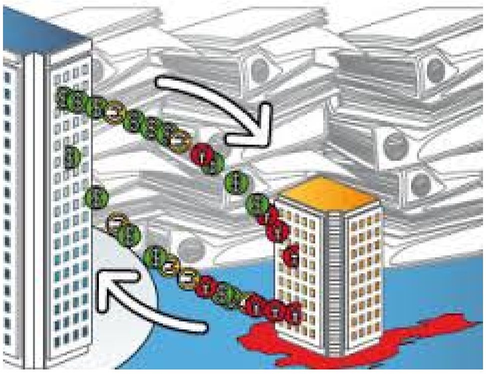
An Overview of South Africa's Withholding Tax Regime



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Venture capital companies are a tax-favoured investment vehicle. The venture capital company ("VCC") scheme, introduced in 2009, is a tax-based scheme designed to encourage individual and corporate investors to invest in a range of smaller, higher-risk trading companies by investing through the VCCs.

Background

Although South Africa has a well-developed private equity industry, its appetite for start-up, early stage and seed capital type transactions is low. To meet the challenge of access to venture capital for small and medium-sized enterprises, government introduced a tax incentive for individual investors, corporate investors and venture capital funds in qualifying small enterprises and start-ups. The tax incentive took effect from 1 July 2009.

Since its inception and despite amendments in 2011 to enhance its attractiveness, the uptake for this tax incentive has been very limited. In the 2014 National Budget Review, Government announced that it will propose one or more of the following amendments to the venture capital company regime:

- making tax deductions permanent if investments in the

VCC are held for a certain period of time;
- allowing transferability of tax benefits when investors dispose of their VCC holdings;
- increasing the total asset limit for qualifying investee companies (i.e. companies in which the VCC may invest) from R20 million to R50 million, and from R300 million to R500 million in the case of junior mining companies; and
- waiving capital gains tax on the disposal of assets by the VCC, and expanding the permitted business forms.

The purpose of this series of articles is to examine the impact of the VCC tax incentives on the investors, the VCC itself and the qualifying investee companies. This article will give a general overview of the VCC scheme while subsequent articles will deal with each of the role players in increasing levels of detail.

What is a VCC?

An approved VCC is a company designed to provide individual and corporate investors with access to a range of trading companies which have the potential for growth. The VCC aims to make money by investing in these smaller trading companies. The VCC raises funds by issuing equity shares to investors and the money is then allocated to those businesses that the managers judge to have the best prospects.

Overview of the tax treatment

Upfront income tax relief:

An investor which subscribes for VCC shares receives an immediate tax deduction equal to 100% of the amount invested with no annual limit or lifetime limit. The relief is available provided that the investor subscribes for equity shares, as opposed to buying them second hand from other investors. There is no minimum holding period.

Taxable recoupment

The upfront income tax relief is temporary. According to the 2014 National Budget Review a proposal will be considered making the deduction permanent if the VCC shares are held for a certain period of time.

No dividends tax relief

Dividends on VCC shares are subject to the 15% dividends tax unless the investor qualifies for an existing dividend tax exemption. For instance, investors which are SA resident companies will enjoy the company-to-company dividend tax exemption.

No capital gains tax relief

CGT is payable when investors sell their VCC shares at the rate applicable to the relevant investor (13.3% for individual investors; 18.6% for corporate investors and effective 26.6%for investors which are trusts). However, there is tax relief for capital losses. Capital losses on the disposal of VCC shares can be set off against investors' capital gains. It is not possible to set off capital losses against the investors' income.

No reinvestment relief

It is not possible for an investor to defer the gain on another investment by applying the sale proceeds to subscribe for VCC shares. Thus, investors that sell their, say, Sasol or MTN shares in order to reinvest the proceeds in VCC shares will be subject to CGT on the sale of the Sasol or MTN shares. The after-tax proceeds from the sale of those shares will be invested in VCC shares.

The venture capital scheme is temporary

The VCC regime, introduced in 2009 is subject to a 12 year sunset period that ends on 30 June 2021. The upfront income tax relief will only apply to VCC shares acquired on or before 30 June 2021.