Investments in venture capital companies not looking so attractive anymore

National Treasury yesterday released the draft bills for public comment, which once approved will serve to effect the legislative amendments announced as part of the 2019 Budget Review.

Of interest to the individual taxpayer and especially one whom has surplus funds available for investment is the proposed changes to cap the tax deduction available in respect of investments to the section 12J Venture Capital Companies (VCC). It is proposed to introduce a cap of R2.5million per annum per investor.

If the proposal is approved the amendment will be effective retrospectively to 21 July 2019 (the draft bill release date) thereby mitigating opportunities for the investor to have made a substantial lump sum investment before the changes were introduced.

The main reason for the introduction of the VCC legislation and its beneficial tax dispensation, more than 10 years ago, was to raise funding in support of and to quote from the Explanatory Memorandum, *the socio-economic development of small business which otherwise would not have had access to market funding due to either or both their size and inherent risk.* And based on the substantial amounts invested it seemed that many an individual taxpayer was whole-heartedly behind this initiative!Whether looking to diversify his or her investment portfolio or simply to legitimately reduce his or her tax liability many taxpayers took up the opportunity to purchase shares in the VCC as the cost of the investment served as an immediate upfront tax deduction while no recoupment of such tax deduction is required where the shares are sold after 5 years.

On the eventual disposal of the VCC shares the principle tax rules will apply namely, if the individual taxpayer held such for long term investment purposes the Capital Gains Tax dispensation should be applied while if the shares were held for speculative purposes the profit or loss would on revenue account.

Therefore, an individual taxpayer whom is subject to normal tax at the maximum marginal tax rate of 45% would benefit from an immediate 45% tax saving on such investment. The proposal now limits such annual tax saving to a maximum of R1,125,000.00.

National Treasury has indicated its reasoning and thoughts behind the proposal, which seems more driven by the inability to counter tax avoidance at the VCC level rather than at investor level. Surely it is the investor whom should continuously be incentivised to invest in such government backed initiatives, because honestly where else will the funding come from?

National Treasury and SARS should surely focus on implementing and monitoring the anti-avoidance measures at the VCC level to ensure that the criteria to qualify as a VCC are strictly met. The fact that this VCC regime is also subject to a 12-year sunset clause, ending in June 2021, begs the question why National Treasury would make such drastic changes to the funding mechanism now, rather than waiting until the entire regime is up for reconsideration in less than 24 months?

On a practical note, since the R2.5million cap is applicable to any cost incurred on or after 21 July 2019 what will happen where an individual taxpayer has bought shares on 19 July 2019 for R5million and a further R2.5million shares on 22 July 2019 would the taxpayer qualify for an overall deduction of R7.5million in the current 2020 year of assessment or only the R2.5million? This is unclear from the draft legislation.

Furthermore, would the individual taxpayer qualify to claim as a tax deduction the balance of the expenditure in excess of the R2.5 million in the subsequent year of assessment, similar to the tax dispensation afforded to donations made to approved public benefit organisations?

These and many more questions will be posed to National Treasury by ourselves and our registered controlling body, the South African Institute of Tax Practitioners (SAIT), as clarity is vital before an individual taxpayer should consider investing more in the VCC.

–ENDS-

Note to editors

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SARS issues a further ruling

on venture capital companies

Authors: Mansoor Parker and Anuschka Wischnewski.

On 6 June 2017, the South African Revenue Service (**SARS**) issued binding private ruling 274 (**BPR 274**). BPR 274 deals with a venture capital company (**VCC**) investing in a company providing and expanding plants for the generation of solar electricity.

This brings the number of binding private rulings that SARS has issued in respect of venture capital companies to four. Below, we compare the rulings in this matter with prior rulings issued by SARS to determine whether there are any trends with regard to rulings issued by SARS in respect of venture capital companies.

Before dealing with these trends, we first set out the proposed transaction in BPR 274.

