure should *inter alia* be simple, and this proposal will likely add complexity to the regime.

Instead of allowing a tax deduction, a tax credit could be another option. For example, by allowing a tax credit of 28% of the amount invested the same tax saving for all taxpayers would be provided notwithstanding their individual tax rates. However, this is likely to have a negative effect on the incentive for investment by high net worth individuals currently being taxed at a rate higher than 28%.

Alternatively, it could be considered that the taxpayer be allowed to carry forward the amount of the investment exceeding R2.5 million that was not allowed as a deduction in the year of investment, to claim as a deduction in the next year, similar to the allowance in respect of donations to public benefit organisations in section 18A and excess retirement fund contributions.

As noted earlier, when the incentive was first introduced, Treasury specifically did not impose monetary limitations for listed entities,<sup>154</sup> and even allowed an investment into a VCC of up to 40%.<sup>155</sup> Considering the need for anchor investors (and the relatively low loss to the fiscus where these are companies), it may be beneficial not to impose a monetary limit on companies and to specifically allow listed entities to invest up to 40%, as a specific exclusion from the 20% and connected person tests.

As per the current wording of the draft bill, the proposed amendment is likely to have a substantially negative impact on new VCC's and the future of the incentive.

#### *Making the deduction permanent*

Effective 1 January 2015, the deduction was no longer subject to recoupment on disposal as long as the shares are held for five years.<sup>156</sup> Prior to the change, Treasury's reasons for not wishing to

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<sup>154</sup> SARS, Explanatory Memorandum on the TLAB, 2008:68

<sup>155</sup> SARS, Explanatory Memorandum on the TLAB, 2009:73

<sup>156</sup> SARS, Explanatory Memorandum on the TLAB, 2014:50

provide the change were that the incentive could be compared to the retirement arena where the deduction was matched by a subsequent recoupment of a taxable lump sum or annuity and that a straight deduction without a recoupment may be a magnet for avoidance transactions.<sup>157</sup> The Response Document did not provide examples of avoidance transactions it foresaw. It is the writer's view that it was referring to VCC's being solely registered to obtain the tax allowance while carefully planning to ensure that the qualifying investments are made but without any real intention to invest into companies or projects that are unaffiliated with the original investor.

Due the increase in the capital gains inclusion rate in 2017 the tax benefit associated with this regime has, however, been somewhat eroded. With reference to Example 2.4.1, it is clear that the benefit for an individual whose marginal tax rate is 45% is much higher than for a company. To the extent that the VCC is able to maintain or grow its investments, the benefit to the corporate investor is largely a timing difference in the form of an upfront tax deduction which is likely to be recovered in the form of capital gains tax later on. Should the VCC fail, and considering the tax rates of the corporate and individual investor, the individual will lose 55% of his capital compared to 72% for the corporate investor. Treasury effectively loses 45% and 28% respectively. Clearly, individual investors have less to risk and more to gain than corporate investors.

Nevertheless, the upfront tax deduction is still very appealing in that it provides an 'immediate return' and reduces investor risk. If a profit arises on exiting the investment, it is noted that the upfront deduction would have reduced the base cost to nil. This would mean that the capital gain will be equal to total proceeds. Assuming the proceeds are equal to the original amount invested it stands to reason that after five years the individual and corporate investor would pay tax on 40 and 80 per cent, respectively,<sup>158</sup> of their original investment only. Due to the upfront deduction in year 1, the taxpayer would further have had the 'time value of money' benefit to set off against the amount of tax it eventually has to pay in year 5.

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<sup>157</sup> Standing Committee on Finance (SCOF): Report-Back Hearings Taxation Laws Amendments Bills, 2011 Response Document from National Treasury and SARS [Final] page 25

<sup>158</sup> Based on current capital gains inclusion rates

With reference to Figure 2.1, making the tax deduction permanent seems to have been a key catalyst for the regime that led to a sharp increase in the number of VCC's.

### *The shares*

No tax deduction will be available for the investor if the shares issued by the VCC are:

- i) third-party backed shares as defined in section 8EA(1);
- ii) hybrid equity instruments (but for the three year period requirement) as defined in section 8E(1) or
- iii) issued solely in respect or by reason of services rendered or to be rendered by the taxpayer in respect of the incorporation, marketing, management or administration of the VCC or a qualifying company in which the VCC holds or acquires a share.

It should be noted that the tax deduction is only available for shares *issued* by the VCC. If the investor were to sell its shares to another investor, the new investor will not benefit from the tax deduction. VCC shares are generally in respect of private companies which means that the shares cannot be as easily disposed of as listed shares. As such, some VCC's have put in place clear exit strategies for investors.<sup>159</sup>

If the investor used debt to finance the VCC shares, the investor must bear the risk of the credit facility in order to qualify for the deduction. The debt will not be deemed to satisfy the "at-risk" criteria if the debt is directly or indirectly provided by the VCC. Notably, the debt must be repayable within 5-years to avoid "time-value of money" schemes.<sup>160</sup> "Time-value of money" schemes are schemes where repayment is delayed for so long that the repayment becomes meaningless after inflation is taken into account.<sup>161</sup>

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<sup>159</sup> Lee T. 2018. Pay less tax and be patriotic? Yes it can be done. *Moneyweb*. Available <https://www.moneyweb.co.za/financial-advisor-views/pay-less-tax-and-be-patriotic-yes-it-can-be-done/> [2019, 24 November]

<sup>160</sup> SARS, Explanatory Memorandum on the TLAB, 2011:76

<sup>161</sup> *Ibid*

## **2.5. Final remarks**

This Chapter has set out the evolution of section 12J since its original implementation. Although the changes have been justified, both to improve the attractiveness of the incentive and to insert anti-avoidance provisions, it demonstrates the constantly changing landscape. Further recommendations are made with regards to the legislation and summarized in Chapter 5. Notably, constant changes that require participants to the VCC regime to continuously amend their business models, or risk non-compliance, can in itself act as a disincentive.

# Chapter 3 – The venture capital industry

## 3.1. Introduction

Following from the economic sanctions imposed on SA during the 1980s, an opportunity for private equity investors including venture capitalists emerged. By 1995 private equity had a strong presence in SA, but the provision of venture capital for start-ups and other early stage investing mainly associated with SME's was not so prominent.<sup>162</sup> The SA venture capital industry might still be underdeveloped, but it is growing quickly.<sup>163</sup> Certain regulations like Broad Based Black Economic Empowerment (“BBBEE”) appear to have been a catalyst for private equity but an inhibitor for venture capital.<sup>164</sup>

Venture capital has an important role in filling the funding gap between an entrepreneurial start-up and a more self-sustaining established business.<sup>165</sup> In order to more fully comprehend the role of venture capital in SA this Chapter will:

- i) Distinguish venture capital from other forms of funding and the stages at which the funding generally occur;
- ii) Provide insights on the South African venture capital industry; and
- iii) Consider how actual section 12J venture capital companies fit into the South African venture capital industry and whether these companies are advancing government's original stated intention of promoting economic growth and job creation to the SME sector.

## 3.2. Distinguishing venture capital from other forms of funding

In the context of this dissertation it is necessary to understand what is meant by venture capital and how it differs from other forms of investing. This section will distinguish venture capital from funding by debt, angel investors and private equity.

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<sup>162</sup> SAVCA. 2015. Three Decades, An account of the rise and establishment of South African private equity. At page 7

<sup>163</sup> SAVCA 2015. Three Decades, An account of the rise and establishment of South African private equity. At page 32

<sup>164</sup> Portmann D. & Mlambo C. 2013. Private Equity and Venture Capital in South Africa: A Comparison of Project Financing Decisions. SAJEMS NS 16 (2013) No 3:258-278. At page 266

<sup>165</sup> Snyman H. 2012. *Economic Growth, Entrepreneurship and Venture Capital in South Africa*. At page 24 and 25

### *Debt finance*

Long term debt financing generally requires security and does not give the lender any voting rights or participation right except for interest. Banks are unable to finance early stage companies due to the banking business model, where finance is based on securitized assets or cash flows.<sup>166</sup> Mezzanine finance is another form of debt finance. The stage at which this type of funding is most prevalent is between the late stages where bank debt (or senior debt) is most prevalent and the earlier private equity stage of funding. Mezzanine funders may settle for more creative ways of securing a loan, which may include intangible assets, equity pledges and the right to participate in cash flows. Notably, mezzanine funding generally comes with higher interest rates as compared to bank finance.<sup>167</sup>

At the early stage of a business, it is less likely that there will be sufficient assets to provide security for a loan. Furthermore, cash flow might be volatile and constrained and will be better utilized by investing back into the business instead of servicing debt. For these reasons, high levels of debt financing are generally more relevant in more mature businesses as compared to SME's, especially start-ups. To be able to reach the required levels of assets and/ or cash flows, an SME requires an upfront equity injection.<sup>168</sup>

### *Equity finance – private equity*

Private equity can be loosely defined as equity investing in non-listed companies or business ventures.<sup>169</sup> Venture capital may be considered a subcategory of private equity. Over time the meaning of private equity has evolved, and for purposes of this dissertation, it can in general be distinguished from venture capital as follows:<sup>170</sup>

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<sup>166</sup> Snyman H. 2012. Economic Growth, Entrepreneurship and Venture Capital in South Africa. At page 24

<sup>167</sup> SAVCA. 2015. Three Decades, An account of the rise and establishment of South African private equity. At page 50

<sup>168</sup> Garwe D. Olawale F. 2010. Obstacles to the growth of new SMEs in South Africa: A principal component analysis approach. African Journal of Business Management Vol. 4(5), pages 729-738

<sup>169</sup> Snyman H. 2012. Economic Growth, Entrepreneurship and Venture Capital in South Africa. At page 14

<sup>170</sup> <https://www.investopedia.com/ask/answers/020415/what-difference-between-private-equity-and-venture-capital.asp> [2019, 21 September]

- i) It is not necessarily a form of funding and includes buy-out transactions, where for instance company founders or business owners wish to transfer some of their ownership stakes;
- ii) Private equity firms generally buy into more mature and established businesses. They are also more likely to buy a controlling stake, and buy-out the previous owners.
- iii) The business model of a private equity firm is to buy businesses on which it can turn a profit. As such, it is likely to target businesses that it can acquire at a discount, are deteriorating or not making profits due to inefficiency, which it will buy with the intention of turning the business around to increase revenues. The possibility of deriving a profit is a key driver for decisions made by a private equity firm.

#### *Equity finance – angel investors*

Angel investing generally involves a high net worth individual who invests directly into a business. Many of these individuals are entrepreneurs themselves with experience in a particular industry. It is understood that they generally invest their own money into businesses<sup>171</sup> or entrepreneurs they believe in and to which they can impart their knowledge and experience. The stage of investing is usually during the startup phase. The motive of an angel investor is not necessarily to turn a profit, with some merely seeking to help startups take their first steps.<sup>172</sup> The training and expertise that an angel investor can provide to the business is unlikely to be as comprehensive as a reputable investment firm that has teams in place to provide support to portfolio companies, as is seen with a private equity or venture capital scenario.<sup>173</sup>

#### *Equity finance – venture capital*

As noted earlier, venture capital is a subcategory of private equity. It generally provides financing at the startup or early stage of a business that is believed to have long term growth potential.<sup>174</sup> Due to the high risk of start-up businesses failing, a venture capital firm would generally diversify

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<sup>171</sup> Lamprecht S. & Swart E. 2010 SAVCA Venture Solutions VC survey. At page 9

<sup>172</sup> <https://www.investopedia.com/terms/a/angelinvestor.asp> [2019, 21 September]

<sup>173</sup> Snyman H. 2012. Economic Growth, Entrepreneurship and Venture Capital in South Africa. At page 16

<sup>174</sup> <https://www.investopedia.com/terms/v/venturecapital.asp> [2019, 21 September]

by investing a smaller amount for a non-controlling stake in a number of companies, in contrast to most private equity firms.<sup>175</sup>

Venture capital firms tend to be actively involved and regularly interact with their investments, providing support in the form of training, strategic advice and management expertise. Having a credible venture capital partner on board also provides credibility to the business and provides business contacts and networks.<sup>176</sup> The capital is sourced from a variety of sources, which include individuals and corporates.

### **3.3. Venture capital in SA**

The 2008 financial crisis also affected private equity and venture capital investments which declined from 2007 to 2009.<sup>177</sup> A 2009 survey by SAVCA and Deloitte indicated that the most significant decline was in investments in start-up and early-stage investments. During 2009 a mere 5% of investors were interested in investing in startups.<sup>178</sup> However, a significant increase in the value of venture capital investment started to emerge from 2015 onwards. The SAVCA survey for the 2018 calendar year indicated that 60% of active deals were due to seed or start-up capital (47% based on value),<sup>179</sup> a significant improvement from the 5% recorded in 2009.

