ASAP

Legal and Technical Update

Section 12J investments

This section was introduced into the Income Tax Act with the sole purpose to aid economic growth by providing small and medium sized businesses with access to equity finance, thereby creating jobs. It attracts investors to a business sector that would not traditionally receive much attention. It effectively offers investors a tax incentive when investing in recognised Venture Capital Companies (VCC).

Investing in a VCC

When investors invest in VCCs, that VCC will buy shares in qualifying companies. Any taxpayer is eligible to invest (natural persons, trusts, companies, CCs). The VCC will issue investor certificates to the investors as proof of the investment. This will be used when claiming the tax deduction.

The total investment will be tax deductible in the tax year in which it was made. The investor can also deduct any expenses actually incurred to acquire the shares in the VCC. There is no limitation to the amount that can be invested and also no limitation to the amount that can be deducted for income tax purposes.

To ensure the tax benefit is not lost, investors must make sure the amount invested does not exceed their taxable income, as there is no ‘disallowed investment’ that is carried over to the following tax year. Therefore, if the total investment is not tax deductible in that tax year, the benefit is essentially lost. The following example will illustrate this.

Example:

Grace’s taxable income for the tax year is R1 000 000 resulting in a marginal tax rate of 41% (R410 000 tax payable ignoring the rebate). Grace inherited R2 000 000 from her grandmother and she wants to invest the full amount in a VCC, as she wants to support economic growth and she wants to enjoy the tax benefit.

Scenario 1 – Grace invests only R1 000 000 in a VCC

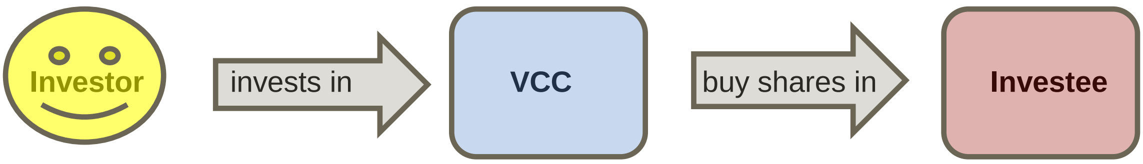
Taxable income before this deduction	R1 000 000
Less: section 12J deduction	R1 000 000
Taxable income	Nil
Tax saving	R 410 000

Scenario 2 – Grace invests the total R2 000 000 in a VCC

Taxable income before this deduction	R1 000 000
Less: section 12J deduction	R2 000 000
Taxable income	Nil
Tax saving	R 410 000

This shows that if the contribution exceeds the taxable income of the investor, the tax benefit associated with the surplus amount will be lost. It will be more beneficial to retain the additional R1 000 000 and to invest it in the following tax year – which will then result in another tax saving in that following tax year.

The typical investment structure will be as follows:



What are the requirements to be a recognised VCC?

All the following preliminary requirements must be met for an approved VCC status. The requirements must be met during each year or assessment:

- The company must be a resident;
- The sole purpose of the company is to manage investments in qualifying companies (investees);
- The company's tax affairs must be in order;
- The company must be a licensed FSP under section 7 of the FAIS Act.

In addition, the company must meet the following requirements by the end of each tax year after the expiry of 3 years from the first date of issue of venture capital shares:

- A minimum of 80% of the expenditure incurred by the VCC to acquire assets must be for qualifying shares and each investee must, immediately after issuing qualifying shares, hold assets with a book value not exceeding:
    - R500 million in any junior mining company, or
    - R50 million in any other qualifying company.
- The expenditure incurred by the VCC to acquire qualifying shares in any one investee may not exceed 20% of any amounts received in respect of the issue of venture capital shares.

If the requirements are not met at any stage, the approval can be withdrawn.

An approved VCC is responsible to maintain records of all investors and investees and the records must be submitted to SARS twice a year. The VCC is responsible to ensure it invests in qualifying companies

Who qualifies as an investee (qualifying company)?

This is the company in which the VCC can invest the funds it receives from investors. The following requirements must be met to be an investee:

- It must be a company that is resident in SA;
- The company's tax affairs must be in order;
- The company must be unlisted, unless it is a junior mining company, in which case it may be listed on the Alternative Exchange Division of the JSE;
- During any tax year, the sum of investment income derived by the company may not exceed 20% of its gross income.

- Investment income for this purpose is defined as any income from dividends, royalties, foreign dividends, rental iro immovable property, annuities or similar income, interest, proceeds from investment or trading in financial instruments, marketable securities or immovable property.
- It is clear that the investee cannot simply use the funds to invest in 'traditional investments' and that the main purpose must be to invest in a business that generates income associated with a trade or business of some sort.

- The company may not carry on the following impermissible trades:
  - Any trade iro immovable property, except if it is a hotel (including bed and breakfast),
  - Financial service activities including banking, insurance, money-lending and hire purchase financing,
  - Provision of financial or advisory services, including legal, tax advisory, stock broking, management consulting, auditing or accounting,
  - Manufacturing, buying or selling liquor, tobacco products, arms or ammunition, or
  - Any trade outside of SA.

These qualifying companies do not enjoy any special tax treatment.

Investment term

The ideal investment term is in excess of 5 years. Where the investor sells the shares in the VCC within 5 years of making the investment, there will be a recoupment of the tax benefit enjoyed when the investment was made.

In the example of Grace, if she sold her shares in year 3, the total tax saving will be recouped – which will result in her tax liability being increased by the R410 000 in that year.

Realising the investment

It is important to determine when and how the investment can be liquidated. When the investment is liquidated or disposed of after the 5 years, capital gains tax (CGT) will be payable on any gains realised.

It is important to note that the base cost for an investment in a VCC is nil due to the tax deductibility of the investment initially.

The net return

The CGT treatment of the investment can result in client's questioning the net return on the investment.

If we use Grace's example and assume she invests R1 000 000 into a section 12J investment vs an investment in a general equity collective investment realising a return of 10% per annum, the outcome after 5 years will be as follows:

	Section 12 J	Collective Investment
Initial investment	R1 000 000	
After tax cost of investment	R590 000	R1 000 000
Value after 5 years	R1 610 510	
	Section 12 J	**Collective Investment**
Base cost	Nil	R1 000 000
Taxable capital gain	R628 204	R228 204
Capital gains tax	R257 563	R93 563
After tax return	R1 352 947	R1 516 947
After tax rate of return Per annum	18% R590 000 to R1 352 947	9% R1 000 000 to R1 516 947

Investment risk

This investment can be categorised as high risk and it is not suited for all investors. Venture capital as an asset class has a high risk and in the case of a VCC, the investments are made into small and medium sized businesses which also contribute to the risk.

It is important that the financial adviser and investor does not stare themselves blind against the tax benefit associated with the investment – the tax benefit must be ignored when considering the appropriateness of the investment. The tax benefit should be an added bonus, not the driving force.

Financial advisers should take care to do a proper due diligence on investment options and to make sure financial advice resulting in a section 12J investment is comprehensive and clearly understood by the client.

Time restriction

When the legislation was introduced, it was made subject to a 12 year sunset clause, meaning that it is available until 30 June 2021. At that time its effectiveness will be assessed and decisions will be made on the future of the 'offering'.

Proposed Amendments

The 2019 Taxation Laws Amendment Act introduced an increased annual cap of R2 500 000 for any person investing in these structures. The purpose is to prevent tax abuse. The effective date is 21 July 2019. Therefore, for the year of assessment ending 29 February 2020, the investor (natural person) will be limited to a tax deduction of R2 500 000. For a company as an investor, the cap is R5 000 000 per annum.