BPR 274 deals with two issues that have been a common feature in all the VCC-related rulings given thus far by SARS: equity share and controlled group company. The table below indicates that all four binding private rulings have considered the equity share and the controlled group company issue:

Controlled group company

The reason why many VCCs request a ruling from SARS on this issue, is that a VCC may not invest in a qualifying company if it is a controlled group company in relation to a group of companies. A controlled group company in relation to a group of companies, is where at least 70% of its shares are held by a controlling group company or by other controlled group companies within the group of companies.

The practical problem faced by VCCs occurs where they contribute 70% of the contributed tax capital to the qualifying company. If the qualifying company issues a commensurate amount of equity shares to the VCC, then the VCC becomes a controlled group company in relation to the qualifying company, as it will hold 70% of the equity shares in the qualifying company.

The mechanism that is used to overcome this problem, is for the qualifying company to issue different classes of shares. The VCC subscribes for a class of share with a high subscription price, for example, ZAR1 000 per share. The other investors subscribe for a class of share with a low subscription price, for example, ZAR10 per equity share.

As a result, the VCC contributes more of the contributed tax capital but acquires less of the equity shares. These rulings confirm that the test is the number of shares that the VCC holds in the qualifying company, not the VCCs economic interest (ie the value of those shares) in the qualifying company.

Equity share

The VCC that acquires higher-priced shares in the qualifying company would naturally want a preferential right to distributions from the qualifying company. This is why it is necessary that in all the VCC rulings issued by SARS, the applicants seek rulings that the shares are equity shares.

According to the Income Tax Act, 1962, an equity share is any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution.

It is only if there is a restriction placed on both returns of capital and dividends that a share will not qualify as an equity share and therefore, will not be a qualifying share under the VCC scheme.

What can be taken from the BPRs, is that an investor can contribute a disproportionate amount of share capital entitling the investor to a first distribution of profits or capital, in other words, the share is preferential in nature, yet it still remains an equity share.

Impermissible trade

A company cannot be classified as a qualifying company if it carries on an impermissible trade. Section 12J of the Income Tax Act lists a number of activities that are considered to be impermissible trades. The impermissible trade that BPR 274 deals with, is any trade carried on in respect of immovable property (other than a trade carried on as an hotel keeper).

BPR 274 deals with the business of conducting a solar facility at specific sites to its customer. The facilities provide for solar electricity. The difficulty with renewable energy facilities, is that they may be constructed in such a way that they accede to the land thereby, becoming immovable property. It was ruled that solar panels are movable assets, thus the qualifying company is not carrying on an impermissible trade.

Investment income

A VCC may not invest in a qualifying company that receives investment income that exceeds 20% of its gross income for a particular year of assessment. Investment income includes any income in the form of interest, dividends, foreign dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature.

Since SARS ruled that the solar facilities are movable assets, it followed that the rental to be derived by the qualifying company is derived from movable property rather than immovable property. The investment income limitation is an important area that we feel will receive more attention particularly in light of the increase in the number of VCCs over the past three years.

For example, companies that license the use of intellectual property to others may be receiving royalty income that could result in them being ineligible to receive financing from venture capital companies if their royalty income exceeds the 20% investment income limitation.

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Investment by a venture capital company

Author: Gigi Nyanin (Associate at Cliffe Dekker Hofmyer).

The South African Revenue Service (SARS) released Binding Private Ruling 274 (BPR 274) on 6 June 2017, which deals with the investment by a venture capital company (VCC) in a company providing and expanding plants for the generation of solar electricity.

By way of background, the VCC tax regime was introduced into the Income Tax Act, No 58 of 1962 (Act) in 2009 to encourage investment into small and medium-sized enterprises and junior mining companies. The relevant legislation, which is found in s12J of the Act, provides for the formation of an investment holding company, described as a VCC. Investors subscribe for shares in the VCC and claim an income tax deduction for the subscription price incurred. The VCC, in turn, invests in qualifying companies (ie investee companies).