The survey also notes that the SA venture capital asset class was made up of R5.37 billion invested in 665 deals. Notably, 35.1% of deals (by value) were completed by independent fund managers, which makes up the majority, followed closely by government being responsible for 33.7%.<sup>180</sup> Although these statistics include the entire venture capital industry, it is understood that section 12J registered VCC's form part of the independent fund manager's category and it was specifically mentioned that a substantial amount of the investments reported came from VCC's.<sup>181</sup>

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<sup>175</sup> Ibid

<sup>176</sup> SAVCA 2018. Venture Capital Industry Survey. Covering the 2017 Calendar Year. Page 47 to 55

<sup>177</sup> Portman D. & Mlambo C. 2013. Private Equity and Venture Capital in South Africa: A Comparison of Projects Financing Decisions

<sup>178</sup> Ibid

<sup>179</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 12 and 18

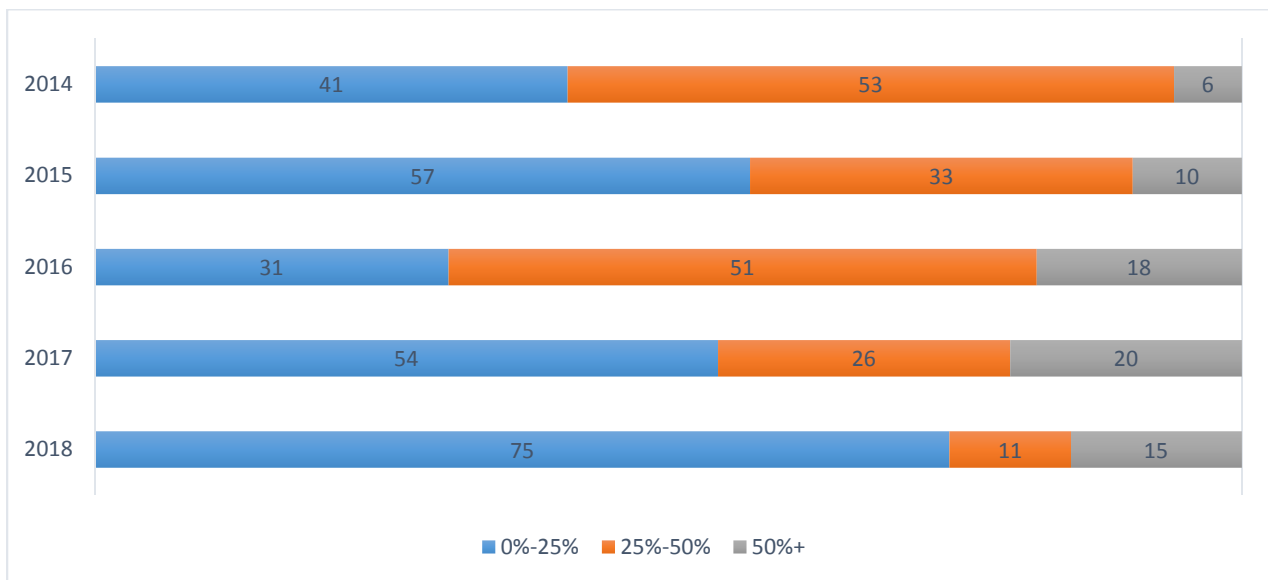
<sup>180</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 11

<sup>181</sup> SAVCA 2018. Venture Capital Industry Survey. Covering the 2017 Calendar Year. At page 18

The survey indicates that 64% of fund managers operate portfolios with capital of less than R50 million, and 74% of portfolios contained fewer than 10 active deals. The investments made continued to increase by over 30% year-on-year from 2016 to 2018 (2018: R1.52 billion, 2017: R1.16 billion, 2016: R872 million), with an average deal size during 2018 of R8.3 million.<sup>182</sup>

The SAVCA survey notes that the majority of venture capital investors prefer to remain minority shareholders, less than 25%, although there are some taking up a majority stake.<sup>183</sup> The VCC regime similarly requires that VCC’s diversify their investments and that no qualifying company is a controlled group company. SAVCA notes that where majority stakes are held, it is mainly as a result of follow-on investments made. During 2018, a substantial amount of new deals, rather than follow-on transactions, resulted in the substantial increase in minority equity stakes in comparison to previous years.<sup>184</sup> The below illustration depicts the preferred percentage equity stake held by investors as per the SAVCA survey. It shows the preference with reference to three categories; below 25%, between 25 and 50%, or more than 50%.

**Figure 3.1**



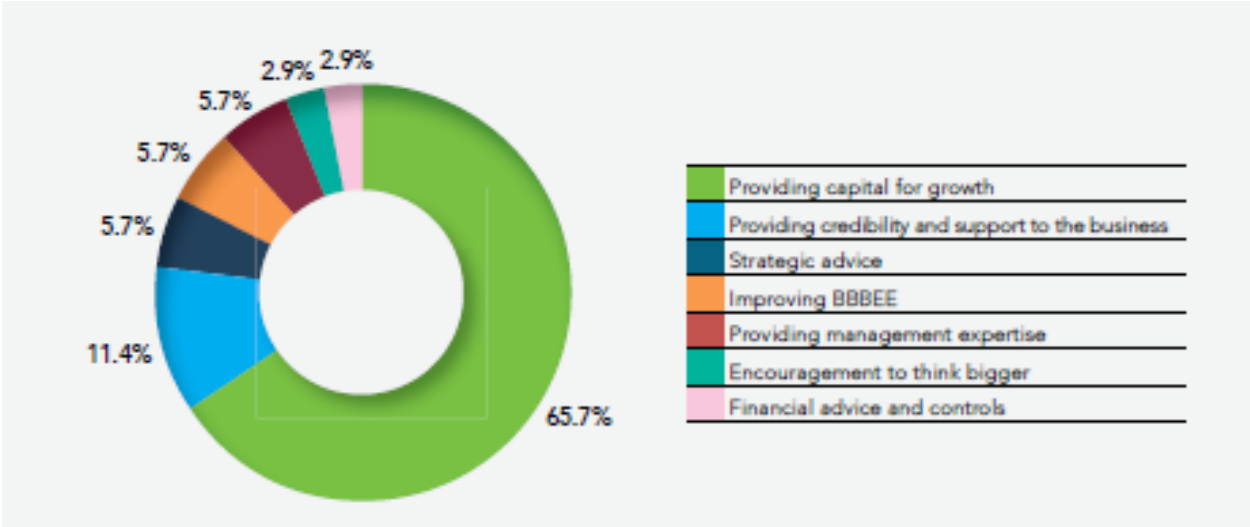
<sup>182</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 12

<sup>183</sup> SAVCA 2018. Venture Capital Industry Survey. Covering the 2017 Calendar Year. At page 23

<sup>184</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 23

Although venture capital investment is not suitable for all business, nor is it likely to address all of SA’s growth challenges, a survey of 38 venture capital backed companies, almost all of which were classified as SME’s,<sup>185</sup> indicated that venture capital is a critical tool for business growth and achieving sustainability.<sup>186</sup> Of the participants, 97.1% indicated that the business would not have existed or would have developed slower if not for venture capital investment. The illustrations below show the responses of the participant when asked about the “the single most significant benefit to date, of having the venture capital investor on board”, the effect on employment and the effect on turnover and earnings before interest and taxes (“EBIT”).

**Figure 3.2\***



**Figure 3.3\***

<sup>185</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 56  
<sup>186</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 47

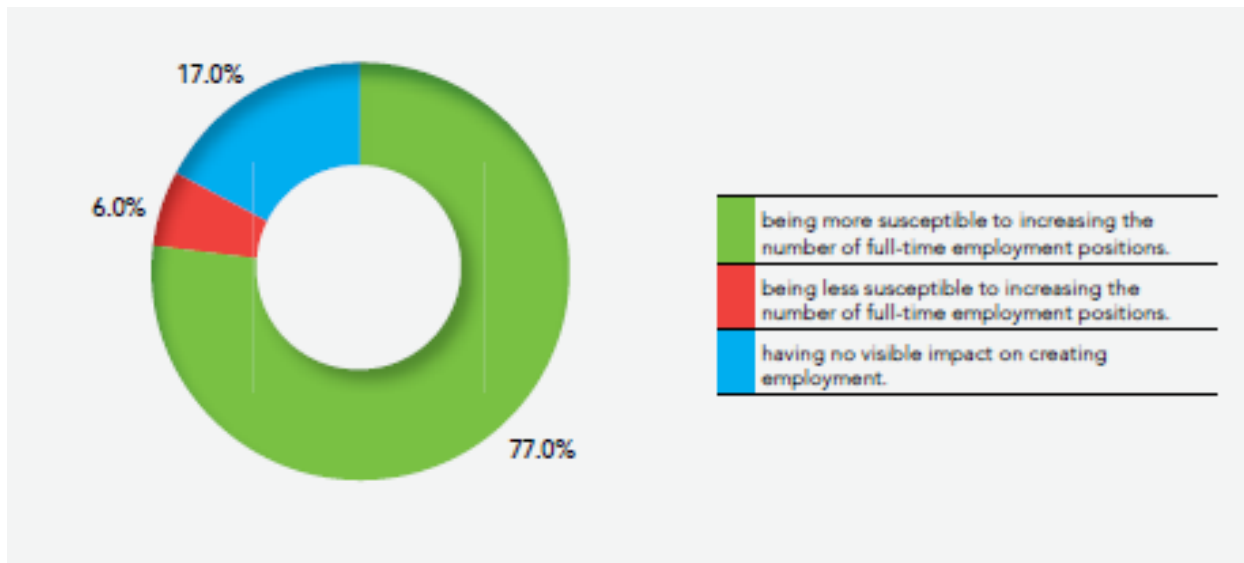
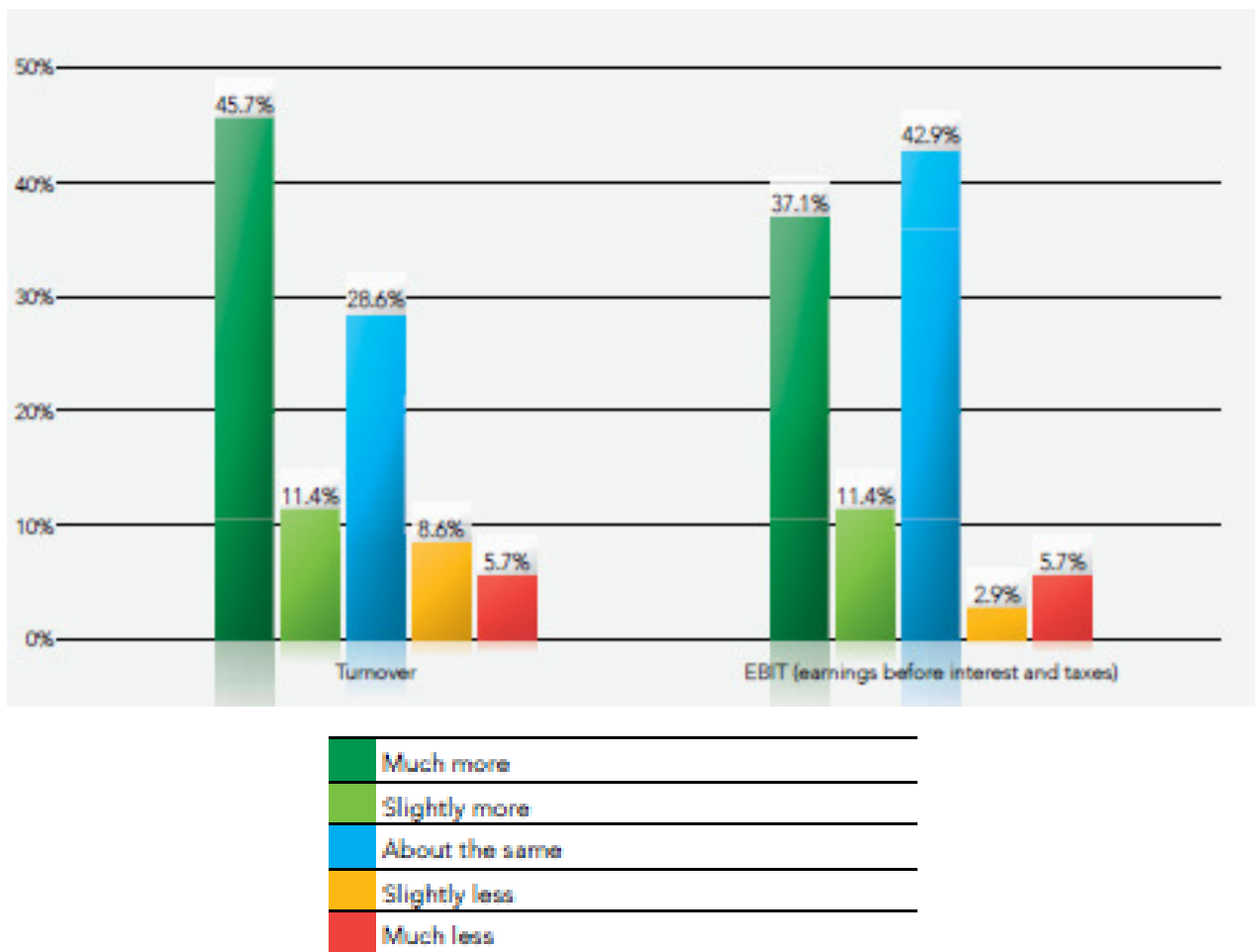


Figure 3.4\*



\* Source: SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year.

The data indicates that having a venture capital firm onboard not only provides growth capital, but also credibility and support to the business. It further provides opportunity to increase permanent jobs and grow turnover and earnings.<sup>187</sup> From a BBBEE perspective, it is understood that venture capital investment improved compliance with the regulations.

The information derived above was mainly from the SAVCA 2019 survey, which provided for certain restrictions. The following is noted in this regard:<sup>188</sup>

- i) Due to confidentiality limitations a substantial number of deals which were facilitated by independent fund managers were not included;
- ii) Deals requiring equity securitization were also excluded. This includes deals that focus primarily on real estate acquisition, property investments and buying up land for development and agricultural purposes. Businesslive reported that at least three quarters of investment into section 12J was in respect of property, which included hotels and student accommodation.<sup>189</sup> For this reason the SAVCA survey does not identify the impact of section 12J on fixed properties.
- iii) The number of fund managers that participated are only 57.<sup>190</sup> As at February 2019 there were 151 registered VCC's.<sup>191</sup> By analyzing the list based on duplicate contact details, the writer estimates that the number of VCC fund managers are about 87. There is furthermore no obligation for a VCC to register with SAVCA or participate in the survey.