Recent legislative amendments to s12J have given rise to an increased participation in the asset class and use of the investment vehicle, evidenced by the increasing number of binding private rulings that have been issued by SARS in relation thereto. BPR 274, which is discussed in more detail below, is the latest of these rulings.

Background to the proposed transaction

An operating company incorporated in South Africa and a tax resident of the country (OpCo) has a number of shareholders which are South African individuals (Individuals). The Individuals subscribed for their shares (A shares) in OpCo and paid nominal subscription prices. The applicant, a South African company that has been approved as a VCC (Applicant), intends to invest in the OpCo, as follows:

- The Applicant will subscribe for B class shares (B shares), which will constitute 20% of the equity shares in OpCo. The B shares will entitle the Applicant to:
    - receive an aggregate amount of distributions that will result in the Applicant receiving an aggregate amount equal to the subscription amount, plus a cumulative nominal monthly return; and
    - dividends which must be paid regularly out of excess or free cash. In this regard, the Individuals will not, unless otherwise determined unanimously by the board of directors of OpCo, be entitled to receive any dividends or distributions until the Applicant has received the total return as described above.

- It is important to note that the terms of the B shares also provide that, notwithstanding the number of A and B shares in issue, such shares will carry 50% of the total voting rights, until the Applicant has received the full return. Following this, the A and B shares will rank *pari passu* in all respects and carry a single vote each.

As part of its business operations, OpCo will acquire an existing solar services agreement (SSA) from a partnership (Partnership) which has the Individuals as limited partners and a South African company as the general partner (Company A). The SSA enables the provision, maintenance, and expansion of solar electricity at the sites of its customer.

The sale agreement between OpCo and the Partnership provides that OpCo will acquire the business of conducting a solar facility at specific sites of its customer. In addition, OpCo will enter into an installation development contract with Company A as the developer, for the purpose of extending the existing photovoltaic plants.

Company A built and supplied the solar panels. As a result, OpCos business operations will continue to be supplied by Company A. OpCo will, however, own the assets relating to the supply of solar electricity, including solar panels, transmission cables and other related facilities, which will be supplied to the customer in terms of an operating lease as stipulated in the SSA.

Neither Company A nor the Individuals are directly or indirectly responsible for the financing needs of OpCo.

Issues for consideration

The parties to the proposed transaction required SARS to consider, among other things, the following issues:

- The meaning of controlled group company for purposes of the definition of qualifying company

Section 12J(5)(b) of the Act requires that the sole object of a VCC must be the management of investments in qualifying companies. Paragraph (b) of the definition of qualifying company in s12J(1) excludes a company that is not a controlled group company in relation to a group of companies. A controlled group company in relation to a group of companies is a company where at least 70% of its shares are held by a controlling group company or by other controlled group companies within the group of companies.

In this regard, SARS ruled that for purposes of the definition of qualifying company in s12J(1), OpCo will not constitute a controlled group company for as long as the number of equity shares which the Applicant holds constitutes less than 70% of the total number of equity shares in issue, irrespective of the fact that the Applicant would have invested more than 70% of the aggregate share capital in monetary terms.

- The meaning of equity share for purposes of the definition of qualifying share with reference to the issue of different classes of shares

A qualifying share is defined in s12J(1) as an equity share held by a VCC which is issued to that VCC by a qualifying company and which does not include a hybrid equity instrument as defined in s8E(1) of the Act (but for the three year period requirement), nor a third-party backed share as defined in s8EA(1) of the Act. Whereas, equity share is defined in s1 of the Act as any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution.

It is therefore important to have regard to the rights and limitations attached to the shares in the qualifying company in order to ascertain whether such shares constitute equity shares and thereby qualifying shares.

Based on the facts and the terms of the B shares discussed above, SARS ruled that the shares held by the Applicant will be equity shares as defined in s1.