There are a number provisions in the ITA that create an enabling environment for both private equity and venture capital. Section 12J is the primary focus of this dissertation and the legislation is fully covered in Chapter 2. Another notable provision is the exclusion of non- SA tax residents

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<sup>187</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 47

<sup>188</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 29

<sup>189</sup> Cranston S. 2019. SA's fledgling venture capital hub. Available <https://www.businesslive.co.za/fm/opinion/investors-notebook/2019-09-26-stephen-cranston-sas-fledgling-venture-capital-hub/> [2019, 26 September]

<sup>190</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 27

<sup>191</sup>List of Approved Venture Capital Companies ("VCC") <https://www.sars.gov.za/ClientSegments/Businesses/Pages/Venture-Capital-Companies.aspx> [2019, 25 February]

from the South African capital gains tax regime so long as their disposals do not pertain to a permanent establishment or that the capital gain is not in respect of immovable property in SA or any interest or right in immovable property. More importantly the exclusion would apply to equity shares so long as less than 80% of the market value of the shares are attributable to immovable property in SA.<sup>192</sup>

In terms of section 24H, foreign limited liability partnerships (and other foreign partnerships) ('LLP') are specifically excluded from the definition of company, which ensures they are not brought into the South African tax net. The partners of the partnership are however taxed in their individual capacities. LLP's have long been a prominent part of the structure for private equity and venture capital firms.<sup>193</sup> The amendment of this section in 2010 has improved the effectiveness of structuring investment partnerships in SA, where foreign partners exist, instead of setting up the partnership offshore.<sup>194</sup> However, tax incentives on their own would not attract foreign direct investors which are likely to consider other factors more important, such as policy certainty, political stability, electricity supply and the labor market.<sup>195</sup>

Furthermore, section 9C provides a so-called "safe harbor" where amounts received on the disposal of shares will be treated as capital in nature where shares were held for over three years. This provides certainty for the local private equity and venture capital industry on the tax treatment on disposal of their investments after three years.

### **3.4. Examples of the impact of section 12J venture capital companies**

#### *Capital raised and invested*

As noted in Chapter 2 and above, from 2015 onwards a marked increase in the number of section 12J VCC's occurred. SAVCA noted that fund managers are setting up funds to draw on the section 12J incentive which added to a substantial amount of investment recorded up to 2017.<sup>196</sup> The below

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<sup>192</sup> Paragraph 2 of the Eighth Schedule of the ITA

<sup>193</sup> SAVCA. 2015. Three Decades, An account of the rise and establishment of South African private equity. Page 39

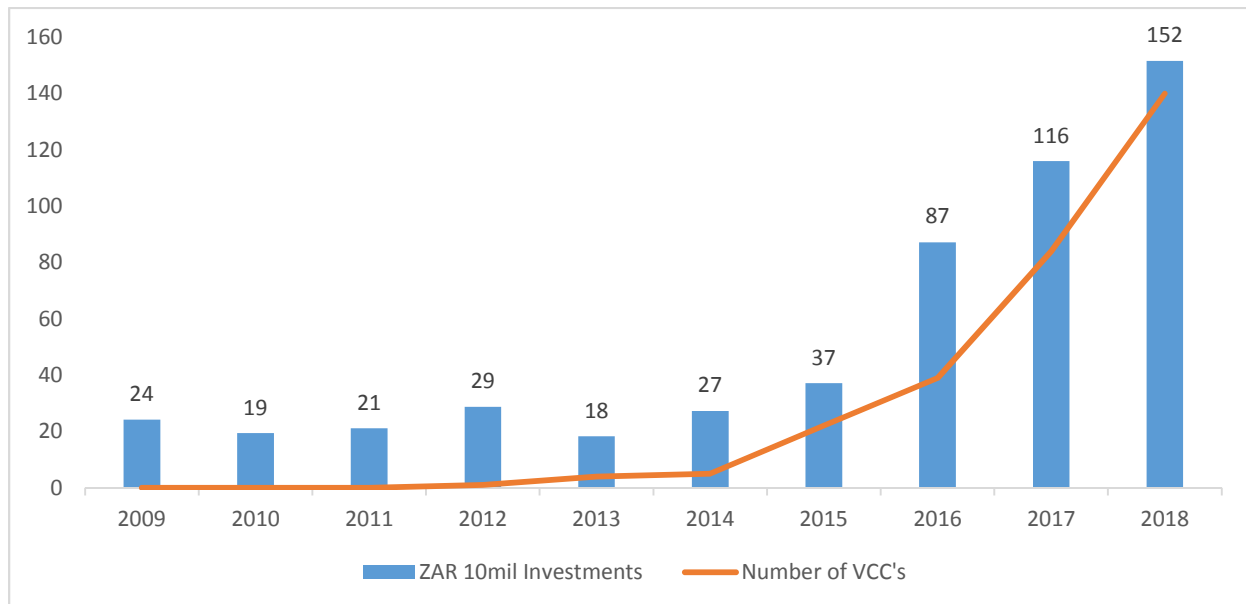
<sup>194</sup> SAVCA. 2015. Three Decades, An account of the rise and establishment of South African private equity. Page 23.

<sup>195</sup> Thuronyi V. 1998. Tax Law Design and Drafting (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. Page 2 and The G-20 Development Working Group by IMF, OECD, UN and World Bank. Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment. 2015. At page 10

<sup>196</sup> SAVCA 2018. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 18

figure illustrates investments by value (ZAR 10 millions)<sup>197</sup>, in relation to the number of VCC's registered with SARS from 2009 to 2018.<sup>198</sup>

**Figure 3.5**



It is estimated that the section 12J incentive has managed to raise more than R5 billion,<sup>199</sup> of which the majority has been raised in the last two years.<sup>200</sup> The 12J Industry Association recently announced that the figure is closer to R8.3 billion as at February 2019 (compared to R3.8 billion at February 2018). Of the R8.3 billion raised only R3.7 billion has been deployed across 444 qualifying companies.<sup>201</sup> As such, the average deal size agrees to the R8.3 million reported by SAVCA. Figure 3.5 appears to support the fact that a significant amount of capital remains unallocated since the growth in the number of VCC's have outperformed the growth in the value

<sup>197</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 19

<sup>198</sup> List of Approved Venture Capital Companies ("VCC")

<https://www.sars.gov.za/ClientSegments/Businesses/Pages/Venture-Capital-Companies.aspx> [2019, 25 February]

<sup>199</sup> Hesse M. 2019. Section 12J proposals bad for investors, economy. *Pretoria News Weekend – Personal Finance*

<sup>200</sup> Hedley N. 2018. Tax scheme spurs innovation. Section 12J of the Income Tax Act has sparked venture capital industry and unlocked funding for small business. *BusinessLive* Available <https://www.businesslive.co.za/bd/companies/financial-services/2018-03-09-section-12j-tax-scheme-spurs-innovation/> [2019, 11 November]

<sup>201</sup> Zuccollo D. Tax Indaba 2019. Section 12J The tax incentive that has created an industry. At page 8. Available <https://taxindaba.co.za/sites/default/files/Section%2012J%20The%20tax%20incentive%20that%20has%20created%20an%20industry.pdf> [2020, 9 January]

of investments made. SAVCA anticipated a large increase in deal activity after 2018 in this respect.<sup>202</sup>

As noted in Chapter 2, a VCC will be required to invest into a minimum of five qualifying companies. The perceived benefit of the section 12J incentive is to bring together small investors, pooling their funds into a VCC.<sup>203</sup> In this respect it has been noted that VCC's typically require investors to invest a minimum amount of R500,000.<sup>204</sup> Treasury reported that a VCC shareholder spent between R1.3 million and R2.1 million on acquiring VCC shares for the past four years.<sup>205</sup> This translates to an average of R1.7 million which is also quoted by the 12J Industry Association as the average investment made by an investor.<sup>206</sup> The following example illustrates the typical investment requirements applied to VCC's:

*A VCC is required to invest into 5 qualifying companies. Assume all five deals amount to the average deal size of R8.3 million<sup>207</sup>:*

*Total funding required: 5 x R8.3 million = R41.5 million;*

*Individual investors are capped at R2.5 million per year and corporates at R5 million per year.*

*If all investors are individuals, the minimum number of VCC investments required is:*

*R 41.5 million ÷ R2.5 million = 16.6, i.e. 17 investors (rounded up)*

*If all investors are corporates, the minimum number of VCC investments required is:*

*R 41.5 million ÷ R5 million = 8.3, i.e. 9 investors (rounded up)*

*Considering the average investment of R1.7 million, the typical number of investments required is:*

*R 41.5 million ÷ R1.7 million = 24 investors*

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<sup>202</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 11

<sup>203</sup> SARS, Explanatory Memorandum on the TLAB, 2008:67

<sup>204</sup> Hesse M. 2018. Time running out for you to cut your tax bill. *Saturday Star Personal Finance*

<sup>205</sup> National Treasury, Explanatory Memorandum on the draft TLAB, 2019:36

<sup>206</sup> Zuccollo D. Tax Indaba 2019. Section 12J The tax incentive that has created an industry. At page 8. Available <https://taxindaba.co.za/sites/default/files/Section%2012J%20The%20tax%20incentive%20that%20has%20created%20an%20industry.pdf> [2020, 9 January]

<sup>207</sup> See subsection 3.3 of this dissertation

*As such, the number of investments a VCC will require to invest into five qualifying companies range from 9 to 24 investors, for a total of R41.5 million.*

Historically, a VCC only had three years to source sufficient investors and capital<sup>208</sup> as well as make at least five qualifying investments.<sup>209</sup> VCC's have been accused of focusing more on the tax relief provided than the investment opportunity and this leads to low quality investments.<sup>210</sup> The writer notes that low quality investments will likely also be made if the end of the deferral period arrives and a VCC is forced to invest into qualifying companies to merely satisfy the legislative requirements. As noted in subsection 2.3, a VCC will be allowed up to four years to make suitable investments once the 2019 TLAB is promulgated.<sup>211</sup>

Another way to address the low quality of investments is to impose a requirement to prove that the investment has made a meaningful contribution to creating long term jobs and stimulating the economy. As an example, the Irish employment and investment incentive, which provides upfront tax relief of 30% of the investment made, provides for a further 11% tax relief if it is proven that additional jobs were created or that the capital was used for research and development, after the investment was held for three years.<sup>212</sup>

#### *Type of investments and qualifying companies*

The industries that have been benefitting the most from VCC funding are renewable energy, asset rental, student accommodation and hospitality<sup>213</sup> with the latter two categories estimated to make up about 75% of all VCC investments.<sup>214</sup> There is a further uptick on the return on investment for

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<sup>208</sup> Section 12J(3A)

<sup>209</sup> Section 12J(6A)

<sup>210</sup> Lessem I. 2018. Beware of the hype over section 12J. *Pretoria News Weekend – Personal Finance*

<sup>211</sup> SARS. Taxation Laws Amendment Bill 2019. At page 12

<sup>212</sup> Cohen G. 2019. Limiting incentives to funding small businesses is shortsighted. *BusinessLive*. Available <https://www.businesslive.co.za/bd/opinion/2019-08-07-limiting-tax-incentives-to-investment-in-smes-is-shortsighted/> [2019, 9 September]

<sup>213</sup> Whitfield B. 2019. Balancing retirement annuities (RAs) and Section 12J investments. *Capetalk*. Available <http://www.capetalk.co.za/podcasts/201/the-best-of-the-money-show/261894/balancing-retirement-annuities-ras-and-section-12j-investments> [2019, 12 December]

<sup>214</sup> Cranston S. 2019. SA's fledgling venture capital hub. *BusinessLive*. Available <https://www.businesslive.co.za/fm/opinion/investors-notebook/2019-09-26-stephen-cranston-sas-fledgling-venture-capital-hub/> [2019, 12 December]

the investors where the qualifying company in turn qualifies for further specific tax deductions, for example the manufacturing allowance,<sup>215</sup> renewable energy allowance<sup>216</sup> and the hotel keeper building allowance.<sup>217</sup>

Section 3.2 noted that financial institutions regularly provide debt finance where the debt is secured over assets. As such, asset rich businesses could generally be predominantly funded by banks, without a cost to the fiscus.<sup>218</sup> VCC fund managers have been marketing certain VCC's as being in a lower risk spectrum as compared to VCC's investing into industries that are not asset backed, for example technology.<sup>219</sup> Due to the lower risk, further gearing of the equity investment allows for additional debt funding that would otherwise not have been available, or would have come at a higher interest rate.<sup>220</sup> Investing into asset rich businesses has been criticized as not being true venture capital investments.<sup>221</sup> Concern has further been raised that the incentive is often abused when investment would have been made even if the incentive was not available. In this regard inappropriate VCC vehicles are created to invest into holiday homes and capital equipment.<sup>222</sup>

Notably the definition of hotel keeper would include a bed-and-breakfast where only one meal is provided. This would mean that a property listed on "Airbnb" could meet the definition of hotel keeper.<sup>223</sup> The definition of qualifying company merely requires that the investment income derived by that company does not exceed 20% of its gross income and is further silent as to whether, and to what extent, the company should be conducting a trade.<sup>224</sup> As such taxpayers have

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<sup>215</sup> Section 12C

<sup>216</sup> Section 12B

<sup>217</sup> Section 13quin

<sup>218</sup> Timm S. 2018. State must close door on those that misuse VC tax incentive. Available <http://ventureburn.com/2018/08/vc-tax-incentive-end-abuse-opinion/> [2019, 20 February]

<sup>219</sup> <https://www.bizcommunity.com/Article/196/837/196055.html> [2019, 16 November]

<sup>220</sup> <https://www.flytproperty.co.za/flyt-hospitality/> [2019, 16 November]

<sup>221</sup> Buthelezi L. 2019. Venture capital industry is taking off, but will it keep flying? *BusinessLive*. Available <https://www.businesslive.co.za/bd/business-and-economy/2019-09-22-venture-capital-industry-is-taking-off-but-will-it-keep-flying/> [2019, 16 November]

<sup>222</sup> Ensor L. 2018. Treasury's plan to fix abuse of venture capital incentive will kill the industry, MPs told. *BusinessLive* Available <https://www.businesslive.co.za/bd/national/2018-08-21-treasurys-plan-to-fix-abuse-of-venture-capital-incentive-will-kill-the-industry-mps-told/> [2019, 16 November]

<sup>223</sup> Zuccollo D. & Le Roux K. 2019. Pay up to 45% less tax by investing in a small business (Section 12J incentive). *Capetalk*. Available <http://www.capetalk.co.za/features/1/money/334973/pay-up-to-45-less-tax-by-investing-in-a-small-business-section-12j-incentive> [2019, 16 November]

<sup>224</sup> Section 12J(1), definition of "qualifying company" paragraph (f)

used the section 12J incentive to finance the acquisition of holiday homes.<sup>225</sup> Notably, it appears as if SARS would accept that meals are sourced from an external restaurant operator as long as the cost of the meal is included in the room rate charged to the guest.<sup>226</sup> As such, a catering company may be contracted by the qualifying company to provide meals.