- Whether OpCo will be regarded as carrying on an impermissible trade in immovable property as contemplated in paragraph (a) of the definition of that terms in s12J(1)

As mentioned above, s12J(5)(b) of the Act requires that the sole object of a VCC must be the management of investments in qualifying companies. The definition of a qualifying company in s12J(1) of the Act encompasses, among other things, a company that does not carry on an impermissible trade. An impermissible trade is defined, among other things, as any trade carried on in respect of immovable property, other than a trade carried on as a hotel keeper.

SARS ruled that OpCos trade is carried on in respect of solar panels, which are movable assets. Therefore OpCo will not be carrying on an impermissible trade as contemplated in paragraph (a) of the definition of impermissible trade in s12J(1).

- Whether rental income derived by OpCo will be investment income as defined in s12E(4)(c) and contemplated in paragraph (f) of the definition of qualifying company in s12J(1)

Paragraph (f) of the definition of qualifying company in s12J(1) includes any company if the sum of investment income, as defined in s12E(4)(c), derived by that company during any year of assessment does not exceed an amount equal to 20% of the gross income of that company for that year. Section 12E(4)(c) of the Act defines investment income to include rental derived in respect of immovable property.

In this regard, SARS ruled that the income derived by OpCo in terms of its contracts with its customers will not constitute rental derived in respect of immovable property and this amount will not be taken into account in determining the investment income for the purposes of paragraph (f) of the definition of qualifying company in s12J(1).

Conclusion

It is important to note that binding private rulings are issued to taxpayers to provide guidance on how SARS interprets and applies the tax law to specific transactions. It is therefore important for taxpayers to be cautious when relying on rulings issued by SARS as persons not party to the ruling cannot bind SARS thereto.

BPR 274 is valid until 28 February 2022.

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Are we seeing more positive developments in the venture capital companies regime?

On 15 June 2016 the South African Revenue Services (SARS) released Binding Private Ruling 242 (Ruling), which provides clarity on the interpretation and application of certain provisions of the Income Tax Act, No 58 of 1962 (Act) in the

context of venture capital companies. Specifically, the Ruling deals with the interpretation and application of the terms “controlled group company”, “equity share” and “hotel keeper”, as defined in s1 of the Act, and the terms “qualifying company” and “qualifying share” as defined in s12J of the Act.

By way of background, the venture capital company (VCC) regime was introduced in 2009 and came into operation on 1 July 2009 by the introduction of s12J into the Act. The purpose of this regime was to encourage investors to invest their capital into the growth, development, and long-term sustenance of resident small and medium-sized enterprises, which would have had a lower growth or would not have been able to sustain their existence without funding, in exchange for certain tax benefits.

In essence, a VCC may be described as a company (similar to an investment holding company) that issues shares to an investor to raise capital, and applies the proceeds towards investing in other companies. Provided that various requirements are met, the investor may claim the amount invested in the VCC as a deduction from income. The deduction may be claimed up-front, and no recoupment will arise upon disposal if the share is held for more than five years. The VCC must be approved by SARS, and must make investments in qualifying companies.

In this case the Applicant (an approved VCC), together with two qualifying companies (Company One and Company Two) applied for a binding private ruling in respect of the following proposed transaction: Company One and Two intend to carry on the business of hotel keepers. Each of them will appoint a managing company to operate their hotels. The managing company would guarantee a certain EBITDA per year.

The Applicant intended to subscribe for A class ordinary shares in Company One. A co-investor would subscribe for B class ordinary shares in Company One.

The A class shares would be entitled every year to a distribution equal to the guaranteed EBITDA. The B class shares would be entitled to a distribution of the remaining profits.

Upon an exit the A and B class shares will carry a right to a return of capital plus a cumulative compound return. The A class shares will rank ahead of the B class shares in respect of these returns, after which they will rank *pari passu*.