Property developers have also been successful in ensuring that a development meets the “hotel keeper” definition and have been able to channel funding through VCC’s. Many of these developments are described as “apartment-hotels” or “mixed-use”, meaning that some of the units are residential units. These developments generally include an area where meals can be served such as coffee shop.<sup>227</sup> This ensures the definition of “hotel keeper” is met. The head of the 12J Industry Association is of the opinion that “although building hotels might not be everyone’s idea of venture capital it is one of the best job creators per million rand of investment”.<sup>228</sup> The Association further notes there is nothing wrong with using the section 12J incentive to build hotels.<sup>229</sup>

The Capital Hotel group (funded by Westbrooke Base VCC fund)<sup>230</sup> and Flyt Property Investments (funded by Anuva Investments)<sup>231</sup> are examples of section 12J being used to develop hotel-like properties. Westbrooke is the largest VCC fund manager whereas Anuva Investments is the longest standing VCC. Anuva Investments has accumulated a diverse portfolio of qualifying

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<sup>225</sup> Buthelezi L. 2019. Venture capital industry is taking off, but will it keep flying? *BusinessLive*. Available <https://www.businesslive.co.za/bd/business-and-economy/2019-09-22-venture-capital-industry-is-taking-off-but-will-it-keep-flying/> [2019, 16 November]

and  
Anderson A. 2017. Section 12J venture capital company structures ‘benefit investors’. *BusinessLive*. Available <https://www.businesslive.co.za/bd/companies/financial-services/2017-12-13-section-12j-venture-capital-company-structures-benefit-investors/> [2019, 16 November]

<sup>226</sup> Lessing, D & Fairbairn, N. 2019. BPR 314: An Interesting Ruling on Several Levels. *Werksmans Attorneys*.

<sup>227</sup> Flyt Property Investment. 2019. Flyt Hospitality Fund. Private Placement Memorandum. Page 7. Available: [https://www.flytproperty.co.za/wp-content/uploads/Flyt-Hospitality-Fund-PPM-20191122\\_02.pdf](https://www.flytproperty.co.za/wp-content/uploads/Flyt-Hospitality-Fund-PPM-20191122_02.pdf) [2019, November 16]

<sup>228</sup> Cranston S. 2019. SA’s fledgling venture capital hub. Available at <https://www.businesslive.co.za/fm/opinion/investors-notebook/2019-09-26-stephen-cranston-sas-fledgling-venture-capital-hub/>

<sup>229</sup> Buthelezi L. 2019. Venture capital industry is taking off, but will it keep flying? *BusinessLive*. Available <https://www.businesslive.co.za/bd/business-and-economy/2019-09-22-venture-capital-industry-is-taking-off-but-will-it-keep-flying/> [2019, 16 November]

<sup>230</sup> Klein M. 2019. More diversification with Section 12J. *Moneyweb*. Available at <https://www.moneyweb.co.za/investing/equities/more-diversification-with-section-12j/> [2019, 16 November]

<sup>231</sup> <https://anuvainvestments.co.za/hospitality-fund/>. [2019, 16 November]

investments,<sup>232</sup> where-as the VCC's being managed by Westbrooke generally invest into asset rich qualifying companies that develop or provide short term rental of properties in the hospitality and student accommodation sector, or provide movable asset rentals.<sup>233</sup>

Asset rental businesses free up funds for their customers that would otherwise have been required to purchase expensive capital equipment. The customer may also be subject to less risk in that the lessor is responsible for the maintenance of the asset. It is however noted that hire-purchase arrangements would be an "impermissible trade".<sup>234</sup>

Westbrooke has indicated that its focus is not on startups but rather to fund existing businesses.<sup>235</sup> Grovest, another large VCC manager, has indicated that although the section 12J incentive might have started out with the objective of facilitating funding into high risk investments into startups, the industry has evolved to be more conservative.<sup>236</sup> It now operates similar to the private equity industry by investing into later stage businesses with less risk. It is categorized as providing growth capital instead of startup capital.<sup>237</sup> As such, startups are not necessarily benefitting from section 12J as was originally intended. However, due to the requirement that the book value of a qualifying company should not exceed R50 million (or R500 million where that company is a junior mining company) after the issue of shares,<sup>238</sup> VCC's are still required to fund only SME's.<sup>239</sup> Grovest suggests that the R50 million threshold is too low to attract private equity investment in the main, which suggests that VCC's are playing a role in providing SME's with expansion capital.<sup>240</sup>

Since 1 January 2012, VCC's can also invest into franchises. This has gained some traction in recent years. However, some VCC fund managers have been marketing the fact that a new

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<sup>232</sup> <https://anuvainvestments.co.za/anuva-general-fund/> and [https://anuvainvestments.co.za/new/wp-content/uploads/2019/01/Anuva\\_AFS-2018.pdf](https://anuvainvestments.co.za/new/wp-content/uploads/2019/01/Anuva_AFS-2018.pdf). [2019, 16 November]

<sup>233</sup> <https://westbrooke.co.za/westbrooke-alternative-asset-management/sas-largest-s12j-fund-manager/>. [2019, 16 November]

<sup>234</sup> Section 12J(1), definition of "impermissible trade", paragraph (b)

<sup>235</sup> Musviba N. 2015. Venture capital embraces tax breaks. Available at <http://www.sataxguide.co.za/venture-capital-embraces-tax-breaks/>. [2019, 23 February]

<sup>236</sup> <https://grovest.co.za/2019/10/14/should-you-really-keep-your-money-in-sa/>. [2019, 16 November]

<sup>237</sup> Ibid

<sup>238</sup> Section 12J(6A)(b)

<sup>239</sup> <https://grovest.co.za/2019/10/14/should-you-really-keep-your-money-in-sa/>. [2019, 16 November]

<sup>240</sup> Ibid

franchisee can structure his franchise through a VC, retaining full control but still being entitled to the tax deduction.<sup>241</sup> The anti-avoidance rules that came into effect in 2018, *inter alia* aimed at preventing the investor from being connected to the qualifying company or the VCC, is aimed to prevent this arrangement.<sup>242</sup>

Section 12J is further aimed at incentivizing junior mining operations. Mining is a significant contributor to the South African economy and creates a significant number of jobs.<sup>243</sup> However, it appears as if the incentive is as of yet unsuccessful in promoting mining exploration. The problem does not necessarily lie with the incentive and could rather be attributed to the impediments in obtaining an exploration license.<sup>244</sup> This includes factors such as the process, cost and timing of obtaining a license. There are however some VCC's that fund ancillary mining projects.<sup>245</sup> The definition of "junior mining company" is such that most mining companies would fall within the definition. VCC specialists have proposed that an existing large mining company can potentially structure its new explorations or mining projects through a VCC to obtain a tax deduction.<sup>246</sup> This is not in line with the intention of the legislature and would be prevented to some degree by prohibiting an investor from being connected to the VCC or qualifying company. The CCP 12J fund invests into secondary expansion projects in the mining sector. This typically includes tailings and dump retreatment projects or brownfields expansions.<sup>247</sup> The fund is however not looking to take on geological risk, such as mining exploration.<sup>248</sup>

Kalon Ventures is an established VCC fund manager investing in the technology sector. Unlike the previous examples, these investments are considered to be high risk. The fund manager's strategy is to provide equity finance in return for a minority stake in a high growth innovative

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<sup>241</sup> <https://jaltech.co.za/section-12j-vcc/>. [2019, 24 September]

<sup>242</sup> See subsection 2.3, under "New requirements" and subsection 2.4

<sup>243</sup> Creamer, M. 2018. Govt must be forced to reveal identities of those holding exploration licences. *Mining Weekly*

<sup>244</sup> Ibid

<sup>245</sup> Cavvadas D & Nhlapho T. 2019. How is SA supporting mining exploration and its junior mining industry? *BusinessLive*. Available <https://www.businesslive.co.za/bd/national/2019-01-28-how-is-sa-supporting-mining-exploration-and-its-junior-mining-industry/>. [2019 18 February]

<sup>246</sup> <https://jaltech.co.za/section-12j-vcc/>. [2019, 24 September]

<sup>247</sup> <https://ccp12j.co.za/>. [2019, 23 November]

<sup>248</sup> Creamer, M 2018. New mining fund raising R750m to co-finance ancillary mine projects. *Mining Weekly*. Available: [https://www.miningweekly.com/article/new-mining-fund-raising-r750m-to-co-finance-ancillary-mine-projects-2018-07-16/rep\\_id:3650](https://www.miningweekly.com/article/new-mining-fund-raising-r750m-to-co-finance-ancillary-mine-projects-2018-07-16/rep_id:3650). [2019, 23 November]

technology company. The fund manager gets actively involved with the qualifying company's business to help the business grow and eventually exits the business by selling to trade buyers or through an initial public offering. The intention is to expand the investee's business into Africa and abroad.<sup>249</sup> As long as the business is mainly conducted in SA, this would not impede the compliance with the section 12J legislation. Kalon Ventures prefers investing into companies that are already producing revenue. The largest portion of the portfolio should be growth capital with the underlying qualifying companies already being profitable. The business should further provide unique intellectual products.<sup>250</sup>

Geographically, the venture capital industry almost exclusively exists in Gauteng and Western Cape.<sup>251</sup> Government, through the Department of Rural Development and Land Reform, is committed to building sustainable rural livelihoods.<sup>252</sup> The writer is of the view that there may be ways of incentivizing the venture capital industry to fund business outside of the current economic hubs, located in Gauteng and the Western Cape. In a recent private ruling issued by SARS, it was noted that VCC funding for farming operations would be allowed. The transaction set out includes the procurement of vacant land on which farming operations will be established.<sup>253</sup> As noted in Chapter 2, this appears to indicate that SARS interprets the phrase "a trade *in respect of* immovable property" to require a direct link between the trade and immovable property, which means that arguably VCC funding might be available to farmers.<sup>254</sup> Agriculture is an integral part of the South African economy and employs over 5% of all employed South Africans across all industries.<sup>255</sup> The industry has been hit by severe droughts in recent years and has been requesting various parties for financial support.<sup>256</sup> If VCC's can successfully invest into this sector, there is a clear benefit to the South African economy.

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<sup>249</sup> <https://www.kalonvp.com/about/our-vision-sub/>. [2019, 23 November]

<sup>250</sup> <https://www.kalonvp.com/about/faqs/>. [2019, 23 November]

<sup>251</sup> SAVCA 2019. Venture Capital Industry Survey. Covering the 2018 Calendar Year. At page 21

<sup>252</sup> <https://www.gov.za/ss/about-sa/rural-development>. [2019, 17 November]

<sup>253</sup> SARS. 2019. Binding Private Ruling: BPR 333

<sup>254</sup> Strauss B. 2019. Venture capital companies and trades in respect of immovable property. *Cliffe Dekker Hofmeyr* Available <https://www.cliffedekkerhofmeyr.com/en/news/publications/2019/Tax/tax-alert-21-november-2019-venture-capital-companies-and-trades-in-respect-of-immovable-property.html> [2019, 24 November]

<sup>255</sup> <http://www.statssa.gov.za/publications/P0211/P02113rdQuarter2019.pdf>. [2019, 24 November]

<sup>256</sup> AgriSA. 2019/2020 Agriculture Drought report. Available <https://www.agrisa.co.za/droughtAidFund> [2019, 8 December]

### *Job creation*

According to the 12J Industry Association, based on initial indicative PwC modeling, statistics showed that for every R1 million invested by a VCC 5 jobs can be created.<sup>257</sup> It is further noted that even if an investment does not directly create jobs, it creates economic activity and may indirectly enable the creation of jobs or opportunities.<sup>258</sup> For example, Mobile Macs (financed by Westbrooke) rents delivery motorbikes to fast food outlets. This enables the employment of delivery drivers and provides the fast food outlet with additional capital and less risk (than if it were to buy the motorbike itself). Westbrooke estimates that 400 jobs have been created for motorbike drivers. It is further understood that the qualifying company, Mobile Macs was also able to increase its staff by almost 50%, to 55 people.<sup>259</sup> In 2018, Westbrooke claimed that it has deployed over R700 million which created more than 1,200 jobs.<sup>260</sup>

Similarly, Optimise Ventures contributed to the creation of 354 jobs and also saved 152 jobs with the deployment of R250 million.<sup>261</sup> The VCC invested in over 20 qualifying companies in sectors such as hospitality, asset rental, technological, renewable energy, manufacturing and retail.<sup>262</sup> By investing into these sectors businesses are able to spend more, increasing overall revenue and fueling the cycle of economic activity.

Anuva Investments has invested in established businesses, many of which had financial problems. As such, Anuva Investments has invested about R235 million which saved or created over 350 jobs.<sup>263</sup> This includes 60 jobs saved in Cape Mohair<sup>264</sup> and 80 jobs in Mastercare. Mastercare also

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<sup>257</sup> Zuccollo D. Tax Indaba 2019. Section 12J The tax incentive that has created an industry. At page 8. Available <https://taxindaba.co.za/sites/default/files/Section%2012J%20The%20tax%20incentive%20that%20has%20created%20an%20industry.pdf> [2020, 9 January]

<sup>258</sup> SAVCA 2019. A journal of activity and trends in Southern African private equity and venture capital

<sup>259</sup> <https://westbrooke.co.za/mobile-macs-rentals/>. [2019, 26 September]

<sup>260</sup> Money Marketing. 2018. Is Section 12J, the investment tax incentive, working for SA?

<sup>261</sup> Cohen G. 2019. Limiting incentives to funding small businesses is shortsighted. *BusinessLive*. Available <https://www.businesslive.co.za/bd/opinion/2019-08-07-limiting-tax-incentives-to-investment-in-smes-is-shortsighted/> [2019, 9 September]

<sup>262</sup> [https://optimise.co.za/wp-content/uploads/2019/07/Rockefeller\\_web.pdf](https://optimise.co.za/wp-content/uploads/2019/07/Rockefeller_web.pdf). [2019, 26 September]

<sup>263</sup> <https://www.iol.co.za/personal-finance/tax/section-12j-putting-your-capital-to-work-to-create-meaningful-jobs-19690407>. [2019, 26 September]

<sup>264</sup> <https://anuvainvestments.co.za/#>. [2019, 26 September]

supports 140 small service agents and it was estimated that a third would have struggled to stay in business if Mastercare had had to close its doors.<sup>265</sup>

Based on these examples, it appears as if an R1million investment into a VCC could create between 1.5 to 5 jobs.

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<sup>265</sup> <https://www.biznews.com/sponsored/2019/05/15/section-12j-business-rescue>. [2019, 26 September]

# Chapter 4 – The role, success and failures of tax incentives

## 4.1. Introduction

Tax incentives have been defined as preferential tax treatment of particular group of taxpayers that deviate from the general tax structure.<sup>266</sup> In other words, when a generous tax provision is available to all taxpayers, regardless of any factors such as employment, business location or the type of business, it would be part of the general tax structure and not a tax incentive.<sup>267</sup> A tax incentive, for a limited timeframe, erodes the tax base but with the expectation of ultimately expanding economic activity and/or other benefits to society by encouraging socio-economic development.<sup>268</sup> Globally, tax incentives are being widely used, by both developed and developing countries.<sup>269</sup>

Although recent studies on the effect of incentives indicate that they can positively affect economic development and growth in certain circumstances,<sup>270</sup> international studies mainly found that tax incentives are ineffective, inefficient and associated with abuse and corruption.<sup>271</sup> Due to being relatively easy to introduce and facing less scrutiny than government's direct expenditure, the evaluation of tax incentives is therefore required to support good governance, informed budget decisions and improving accountability.<sup>272</sup>

Tax incentives in SA have been focused on capital incentives and not necessarily on market failures. Investment incentives have been used to mitigate against the uncertain conditions of doing business in SA and to upgrade or sustain production and employment. Certain incentives have

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<sup>266</sup> National Treasury. 2000. *The Impact Of Globalisation On Tax Policy And The Use Of Tax Incentives*. At page 11 and Chen, D. 2015. The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach. *United Nations*. At page 3. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November]

<sup>267</sup> Ibid

<sup>268</sup> Budget Review 2019. National Treasury. At page 117

<sup>269</sup>The G-20 Development Working Group by IMF, OECD, UN and World Bank. Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment. 2015. At page 8

<sup>270</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 51

<sup>271</sup> The G-20 Development Working Group by IMF, OECD, UN and World Bank. Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment. 2015. At page 6

<sup>272</sup>The G-20 Development Working Group by IMF, OECD, UN and World Bank. Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment. 2015. At page 24

been designed to address market failures in the labor market due to the mismatch between skills required and business needs. Government also uses business incentives to raise competitiveness, address historical inequalities and increase the participation of historically disadvantaged groups in the economy.<sup>273</sup>

The World Bank, on the request by the Davis Tax Commission, reviewed a list of South African tax incentives. It provided three reports to the DTC. The first concluded that overall tax incentives may not be effective in all sectors due to other fundamental factors prevalent in particular sectors which are preventing growth, and that the tax incentive on its own cannot overcome.<sup>274</sup> Notably a survey indicated that incentives rank relatively low amongst other factors when considering investments such as economic and political stability, market size, skilled labor and transparency of the legal framework.<sup>275</sup> As incentives do however lower the cost of investment, it would encourage investment into sectors where the other fundamental factors in that sector are conducive to growth.<sup>276</sup>

An optimal tax structure should be efficient (minimize tax distortion to resource allocation by market forces), fair (tax according to ability to pay) and simple (minimize administrative and compliance costs).<sup>277</sup> Generally, tax incentives violate these principles as follows:<sup>278</sup>

- i) Encouraging inefficient activities that can crowd out market-efficient activities;
- ii) Induce excessive tax planning and even tax evasion, which partly results from the design of the incentive and also the difficulties in auditing taxpayers<sup>279</sup>;

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<sup>273</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 22

<sup>274</sup> Oguttu A, Tickle D & Legwaila T. 2018. Report on The Efficiency of South Africa's Corporate Income Tax System for the Minister of Finance. *The Davis Tax Committee*. At page 5 and 51

<sup>275</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 28 and 49

<sup>276</sup> Oguttu A, Tickle D & Legwaila T. 2018. Report on The Efficiency of South Africa's Corporate Income Tax System for the Minister of Finance. *The Davis Tax Committee*. At page 5 and 51

<sup>277</sup> Chen, D. 2015. *The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach*. United Nations. At page 3. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November] and National Treasury. 2000. *The Impact Of Globalisation On Tax Policy And The Use Of Tax Incentives*. At page 11

<sup>278</sup> Chen, D. 2015. *The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach*. United Nations. At page 4. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November]

<sup>279</sup> Thuronyi V. 1998. *Tax Law Design and Drafting* (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. Page 3

- iii) Increasing the administrative and compliance cost due to the addition of discretionary layers to the general tax system, which is further complicated by the inevitable introduction of anti-avoidance measures<sup>280</sup>; and
- iv) Damaging the integrity of the overall tax system due to providing tax incentives in an *ad hoc* manner outside the normal tax legislation.

With regards to the design of an incentive, targeting an incentive too finely on the one hand, or vaguely on the other, will introduce complexity and/or uncertainty which will negatively affect the efficiency of the incentive. It has been recommended that an incentive is to be clearly defined and the rules kept as simple as possible,<sup>281</sup> while bearing in mind that the qualifying criteria should be clear, simple, specific and objective (with little room for subjective interpretation).<sup>282</sup> Another disadvantage of tax incentives are that once it has been introduced, there is likely to be political and market pressures to expand and keep the incentive in place even after the conditions that lead to the tax incentives being introduced have changed.<sup>283</sup> Notably, policymakers have started making use of automatic expiration clauses, so-called “sunset” provisions.<sup>284</sup>

Some advantages are also apparent. Once a tax incentive is introduced it decentralizes decision-making, in that decisions are made by the taxpayer and not government. This reduces the possibility of administrative discretion or political interference in the activity being promoted. Where governance institutions are inefficient in administering targeted expenditure, or are prone to inappropriate behavior and corruption, an incentive provided to taxpayers could be more efficient and effective.<sup>285</sup> Under these circumstances it would be appropriate to reform the existing laws to make the government institutions more effective while providing temporary tax

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<sup>280</sup> Ibid

<sup>281</sup> Thuronyi V. 1998. *Tax Law Design and Drafting* (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. At page 14

<sup>282</sup>The G-20 Development Working Group by IMF, OECD, UN and World Bank. *Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment*. 2015. At page 24 and 26

<sup>283</sup> Thuronyi V. 1998. *Tax Law Design and Drafting* (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. At page 3 and 17 and The G-20 Development Working Group by IMF, OECD, UN and World Bank. *Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment*. 2015. At page 28

<sup>284</sup> Thuronyi V. 1998. *Tax Law Design and Drafting* (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. At page 14

<sup>285</sup> National Treasury. 2000. *The Impact Of Globalisation On Tax Policy And The Use Of Tax Incentives*. At page 14

incentives.<sup>286</sup> Due to global tax competition and capital mobility, providing tax incentives helps to prevent capital flight to jurisdictions that are more advantageous (this is particularly relevant for high net worth South Africans).<sup>287</sup>

The use of tax incentives has been justified where it can mitigate market failures or encourage firms to undertake activities that provide protection or spillover benefits to society and the economy.<sup>288</sup> However, tax incentives are created by policymakers using their judgement as to what is needed. The policymakers decide which selected group of taxpayers are so crucial to economic growth that they deserve an exclusive tax break. This could lead to rent-seeking and corruption.<sup>289</sup>

To be effective, the overall benefit derived from the incentive to society as a whole should exceed the cost of the incentive to the fiscus.<sup>290</sup> Without appropriate consideration, oversight, transparency and continuous evaluation, tax incentives are unlikely to be effective. However, any evaluation of a tax incentive would be imprecise to some degree since policy changes occur real time, while external factors in the global and local environment also change continuously.<sup>291</sup>

In this respect, a complete analysis of the effectiveness of tax incentives in SA would require further research. This Chapter will only address some key aspects on the subject. These include:

- i) A theoretical way of measuring the cost and success of a tax incentive;
- ii) Measuring incentives in the South African context;
- iii) The effectiveness of the United Kingdom's venture capital trust incentive;
- iv) Applying the context of this Chapter to the VCC incentive.

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<sup>286</sup> Thuronyi V. 1998. *Tax Law Design and Drafting* (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. Page 1

<sup>287</sup> Masters, A. 2006. *Strategies for Improving the Incentive Structure of Tax Systems A Southern African Perspective*. At page 4

<sup>288</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 22 and 73

<sup>289</sup> Chen, D. 2015. *The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach*. United Nations. At page 3. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November]

<sup>290</sup> Chen, D. 2015. *The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach*. United Nations. At page 6. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November]

<sup>291</sup> Chatterjee, A & MacLeod, C. 2016. Employment tax incentive descriptive report. *National Treasury*. At page 7

#### 4.2. A theoretical way of measuring the cost and success of a tax incentive

A tax incentive should be evaluated in terms of its ability to achieve clear goals effectively and efficiently, relative to alternative options (both tax and non-tax) that could achieve the same objectives.<sup>292</sup>

A cost-benefit analysis can measure the effectiveness of a tax incentive. This will require specifically identifying all the costs and benefit components. For example, the costs would include the anticipated loss in tax revenue, loss in economic efficiency and increased cost in administration and compliance, whereas the benefits would include the achievable long-term economic and tax revenue growth.<sup>293</sup> The costs and benefits for a particular tax incentive could be wide ranging. Chen (2015:9-10) provided a list of critical considerations (not exhaustive) that could assist in determining the associated costs and benefits.