Company One will use the amounts invested by the Applicant to purchase sectional title hotel rooms, together with undivided interests in the common areas. Company One will have an option to purchase, within four months of the initial purchase, further units financed with third party debt. The aggregate purchase consideration in respect of the initial purchase and further purchase will exceed R50 million. As part of the purchase, the seller will cede its rights and obligations in respect of a hotel managing contract to Company One.

The Applicant will also subscribe for A and B class ordinary shares in Company Two. The rights attaching to the shares will be similar to the rights attaching to the shares in Company One.

Company Two will use the amounts invested to purchase new developed sectional title rooms from a property developer and accompanying undivided interests in common areas. A hotel managing company will be appointed and will be paid a management fee.

The Applicant intends to exit the investment on or before the fifth anniversary. Company One and Two also intend to sell their respective hotel businesses and distribute the proceeds to the shareholders.

SARS ruled as follows:

- the shares issued to the Applicant by Company One and

Two would constitute qualifying shares as defined in s12J(1) of the Act;

- Company One and Two would not be disqualified as qualified companies as defined in s12J(1) of the Act because they would not constitute a controlled group of companies. This is so because the number of equity shares held by the Applicant in Company One and Two would constitute less than 70% of the total number of the issued equity shares, despite the fact that the Applicant will contribute more than 70% of the total share capital investment in each of Company One and Two;
- the option to acquire additional sectional title units granted to Company One and the right to exercise such option immediately after the issue and initial purchase of the sectional title units would not bring the Applicant within the ambit of s12j(6A)(b)(ii) as a ground for disqualification as a VCC. The said section provides that SARS may withdraw a VCC's approval if after three years of the issue of venture capital shares by that VCC, less than 80% of acquisition expenditure was incurred to acquire qualifying shares in qualifying companies that held assets with a book value of less than R50 million; and
- Company One and Two will each carry on the business of a "hotel keeper", through the agency of the managing company, and could claim specified allowances in terms of s12C(1)(d) of the Act.

Tax and Exchange Control Alert – 28 October 2016

28 Oct 2016 by Mark Morgan, Gigi Nyanin and Heinrich Louw
This article forms part of [Tax and Exchange Control Alert – 28 October 2016:] [Download PDF]

Venture capital companies – summary of the latest tax rulings

Author: Mansoor Parker and Anuschka Wischnewski (ENSafrica).

Introduction

The venture capital company (“**VCC**”) regime was introduced in 2009, with an aim to encourage investors, by way of substantial tax benefits, to invest in small South African trading companies. VCCs are private investment companies, although they need not be, as the Income Tax Act does not prevent VCCs from listing their shares on the Johannesburg Stock Exchange.

The past two years have seen a phenomenal increase in the number of VCCs. There are now 36 South African Revenue Service (“**SARS**”) approved VCCs, of which 29 were approved in the past two years.

The increase in the number of VCCs has also seen the emergence of VCC-specific advance tax rulings. The advance tax ruling system was introduced in 2006. Its purpose is to promote clarity, consistency, and certainty regarding the interpretation and application of tax legislation. An advance tax ruling is a written statement on how SARS will interpret and apply specific provisions of the applicable tax legislation. SARS publishes redacted versions of these advance tax rulings on its website.

On 11 September 2015, SARS issued binding private ruling 205, which dealt with the meaning of a “controlled group company” and “equity share”. More recently, on 15 June 2016, SARS issued BPR 242 which, like BPR 205, also dealt with the meaning of a “controlled group company” and “equity share”. However, BPR 242 goes further than BPR 205 in that it also considers the R50-million book value threshold and whether the qualifying company carried on business as a hotel keeper.

The guidance provided by these rulings is important as they deal with the rules governing the type of investments that can be made and the conditions VCCs must satisfy in order to raise funds from investors. In this article, we will deal with three issues that arose from these rulings: the controlled group company concept, the equity share requirement and the book value threshold.

Before dealing with these rulings, we recap the typical venture capital structure:

Controlled group company limitation

The VCC may not invest in a qualifying company if it is a controlled group company in relation to a group of companies. A controlled group company in relation to a group of companies is a company where at least 70% of its shares are held by a controlling group company or by other controlled group companies within the group of companies.