- i) “Additionality”: This is the true increase in investment brought about by the tax incentive, i.e. that which would not have been possible without it. Factors to be considered with this include the extent to which the tax incentive is redundant (e.g. certain investments that utilize the tax incentive would have occurred in any case), relocating investments (e.g. existing investments that did not make use of the tax incentive will be withdrawn and re-directed to make use of the incentive) and negatively affecting investments that fall outside of the tax incentive (so-called “displacement”).
- ii) “Opportunity cost and alternatives”: What could the tax revenue loss have been used for? In a budget constrained country such as SA, the anticipated revenue loss could be used for direct spending in improving infrastructure for instance. The marginal cost for a group of 38 African countries was estimated as \$1.20 for each \$1 claimed as a tax incentive, i.e. a 20% opportunity cost.<sup>294</sup> There could also be alternatives to providing tax incentives such as providing loan guarantees. For example, in the USA a loan

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<sup>292</sup>The G-20 Development Working Group by IMF, OECD, UN and Word Bank. Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment. 2015. At page 6

<sup>293</sup> Chen, D. 2015. *The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach*. United Nations. At page 7. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November]

<sup>294</sup>The G-20 Development Working Group by IMF, OECD, UN and Word Bank. Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment. 2015. At page 18

- guarantee provided to small businesses had a significantly lower cost per job when compared to a fiscal stimulus or an employee tax credit.<sup>295</sup>
- iii) “Additional cost”: Over and above the direct tax revenue loss there is likely to be additional government spending that will be required. This includes additional administration costs and infrastructure to be developed and maintained.
  - iv) “Multiplier effect”: If the above represent the “first-round” costs and benefits, the “multiplier effect” connotes the “knock-on” or “second-round” effects. For example, the upfront tax revenue loss would result in a reduction in expenditure by government in another sector which would mean that that sector is negatively affected, or the increased investment due to the tax incentive will result in increased jobs and more pay-as-you-earn and the salary-earner spending his salary as a consumer. Potential “spillovers” could also occur where the new investment boosts productivity elsewhere in the economy.<sup>296</sup>

Other factors that require consideration when evaluating incentives are that it might be difficult to isolate the effect of the change in policy, and that the evaluation is likely to be imprecise to some degree due to changes in economic circumstances and other external factors. Furthermore, it takes some time before taxpayers respond and take up incentives. A short period of time after an incentive is introduced is unlikely to provide a true reflection of the impact of the incentive. However, as more time passes, it will become more difficult to disentangle the effects of the change in policy to the change in the economic circumstances and other external factors.<sup>297</sup>

A cost-benefit analysis will only be as accurate as its inputs. In this respect, professional integrity combined with critical thinking and diligent bookkeeping can ensure a reliable assessment.<sup>298</sup>

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<sup>295</sup> Chen, D. 2015. *The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach*. United Nations. At page 10. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November]

<sup>296</sup>The G-20 Development Working Group by IMF, OECD, UN and World Bank. *Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment*. 2015. At page 10

<sup>297</sup> Chatterjee, A & MacLeod, C. 2016. *Employment tax incentive descriptive report*. National Treasury. At page 7 and 8

<sup>298</sup> Chen, D. 2015. *The Framework for Assessing Tax Incentives: A Cost-Benefit Analysis Approach*. United Nations. At page 31. Available: [https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP\\_PaperChen.pdf](https://www.un.org/esa/ffd/wp-content/uploads/2015/04/2015TIBP_PaperChen.pdf) [2019, 30 November]

Another way of measuring an incentive could be to determine the Rand cost per job created.<sup>299</sup> This method could be refined to only take into account new jobs created and the cost to not only include actual revenue forgone but also additional and opportunity costs. The more the cost per job becomes, the less efficient the incentive is likely to be.

#### **4.3. Measuring incentives in the South African context**

Generally, tax incentives should be designed with SA's key economic policies in mind. These include addressing the key constraints facing the economy, such as unemployment and low economic growth.<sup>300</sup>

National Treasury, as part as the annexures to the Budget Review, prepares a "Tax expenditure statement". This is an estimate of revenue foregone as a result of tax incentives. It is understood that the statement is to assist in assessing the costs, benefits and overall effectiveness of the tax incentives. On an overall basis, the estimated revenue foregone ("tax expenditure") for 2016/17 was R209 billion, or 4.7% of GDP.<sup>301</sup> This percentage has been increasing year-on-year since 2013/14.<sup>302</sup> Notably, 88.6% of the R209 billion is attributable to the sum of retirement contributions, medical tax credits, items zero rated for VAT and relief in respect of customs and excise duties for motor vehicle manufacturers. Although most incentives report on the outputs (such as the tax expenditure) there is little information on the outcomes (such as increased economic activity or employment).<sup>303</sup>

In 2016 the World Bank reported on a list of incentives reviewed. It estimated that an additional 34,000 jobs were created at a cost of approximately R116,000 per job across all sectors. This increased to R170,000 per job for Small Business Corporations.<sup>304</sup>

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<sup>299</sup>The G-20 Development Working Group by IMF, OECD, UN and World Bank. Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment. 2015. At page 18

<sup>300</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 73

<sup>301</sup> Budget Review 2019. National Treasury. At page 117

<sup>302</sup> Budget Review 2019. National Treasury. At page 120

<sup>303</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 22

<sup>304</sup> Oguttu A, Tickle D & Legwaila T. 2018. Report on The Efficiency of South Africa's Corporate Income Tax System for the Minister of Finance. The Davis Tax Committee. At page 51

A report to the Department of Planning, Monitoring and Evaluation notes that although most incentives reviewed (this includes incentives that are not administered through tax legislation) were informed by some research activity, only a limited number were backed by substantive research while the majority of incentives were not supported by substantial evidence and research. As such, it appears as if insufficient attention is given to the design of incentives.<sup>305</sup> There was also no evidence of cost benefit nor alternative options analysis for these incentives.<sup>306</sup> The report noted that comparable countries (Chile, Thailand and Germany) gave greater attention to the design, targeting and evaluation of incentives than SA.<sup>307</sup>

Similarly the DTC reported that the analysis on the costs and benefits, and information available on who benefits from the incentives are inadequate.<sup>308</sup> Available data does however suggest that the envisaged outcomes are not being realized.<sup>309</sup> Furthermore, the criteria for incentives are sometimes unclear or get changed based on political or economic demands. Although it is important to adjust policies for change in circumstances, it promotes uncertainty in the market which impacts negatively on the use of incentives.<sup>310</sup>

Due to the lack of academic literature regarding section 12J, this dissertation considered academic research with regards to the success of other tax incentives. Notably, the Employee Tax Incentive and the Research and Development Incentive were selected as these incentives have been widely studied.

### *The Employee Tax Incentive (“ETI”)*

Based on Annexure B to the 2019 Budget Review, the ETI is the fifth largest contributor to total tax expenditure.<sup>311</sup> The incentive reimburses firms for hiring young, inexperienced workers.

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<sup>305</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 20

<sup>306</sup> Ibid

<sup>307</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 24

<sup>308</sup> Oguttu A, Tickle D & Legwaila T. 2018. Report on The Efficiency of South Africa’s Corporate Income Tax System for the Minister of Finance. The Davis Tax Committee. At page 50

<sup>309</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 23

<sup>310</sup> Stern, M. 2018. Report on the Evaluation of Government Business Incentives. *DNA Economics*. At page 21

<sup>311</sup> Budget Review 2019. National Treasury. At page 121

Notably the incentive has been extended to 28 February 2029, indicating government's belief that the incentive is successful.<sup>312</sup>

Ranchhod and Finn (2014:1) using a difference-in-difference regression analysis on the Quarterly Labor Force Survey, indicated that the ETI had no significant impact on youth employment and that there appeared to be no significant effect on churning amongst youth in the labor market. The results imply that the ETI was being claimed by firms which would have employed most of the youth even in the absence of the ETI.<sup>313</sup> This study was however only in respect of the first 12 months in which the incentive was available and on limited data provided only by Stats SA. In this respect, later studies that allowed for more time to pass since the introduction of the incentive and where SARS provided more comprehensive data concluded differently. Borat and Thornton (2016) also found Ranchhod and Finn's study unsuitable to conclude on the effect of the ETI.<sup>314</sup>

It is estimated that for 2015/16 the ETI was claimed by about 32,368 employers for 1.1 million individuals. The claim value amounted to R3.5 billion.<sup>315</sup> The 2017/18 tax expenditure amounted to R4.3 billion. The National Economic Development and Labor Council, in respect of the ETI for 2014/15 to 2015/16, predominantly found that:<sup>316</sup>

- i) Employment growth increased significantly in firms claiming the incentive;
- ii) The effects were most evident in firms with less than 50 employees;
- iii) There was no significant evidence that the ETI displaced older workers;
- iv) The incentive plays a key role in halting job losses;
- v) Due to experience gained by the workers, employers tend to retain the workers even after the two year eligibility period; and

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<sup>312</sup> Kotze L. 2019. A further win for the youth. *Cliffe Dekker Hofmeyr*. Available [www.cliffedekkerhofmeyr.com/en/news/publications/2019/taz/budget-speech-alert-2019-a-further-win-for-the-youth.html](http://www.cliffedekkerhofmeyr.com/en/news/publications/2019/taz/budget-speech-alert-2019-a-further-win-for-the-youth.html) [2019, December 24]

<sup>313</sup> Ranchhod, V., Finn, A. 2014. Estimating the short run effects of South Africa's Employment Tax Incentive on youth employment probabilities using a difference-in-differences approach. *Southern Africa Labor and Development Research Unit*. At page 1

<sup>314</sup> PFMPC Research Report On The Impact Of Employment Tax Incentive Act. 2016. *National Economic Development and Labor Council*. At page 10

<sup>315</sup> PFMPC Research Report On The Impact Of Employment Tax Incentive Act. 2016. *National Economic Development and Labor Council*. At page 5

<sup>316</sup> Budget Review 2019. National Treasury. At page 42

- vi) Workers indicated that the incentive provided them with opportunities that they would not otherwise would have had access to.

Furthermore, it appears as if wages of workers supported by the ETI are higher on average when compared to eligible workers that do not have ETI supported jobs.<sup>317</sup> However, some studies still suggest that there is no positive impact on employment due to the ETI.<sup>318</sup> Further econometric investigation would be required to more conclusively determine the effect of the ETI.<sup>319</sup>

Quantitative and qualitative data are open to interpretation.<sup>320</sup> As such, any assumptions or conclusions made on the data should be interrogated for potential bias. It might be worth performing the analysis of the incentive using different assumptions where bias is suspected in order to determine the sensitivity of final output on these assumptions. Qualitative data such as questionnaires and consultations could also be skewed in that interested parties are more likely to respond that those that are ambivalent.<sup>321</sup>

#### *Research and Development incentive (“R&D”)*

The R&D tax incentive scheme has been beset with various challenges, including administrative delays, complex information and limited access for SME’s and start-ups although companies of any size in and in any industry could qualify for the tax incentive.<sup>322</sup> The administrative issues and backlogs due to the pre-approval system resulted in a significant decrease in the R&D incentive being claimed.<sup>323</sup> Due to the delay in approvals, taxpayers became skeptical of reopening and

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<sup>317</sup> Chatterjee, A & MacLeod, C. 2016. Employment tax incentive descriptive report. *National Treasury*. At page 21 and 24

<sup>318</sup> PFMPC Research Report On The Impact Of Employment Tax Incentive Act. 2016. *National Economic Development and Labor Council*. At page 9

<sup>319</sup> Chatterjee, A & MacLeod, C. 2016. Employment tax incentive descriptive report. *National Treasury*. At page 27

<sup>320</sup> Chatterjee, A & MacLeod, C. 2016. Employment tax incentive descriptive report. *National Treasury*. At page 8

<sup>321</sup> Ibid

<sup>322</sup> Science and Technology on research and development (R&D) tax incentive programme. 2018. *Department of Science and Technology*. Available at <https://www.gov.za/speeches/science-and-technology-research-and-development-rd-tax-incentive-programme-2-mar-2018-0000> [2019, 30 November]

<sup>323</sup> Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive – Final Report to the Minister of Science and Technology. 2016. *Department of Science and Technology*. At page 11

revising historic tax returns as it was likely to trigger larger and detailed audits by SARS. This discouraged taxpayers from applying for the R&D incentive.<sup>324</sup>

International studies show that if R&D tax incentives are appropriately designed they can increase private research spending by at least an amount equal to the loss in tax revenue and that social returns outweigh the private returns. The OECD indicated that the level of R&D has a positive correlation with the level of government funding of business R&D.<sup>325</sup>

It is estimated that between 2006 and 2015, R33.1 billion R&D expenditure has been supported by the tax incentive. During this time, revenue forgone amounted to R6 billion. Companies indicated they had to employ 26,526 R&D personnel.<sup>326</sup> Although business is the largest performer of R&D in SA, business expenditure on R&D as a percentage of GDP remained very low, with 0.33% being recorded in 2013/14.<sup>327</sup> No studies have been performed in SA to determine what the effect would have been had the R&D incentive not been in place.<sup>328</sup>

The generosity of the 150% appears to be less favorable when compared to other countries, even more so in respect of some SME's in SA which are taxed at preferential rates.<sup>329</sup> However, a report by the World Bank found that companies that received the section 11D incentive spent an additional R4 million on R&D compared to those that did not receive the incentive, except for the auto and mining sectors. It was estimated that while tax revenue forgone was only R7 billion between 2008 and 2015, the additional R&D spending amounted to R13 billion. This indicates that the R&D incentive is successful in that for every R1 of tax forgone, R1.83 was spent on R&D.<sup>330</sup>

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<sup>324</sup> Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive – Final Report to the Minister of Science and Technology. 2016. *Department of Science and Technology*. At page 38

<sup>325</sup> Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive – Final Report to the Minister of Science and Technology. 2016. *Department of Science and Technology*. At page 10

<sup>326</sup> Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive – Final Report to the Minister of Science and Technology. 2016. *Department of Science and Technology*. At page 10

<sup>327</sup> Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive – Final Report to the Minister of Science and Technology. 2016. *Department of Science and Technology*. At page 12

<sup>328</sup> Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive – Final Report to the Minister of Science and Technology. 2016. *Department of Science and Technology*. At page 13

<sup>329</sup> Report of the Joint Government Industry Task Team on the Research and Development Tax Incentive – Final Report to the Minister of Science and Technology. 2016. *Department of Science and Technology*. At page 51

<sup>330</sup> Oguttu A, Tickle D & Legwaila T. 2018. Report on The Efficiency of South Africa's Corporate Income Tax System for the Minister of Finance. The Davis Tax Committee. At page 52

#### 4.4. VCC

The VCC tax incentive is aimed at attracting investment into SME's. Many countries may use their tax laws to attract investment (whether local or foreign), foregoing tax revenue to achieve development objectives.<sup>331</sup> Generally, tax incentives aimed at attracting investment are less effective in developing countries. Furthermore, they distort resource allocation, displacing more efficient investments, which could be harmful to long term economic growth.<sup>332</sup> Internationally, tax incentives for investments are generally regarded as being wasteful in that the investments would have been made in any event.<sup>333</sup>

The 2019 Budget Review was the first year in which the tax revenue forgone due to the VCC incentive was estimated. Treasury noted that the revenue forgone would be partly offset through future capital gains tax, which would require future reconciliations to estimate the true cost. Notably, reference was made that CGT would be paid on two levels, i.e. at the level of the VCC and again at the level of the investor, which results in a higher effective capital gains tax rate.<sup>334</sup> Please see Chapter 2, Example 2.4.2 for an illustrative example in this respect.

Based on the information for the 2016/17 fiscal year, tax expenditure resulting from the section 12J deduction was estimated to be R 196 million.<sup>335</sup> It is noted that 81% of this amount was as a result of taxpayers that had taxable income exceeding R1 million (before claiming the section 12J deduction), which were a mere 6% of all the taxpayers that claimed a section 12J deduction.<sup>336</sup> The below figures depict the taxable income brackets before the section 12J deduction as a percentage of:

- i) The total R 196 million tax expenditure (Figure 4.1); and
- ii) The total number of taxpayers that benefitted from the section 12J regime (Figure 4.2).

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<sup>331</sup> Oguttu A, Tickle D & Legwaila T. 2018. Report on The Efficiency of South Africa's Corporate Income Tax System for the Minister of Finance. The Davis Tax Committee. At page 48

<sup>332</sup> Ibid

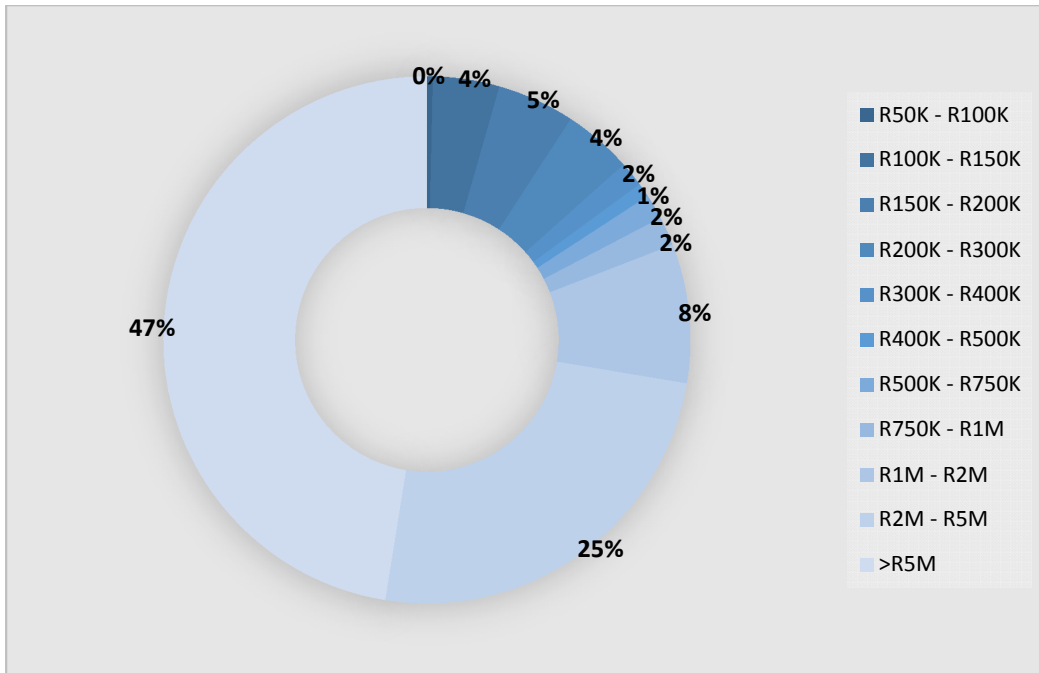
<sup>333</sup> Thuronyi V. 1998. Tax Law Design and Drafting (volume 2; International Monetary Fund). Chapter 23, Income Tax Incentives for Investment. Page 3

<sup>334</sup> Budget Review 2019. National Treasury. At page 118

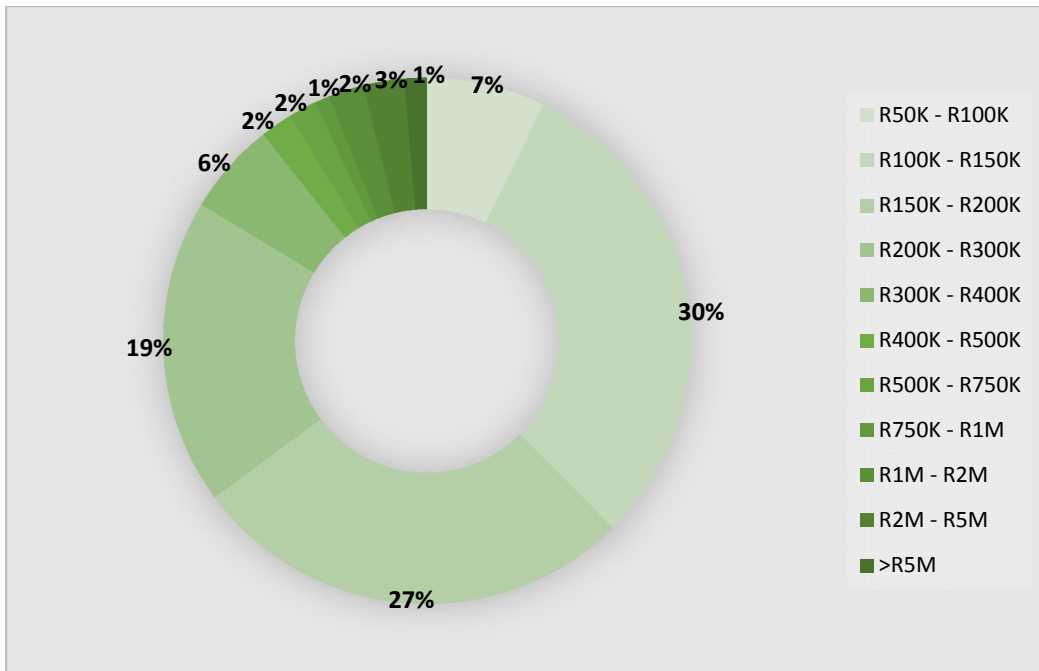
<sup>335</sup> Budget Review 2019. National Treasury. At page 118

<sup>336</sup> Ibid

**Figure 4.1**



**Figure 4.2**



Although the mining sector provides a large part of the SA population with jobs and contributes significantly to the economy, it is noted that neither the R&D incentive nor the incentive on

property investments have had a positive effect on this sector.<sup>337</sup> As noted in Chapter 3, there also appears to be very limited impact on the mining sector by the VCC regime.

Applying the principles noted in this Chapter, the following with regards to the VCC regime can be inferred:

- i) **Clear and precise:** As noted in Chapter 2 certain provisions in section 12J or the reasons for amendments are unclear or appear to counteract the intention of the incentive. *Inter alia*, taxpayers have used the incentive to finance holiday homes and other immovable property investments due to the legislation not being effective in clearly preventing this.
- ii) **Changes:** Similar to the above, section 12J has been subject to continuous amendments. Initially, this was to make the incentive more appealing. Later changes were enacted to prevent abuse. As such, not only do the continuous changes provide uncertainty to the market, introducing anti-avoidance measures complicates the incentive.
- iii) **Imposing a cap:** Notably Treasury has introduced a cap on the deduction per year that an investor can claim in terms of section 12J. This is in line with the perceived best practice. Imposing a cap is likely to prevent excessive tax deductions and deter using the incentive in tax abuse and avoidance schemes, but may reduce the attractiveness of the incentive.
- iv) **Sunset clause:** The incentive has always had a sunset clause for 30 June 2021, which is considered to be a good element in the design of an incentive. However, no real uptake of the incentive occurred until 2015. This significantly reduces the data available that can be used to assess the incentive before the sunset date. See also below.
- v) **Time passed:** Considering that the incentive has only shown significant uptake since 2015, the time that VCC's have to invest into qualifying companies, the time it will take for the investment into qualifying companies to filter through to the economy and the five years that investors are required to invest into VCC's before they can exit, it is

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<sup>337</sup> Oguttu A, Tickle D & Legwaila T. 2018. Report on The Efficiency of South Africa's Corporate Income Tax System for the Minister of Finance. The Davis Tax Committee. At pages 51 and 52

unlikely that there will be sufficient evidence at this stage to prepare an accurate cost and benefit analysis.

- vi) **Cost:** Treasury has been able to measure the upfront tax expenditure. This however needs to be offset against the capital gains tax that would result at the two levels (the VCC and the investor) in future. See also the “Multiplier effect”, at paragraph (ix). The additional administration and compliance costs also need to be considered.

Furthermore, although some VCC’s have put in place clear exit strategies for investors,<sup>338</sup> the lack of marketability of VCC shares need to be taken into account when evaluating the incentive. VCC shares are generally in respect of private companies which means that the shares cannot be as easily disposed of as listed shares.

- vii) **“Additionality”:** It will need to be determined to what extent investments made by way of the incentive are redundant, relocate existing investments and negatively affect investments that fall outside of the tax incentive regime.
- viii) **Opportunity cost and alternatives:** To estimate the true cost of the VCC incentive, it needs to be determined what the tax revenue forgone could have been spent on or the cost of other alternative options that could have given similar results. For example, international examples (see section 4.2, paragraph (ii) above) indicate that providing loan guarantees in respect of loans advanced to SME’s, provide for a much lower cost than a tax incentive.
- ix) **“Multiplier effect”:** The second-round effect of the incentive needs to be considered. This would include the effect of the reduction in expenditure by government in another sector which would mean that that sector is negatively affected, the additional capital gains tax realized by the VCC and the investor on disposal of the investments, the additional jobs and economic activity that would generate more tax revenue following the investments.

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<sup>338</sup> Lee T. 2018. Pay less tax and be patriotic? Yes it can be done. *Moneyweb*. Available <https://www.moneyweb.co.za/financial-advisor-views/pay-less-tax-and-be-patriotic-yes-it-can-be-done/> [2019, 24 November]

Due to the lower risk where VCC's invest into asset-backed businesses, further gearing of the equity investment allows for additional debt funding that would otherwise not have been available, or would have come at a higher interest rate. Asset rental businesses free up funds for their customers that would otherwise have been required to purchase expensive capital equipment. The customer may also be subject to less risk in that the lessor is responsible for the maintenance of the asset. These factors should also be taken into account in order to ensure the evaluation of the incentive is more precise.

- x) **Rand cost per job created:** Based on the information available, between 1.5 and 5 jobs can be created for every R1 million VCC investment. Assuming a tax rate of 28%, this means a tax expenditure of between R56,000 and R186,667 per job created. The VCC regime appears to render similar results when comparing the cost per job created by other SA incentives. However, further studies will be needed to refine the calculation.
- xi) **Political and market pressure:** The section 12J incentive has birthed an entire new industry. Without future support by way of a tax incentive, the industry is unlikely to be sustained. Notably, industry players have indicated that they intend to lobby government to extend the incentive and are collating information to prove the benefits of the incentive. As noted earlier, data should be interrogated for potential bias.
- xii) **Generosity:** A 100% tax deduction is allowed in terms of an investment into a VCC. The level of generosity of the deduction will differ for different taxpayers based on their different tax rates. This is further reduced due to the potential capital gains tax that will arise in future, both for the VCC and the investor, when exiting the investment. There is however a significant benefit in the year the investment is made, which could attract tax avoidance schemes.
- xiii) **External factors:** The South African economy has been plagued by various factors such as intermittent electricity supply and lack of skills. As noted in this Chapter, if the fundamental factors for growth are not in place a tax incentive is unlikely to be effective. Furthermore, it will be difficult to determine what the effect of the incentive is due to the constant change in the external factors.

Significant uptake of the incentive is now apparent. However, there appears to be insufficient data to enable a reasonable analysis of all the costs and benefits of the section 12J incentive. Although this Chapter is unable to conclude in this respect, future studies could further investigate the principles noted.

# Chapter 5 – Summary and conclusions

## 5.1. Summary

The research in this dissertation has set out to answer the following research question:

Does the section 12J venture capital incentive advance government’s original stated intention of incentivising the provision of equity funds to the SME sector?

Based on the outcome of the research on the above main research question, the secondary question to answer has been:

Should section 12J be extended beyond 2021?

These questions are answered and further research areas identified by reference to the summary of the key findings from the research study (and suggestions for improvement) summarized below. These findings are fundamental to determining the answers to the research questions, which answers are set out in the conclusion to this chapter:

It is clear from the significant increase in the number of VCC’s that there has more recently been a significant uptake of the VCC tax incentive, leading to a meaningful investment into the economy.<sup>339</sup> It is estimated that over R8.3 billion has been raised by the incentive. However, only R3.7 billion has been deployed into qualifying companies.