This structure is not permissible as the VCC (controlling group company) holds 70% of the shares in the qualifying company (controlled group company). This structure is not permissible as the other investor (controlling group company) holds 70% of the shares in the qualifying company (controlled group company).

A very simple strategy to avoid the qualifying company becoming a controlled group company in relation to the VCC, is to ensure that the VCC subscribes for less than 70% of the shares in the VCC. But what about situations where the VCC would like to contribute, for example, 85% of the qualifying company's issued share capital? The applicants in BPR 205 and BPR 242 were faced with this problem.

In both BPR 205 and BPR 242, the applicants successfully avoided having the qualifying companies classified as controlled group companies. This was achieved because the qualifying companies issued different classes of shares. In BPR 205, the applicant subscribed for 20% of the qualifying company's issued shares (Class A ordinary shares) at a subscription price equalling 75% of the qualifying company's entire issued share capital. The other investors subscribed for Class B and C ordinary shares, respectively.

In BPR 242, the applicant subscribed for A class ordinary shares and the co-investor subscribed for B class ordinary shares in the qualifying company. The applicant held less than 70% of the total number of shares in issue in the qualifying company, but contributed more than its proportionate share in monetary terms to the qualifying company's share capital.

In BPR 205 and BPR 242, SARS issued rulings that the qualifying company was not a controlled group company in relation to a group of companies despite the fact that the VCC contributed more than its proportionate share in monetary terms to the qualifying company's share capital. These rulings confirm that the test is the number of shares that the VCC holds in the qualifying company, not the VCC's economic interest (i.e. the value of those shares) in the qualifying company. It is possible for classes of shares to be created where the value of those shares are disproportionate to the value of those shares.

Equity share requirement

Where the qualifying company issues different classes of shares, then careful attention must be paid to whether the different classes of shares are equity shares. For instance, assume that a VCC subscribes for 60% of the shares in a qualifying company while two other investors subscribe for the remaining 40% of the shares in the qualifying company. If the shares held by the two investors are not equity shares, then the VCC will, in fact, hold 100% of the equity shares in the qualifying company.

For tax purposes, equity shares are any type of share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution. Thus, the equity share definition excludes certain types of shares. The rationale for excluding these types of shares is that they have more features in common with a debt instrument, and are therefore a "safer" form of investment.

The words "any right" imply that a shareholder must be restricted from participating in distributions from a qualifying company in all respects in that there must be a restriction on both the right to a dividend distribution and a capital distribution before the share will not be an equity share. Put differently, if a shareholder is entitled to unlimited participation in any company distributions (whether dividends or returns of capital), the share will constitute an equity share.

In BPR 205:

- As the applicant contributed a disproportionate amount of share capital, the Class A ordinary shares were entitled to a first distribution of profits or capital equal to the capital invested and a return to the equivalent of prime plus 2%.
- Upon settlement of the Class A ordinary shares, the Class B and Class C ordinary shares subscribed for by Company A and Investor B, respectively, will be entitled to a second distribution of profits or capital equal to a return to the equivalent of prime plus 2%, paid in proportion to their respective shareholding.
- Thereafter, the Class A, B and C ordinary shares will rank *pari passu* in all respects.

In BPR 242, the A and B class shares will carry the following distribution rights:

- The A class shares will be entitled to a profit distribution on an annual basis in an amount equal to the guaranteed earnings before interest, taxes, depreciation and amortisation, less any third party debt payments.
- The B class shares will be entitled to a distribution of the remaining profits on an annual basis.
- On exit, the holders of the A and B class shares will be entitled to a return of capital distribution of their respective amounts contributed together with a cumulative compound annual return linked to prime, with the A class shares ranking ahead of the B class shares.
- The A and B class shares will then participate in the remaining assets of the qualifying company on a *pari passu* basis, *pro rata* to their number of shares held. The B class shares may receive, as a distribution in specie, the common areas in lieu of the cash distribution.
- These rulings confirm that a class of shares can still

be preferential in nature, without losing their "equityness". It is possible to structure a particular class of shares so that the shares carry preferential rights to dividends. The VCC was clearly better off than the holders of the other classes of shares who have to wait in the queue. But in spite of the preferential nature of the VCC's holdings, the shares held by the VCC remain equity shares by virtue of the equity share definition.