VCC’s have, however, been accused of focusing more on the tax relief provided than the investment opportunity and this potentially leads to low quality investments.<sup>340</sup> By imposing an additional incentive to prove that the investment has made a meaningful contribution to creating long term jobs and to stimulating the economy, the quality of investments could be improved.<sup>341</sup>

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<sup>339</sup> SARS, Explanatory Memorandum on the TLAB 2018:27

<sup>340</sup> Lessem I. 2018. Pretoria News Weekend – Personal Finance. Beware of the hype over section 12J

<sup>341</sup> Cohen G. 2019. Limiting incentives to funding small businesses is shortsighted. *BusinessLive*. Available <https://www.businesslive.co.za/bd/opinion/2019-08-07-limiting-tax-incentives-to-investment-in-smes-is-shortsighted/> [2019, 9 September]

One of the principles of an effective and efficient tax incentive is that it is clear, uncomplicated and not subject to constant change. However, the VCC regime has been subject to policy uncertainty and continuous amendments. Inevitably anti-avoidance provisions have further complicated the incentive. Industry players find it challenging to continually modify their business models to remain compliant with the regular changes. This could impact the sustainability of the existing VCC's and the regime as a whole.

Furthermore, not only does a VCC have to continuously adhere to all the VCC requirements, it also has to constantly monitor the investors and qualifying companies against the respective requirements applying to them to ensure that the breaching of these requirements will not impact the VCC status. As such, a VCC could be at risk of losing its VCC status due to the actions of the investor or qualifying company, which actions are unlikely to be controlled by the VCC. Losing its VCC status will result in an inclusion of 125% of the amounts incurred by any person to acquire any shares in the VCC (not only qualifying VCC shares).

The impact of such an inclusion, and its VCC status being withdrawn, is likely to impair the future operations of the VCC. Due to the high risk of abuse, the penalties are however meant to be severe but the writer points out that a breach of the VCC requirements could occur due to actions that are not controlled by the VCC. The writer is further of the view that these risks act as a disincentive to enter the regime. However, except for section 12J(3B)<sup>342</sup>, SARS would generally notify and provide opportunity for the VCC to take corrective steps before withdrawing its VCC approval.<sup>343</sup>

The reasoning behind the 125% inclusion rate was because it translated roughly back to the benefit an individual would have had from the deduction if he had a marginal tax rate of 40%.<sup>344</sup> The marginal rate has now increased to 45%. Furthermore, any taxpayer may now invest into a VCC and obtain the deduction, not just individuals.<sup>345</sup> As such, the reasoning behind the 125% inclusion is outdated and the writer is of the view that it might require re-assessment.

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<sup>342</sup> Section 12J(3B) will require SARS to withdraw the VCC status of a company if any investor becomes a connected person or holds more than 20% of any class of share in the VCC, without any opportunity for the VCC to correct the situation within a reasonable time.

<sup>343</sup> Sections 12J(3A), 12J(6), 12J(6A) of the ITA

<sup>344</sup> SARS, Explanatory Memorandum on the Revenue Law Amendment Bill, 2008:71

<sup>345</sup> SARS, Explanatory Memorandum on the Revenue Law Amendment Bill, 2011:75

The sole object of the VCC must be the management of investments in qualifying companies, but the VCC can still engage in ancillary activities. There appears to be no exact answer as to when the sole purpose test is failed, as each case will need to be decided on a case-by-case basis. This again leads to uncertainty in the industry. It may also be difficult for SARS to effectively monitor when this requirement is breached.

Furthermore, it was thought that the 80% requirement<sup>346</sup> would be sufficient by itself to ensure (by applying objective principles) that the VCC is directed to its objective.<sup>347</sup> The requirement is however deferred for 36 months (48 months once the 2019 TLAB is promulgated)<sup>348</sup> which might still require a test from day one, i.e. the sole purpose test. The writer suggests that a percentage-based limit is re-introduced on any gross income that is not directly related to a qualifying company or is merely investment income from surplus funds. For example, the VCC could be required not to derive more than 25% of its gross income from sources other than (1) management fees, (2) qualifying companies or (3) passive income from short term investment of surplus cash. If this is implemented there should be no further need for the sole object test and this would provide more certainty.

Notwithstanding that the phrase “in respect of” has on various occasions been interpreted as denoting a direct or causal relationship, it does appear as if SARS accepts cases where there is no direct relationship, that there is no “impermissible trade”. However, the VCC Guide gives various examples of indirect relationships that it describes as resulting in a company conducting an impermissible trade. Further certainty in this respect would be welcomed by the Industry.

Inappropriate VCC vehicles are created to invest into holiday homes and capital equipment.<sup>349</sup> Further criticism is that the incentive is being used by persons that are not true venture

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<sup>346</sup> The “80% requirement” refers to the requirement imposed on VCC’s that it invests 80% of its capital in acquiring qualifying shares issued by qualified companies. See Chapter 2, section 2.2 and section 12J(6A)(b) of the ITA

<sup>347</sup> SARS, Explanatory Memorandum on the TLAB 2011:76

<sup>348</sup> SARS. Taxation Laws Amendment Bill 2019. At page 12

<sup>349</sup> Ensor L. 2018. Treasury’s plan to fix abuse of venture capital incentive will kill the industry, MPs told. *BusinessLive* Available <https://www.businesslive.co.za/bd/national/2018-08-21-treasurys-plan-to-fix-abuse-of-venture-capital-incentive-will-kill-the-industry-mps-told/> [2019, 16 November]

capitalists.<sup>350</sup> Many of the investments, such as those into asset rental businesses, could have been funded by banks, or would have been made whether or not the incentive was available, resulting in an unnecessary cost to the fiscus.

Notably, startups are not necessarily benefitting from section 12J as was originally intended. However, due to the requirement that the book value of a qualifying company should not exceed R50 million (or R500 million where that company is a junior mining company) after the issue of shares,<sup>351</sup> VCC's are still required to fund only SME's.<sup>352</sup> Qualifying companies are unlikely to attract private equity investment which generally focus on businesses with assets exceeding R50 million. This suggests that VCC's are still playing a role in providing SME's with expansion capital.<sup>353</sup>

Similar to the DTC's findings on other incentives, the VCC incentive has not resulted in a significant positive effect for mining. It is noted that although there is investment via VCC's into ancillary mining projects on existing sites, there is no exploration or new mines being funded by the VCC regime.

When the incentive was first introduced, Treasury specifically did not impose monetary limitations for listed entities,<sup>354</sup> and even allowed an investment into a VCC of up to 40%.<sup>355</sup> Considering the need for anchor investors (and the relatively low loss to the fiscus where these are companies), it may be beneficial not to impose a monetary limit on companies and to specifically allow listed entities to invest up to 40%, as a specific exclusion from the 20% and connected person tests.

Capping the available tax deduction, although this is likely to reduce the number of anchor investors and act as a disincentive, is seen as a positive indicator as to the design of an incentive. However, if the incentive is based on the premise that a short term loss to the fiscus is offset against

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<sup>350</sup> Buthelezi L. 2019. Venture capital industry is taking off, but will it keep flying? *BusinessLive*. Available <https://www.businesslive.co.za/bd/business-and-economy/2019-09-22-venture-capital-industry-is-taking-off-but-will-it-keep-flying/> [2019, 16 November]

<sup>351</sup> Section 12J(6A)(b)

<sup>352</sup> <https://grovest.co.za/2019/10/14/should-you-really-keep-your-money-in-sa/>. [2019, 16 November]

<sup>353</sup> Ibid

<sup>354</sup> SARS, Explanatory Memorandum on the TLAB, 2008:68

<sup>355</sup> SARS, Explanatory Memorandum on the TLAB, 2009:73

the long term growth of the economy which will increase tax revenues, the introduction of the cap is counterintuitive to allowing a VCC an additional year to invest into qualifying companies.<sup>356</sup> This will increase the timing delay between the initial loss to the fiscus and future tax revenue growth.<sup>357</sup>

The draft bill also does not take into account that those that intend to abuse the incentive and claim excessive tax deductions can bypass the cap by merely introducing further legal entities. The loss to the fiscus is significantly less when a company invests into a VCC as opposed to a natural person taxed at the maximum marginal rate. The cost, but also the incentive for the investor, is further reduced if a capital gain arises. The effect is compounded when both the VCC and its shareholders dispose of their respective investments for a capital gain since capital gains is triggered on two levels as opposed to a direct investment made by the investor.<sup>358</sup>

SARS may seek to invoke the general anti-avoidance rules where it identifies schemes purely aimed at abusing section 12J. If successful, this is bound to be a warning to all taxpayers to not take part in such schemes going forward.

Instead of imposing a cap, it may be suggested that the tax deduction limit be geared for different taxpayers as the only difference between one person investing R5 million, or two persons investing R2.5 million each would be if different tax rates apply. The writer points out that:

- i) The incentive could be limited to the extent that a reduced marginal tax rate would apply due to the section 12J deduction. For example, where a taxpayer would have been taxed at 45% but for the tax deduction, and is now being taxed at 40%, the said deduction is limited to 40/45 of the amount paid for the VCC shares. However, an optimal tax structure should *inter alia* be simple, and this proposal will likely add complexity to the regime.

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<sup>356</sup> Whitfield B. 2019. Balancing retirement annuities (RAs) and Section 12J investments. *Capetalk*. Available <http://www.capetalk.co.za/podcasts/201/the-best-of-the-money-show/261894/balancing-retirement-annuities-ras-and-section-12j-investments> [2019, 17 August]

<sup>357</sup> Ibid

<sup>358</sup> Budget Review 2019. National Treasury. At page 118

- ii) Instead of allowing a tax deduction, a tax credit could be another option. For example, allowing a tax credit of 28% of the amount invested would provide the same tax saving for all taxpayers notwithstanding their individual tax rates. However, this is likely to have a negative effect on the incentive for investment by high net worth individuals currently being taxed at a rate higher than 28%.
- iii) The taxpayer could be allowed to carry forward the amount of the investment exceeding R2.5 million (or R5 million if a company) that was not allowed as a deduction in the year of the investment, to claim as a deduction in the next year.

Without having to re-consider the whole incentive, it could be extended to partnerships or trusts, treating the VCC as fiscally transparent or providing an exemption for capital gains tax at either the level of the VCC or the investor.<sup>359</sup>

The writer is of the opinion that if all qualifying companies in general were permitted to list on the AltX, the scope of qualifying investments could be broadened and this would allow the companies to also source funds via the AltX while not impairing their ability to obtain VCC funding.

Where taxpayers, especially SME's, are seeking to regularize their tax affairs the writer is of the opinion that this should be prioritized and expedited. The following three benefits are apparent:

- i) More companies (as much as 23%) would be considered qualifying companies as defined, allowing for a larger reach for the VCC regime;
- ii) SME companies that were previously not tax compliant, will now become tax compliant leading to an increased tax base and potential tax revenue; and
- iii) The success rate of SME's might increase slightly, due to investments received, reduced tax penalty exposure and management experience.

Alternatively, the 'tax compliant' requirement for qualifying companies may be deferred similar to other requirements in the VCC regime to allow the VCC to invest in and then assist the investee to become tax compliant, through funds and also skills. There is however a significant risk of

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<sup>359</sup> Linington, M. 2016. Funding for small and medium-sized enterprises. *Cliffe Dekker Hofmeyr*. Tax and Exchange Control Alert

investing into a non-compliant company, which can be reduced by an in-depth due diligence and risk assessment by the VCC prior to investment.

Although the incentive has always had a sunset clause for 30 June 2021, which is considered to be a good element in the design of an incentive, no real uptake of the incentive occurred until 2015.

Considering this concurrently with:

- i) VCC's have up to 48 months to find suitable qualifying company investments;
- ii) There is a time delay between the investments in the qualifying companies and the expected positive impact on the economy;
- iii) Taxpayers are likely to stay invested in the VCC's for at least five years before exiting and realizing a potential capital gain (this gain needs to be offset against the upfront tax expenditure); and
- iv) The effect of changes, especially the more recent changes, to the legislation will take some time to filter through into the industry,

it is unlikely that there will be sufficient evidence at this stage to prepare an accurate costs and benefits analysis to determine whether the regime is effective and should be extended.

Assuming a tax rate of 28%, the tax expenditure per job created is of between R56,000 and R186,667. This is similar when compared to the cost per job created by other SA incentives. There is however no data available on the type of jobs and salaries being created, nor on the Multiplier effect, which the writer notes could be significant. Furthermore, further studies will be needed to refine the calculation.

The 12J Industry Association has indicated that it will be conducting its own studies to prove that the incentive is reaching its objectives and will lobby Treasury to extend the sunset date. The writer points out however that since the Association has a beneficial interest in the incentive, a study by an independent researcher is likely to provide better protection against bias.

## **5.2. Conclusion**

Based on the factors set out in this chapter, which are the outcomes and recommendations from all the preceding chapters, whether the section 12J tax incentive is successfully advancing

government's original intention still remains to be seen. Although there has been significant uptake of the regime and evidence to suggest that jobs are being created and meaningful investments are occurring, it still needs to be assessed to what extent the jobs and investments would have occurred even without the incentive. There also remain some short-comings to the design of the incentive and uncertainty to the regime which affects the sustainability of VCC's and the type of investments being made.

Notably the VCC industry has evolved to be more conservative, investing into asset-backed businesses and generally providing more growth capital, meaning that start-ups and other industries such as high growth technological companies are benefitting to a lesser extent. As such, government's intention to provide equity finance to start-ups and high growth industries appear to not be being addressed. Due to the late uptake of the regime, it is further unlikely that sufficient data would be available to analyze the incentive before 30 June 2021, the current sunset date.

The writer's view is that Treasury should appoint an external research organisation to prepare a thorough analysis of the incentive and whether it should be extended, but in any event, as a minimum the incentive should be extended for at least another six years (to make up for the years from its introduction to the year it showed significant uptake, i.e. 2009 to 2015). Alternatively, the section 12J incentive should not be extended but rather replaced with a similar incentive taking into account the recommendations made in this dissertation.

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