The R50-million book value threshold

The R50-million book value threshold applies to all qualifying companies (other than junior mining companies) where the book value threshold is increased to R50-million. The legislation requires the qualifying company's assets to be valued at book value not market value. The book value determination must be made at the time the VCC acquires the equity shares in the qualifying company.

Book value is the price that the qualifying company paid for its assets. It differs from market value, which is the price at which the qualifying company could sell its assets. The book value determination is based on the original cost of the qualifying company's assets less any depreciation, amortisation or impairment costs made against its asset. In many cases, the carrying value of the qualifying company's assets and their market value will differ greatly.

Provided that the book value threshold is satisfied at the time the VCC subscribes for the shares in the qualifying company, any subsequent increase in the book value of the qualifying company's assets will not impact the VCC's tax status. In BPR 242, the qualifying company will acquire sectional title units in two tranches. The combined value of the sectional title units will exceed R50-million which, on the face of it, suggests that the qualifying company will not comply with the R50-million book value threshold.

However, in the first tranche, the qualifying company will use the cash proceeds from the share issue to the VCC to acquire sectional title units with a value below R50-million. Thereafter, the qualifying company will obtain debt funding to acquire additional sectional title units. At the time of the VCC's investment, the qualifying company's book value will be below R50-million despite the fact that it has an option to acquire additional sectional title units. The qualifying company's later purchase of the additional sectional title units does not taint the VCC's initial share subscription in the qualifying company.

SARS ruled that the existence of the option granted to the qualifying company to acquire additional sectional title units will not constitute non-compliance with the R50-million book value threshold nor will the exercise of the option after the acquisition of the first sectional titles constitute non-compliance with the R50-million book value threshold.

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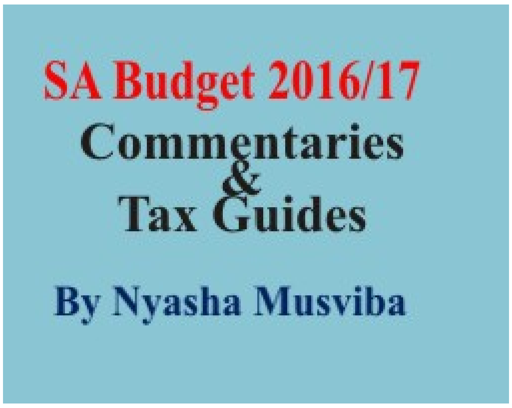
Budget 2016 – Venture Capital Companies



Section 12J of the Income Tax Act was introduced in 2008 to stimulate much-needed equity funding for small businesses. It provides for the formation of an investment holding, described as a Venture Capital Company (VCC). Investors subscribe for shares in the VCC and claim an income tax deduction for the subscription price incurred. The VCC must then deploy most of these subscription proceeds within three years by subscribing for shares in investee companies.

Although s12J was a very welcome addition to the Income Tax Act, it is subject to rigid requirements and anti-avoidance provisions which are difficult to manage and which, if breached, trigger terminal tax consequences. In addition, although s12J provides that there is no recoupment of the investor's tax deduction where the investor sells the shares in the VCC after 5 years, returns of capital after 5 years are not subject to the same exemption.

As a result, the VCC regime is fiscally unstable to implement and does not facilitate the normal economic drivers of a typical investment fund. It is therefore encouraging that National Treasury has heard the call to make further changes to s12J. If it is sufficiently enabling it will allow the VCC regime to fulfil the vital role of stimulating entrepreneurs in South Africa.

by Mark Linington
This article forms part of Special Edition Tax and Exchange Control Alert – 24 February 2016: Download PDF

Venture capital embraces tax breaks

Author: Stephen Timm (BDlive)

The number of venture capital companies approved by the South African Revenue Service (SARS) to take advantage of a venture capital tax incentive has increased to 19, following amendments to tax legislation that took effect in April.

The incentive was introduced in 2009 by the National Treasury in terms of section 12J of the Income Tax Act to spur investments in small businesses through approved venture capital companies.

However, because of the onerous criteria, there was initially limited interest. By August 2013 only one small business had benefited from an investment using the new tax regime.

The recent changes make the incentive more attractive, allowing for a higher investee asset threshold (R50m for qualifying small businesses and R300m for junior mining companies) and a permanent investment deduction.

Most of the approved funds are still in the capital-raising period. While there may have been hopes the incentive would encourage investment in startups and high-impact firms, most approved venture capital companies in SA are looking to invest in existing businesses.

JC Bruce, who oversees two venture capital companies, says his funds will focus on existing businesses. The aim is to capitalise Titanium, a fund that will invest in alternative energy, with up to R1bn, and Carbide, a fund that will invest in "fair-sized" companies, with between R250m and R500m.

Richard Asherson, a partner in Westbrooke Capital Management, says his fund would be looking for businesses that have been around for about five years or more. He said startups were "risky investments".

Neill Hobbs, head of Hobbs Sinclair, which has three venture capital companies approved by SARS, says it is difficult for existing small firms to obtain bank finance. The company has so far raised R15.5m for its Redwood fund, approved by SARS in January. Hobbs says the fund's first investment made in August was R11m pumped into Mastercare, a company operating in the appliance repair sector for 40 years.

Hobbs is also a business rescue practitioner and had been involved in keeping Mastercare afloat when its bank was keen on liquidating it after a troubled merger with TV repair business Early Bird.

Mastercare managing director Wesley Rabie says the investment helped save at least 100 jobs.

Hobbs says Redwood is preparing to invest in a second company, in the medical sector, after its bank had refused an overdraft request.

Samantha Pokroy, who heads Sanari Growth Partners, says the fund is seeking capital of R200m to help small companies scale up.

Pokroy says success will depend on what value a fund manager could add to a business and providing advice would be key.

SMEasy, a company established four years ago with 11 employees, received an undisclosed investment four months ago from Grovest to fund its accounting product.

SMEasy CE Darlene Meintjies says having Grovest on board has helped the company gain access to new networks. “The money was great, but what we got more than that is influence,” she says.

Grovest makes investments in early-stage companies. Its first fund invested R25m in six companies. Its CE Jeff Miller says most of its funds are aimed at late-stage investments because of the difficulty of investing in startups.

“When you’re dealing with third-party money it’s very difficult … which is why funds are being cautious,” he says.

Miller says Grovest is setting up two new funds — one aimed at the hospitality sector (which has been approved by SARS) and one at the alternative energy sector.

SA Venture Capital Association chairwoman Erika van der Merwe says the SARS incentive was set up to direct investment and skills development towards small business in general — regardless of whether they are startups.

SARS spokesman Luther Lebelo says the approved venture capital companies plan to focus on startups and existing small businesses.

He says the provisions of the tax regime provide a vehicle for a wide range of investments and the level of risk is limited by what the investors “are prepared to accept”.

Venture capitalist and Angel Hub founder Brett Commaille says a tax regime should be crafted to allow investors to qualify for a tax break if they invest directly into a small company. The SARS incentive is only available to investors in a venture capital company.

Miller says SARS should also allow individuals to claim a tax rebate for making direct investments into small businesses, as the UK allows. But he concedes that venture capital companies provide the added benefit of helping to reduce investors’ risk by grouping them with other investors.

The SARS incentive is available until June 30 2021.

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