
SOUTH AFRICAN REVENUE SERVICE

**DRAFT GUIDE ON
VENTURE CAPITAL
COMPANIES**

Another helpful guide brought to you by the
South African Revenue Service



South African Revenue Service

Draft Guide on Venture Capital Companies

Preface

The purpose of this guide is to provide users with general guidance on venture capital companies and investments in such companies. It does not delve into the precise technical and legal detail that is often associated with tax and should, therefore, not be used as a legal reference.

This guide is not an “official publication” as defined in section 1 of the Tax Administration Act 28 of 2011 (“the TA Act”) and accordingly does not create a practice generally prevailing under section 5 of that Act. It is also not a binding general ruling issued under section 89 of the TA Act. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

This guide is based on the legislation as at time of issue.

All guides, interpretation notes, rulings, forms and returns referred to in this Guide are available on the SARS website at www.sars.gov.za. Unless indicated otherwise, the latest issue of these documents should be consulted.

For more information you may –

- visit the SARS website at www.sars.gov.za;
- visit your nearest SARS branch;
- contact your own tax advisor or tax practitioner; or
- contact the SARS National Call Centre –
 - if calling locally, on 0800 00 7277; or
 - if calling from abroad, on +27 11 602 2093 (only between 8am and 4pm South African time).

Comments on this guide may be sent to policycomments@sars.gov.za. Queries which are specifically related to venture capital companies may be sent to vcc@sars.gov.za.

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Glossary

In this guide unless the context indicates otherwise –

- “**JSE**” means the exchange operated by JSE Ltd which facilitates trade in securities under the style of “Johannesburg Stock Exchange” and is licensed as an exchange under the Financial Markets Act 19 of 2012;
- “**qualifying share**” means a share as defined in **3**;
- “**section**” means a section of the Act;
- “**TA Act**” means the Tax Administration Act 28 of 2011;
- “**the Act**” means the Income Tax Act 58 of 1962;
- “**VCC**” means Venture Capital Company as defined in **2**;
- “**venture capital share**” means a share as defined in **3**; and
- any other word or expression bears the meaning ascribed to it in the Act.

1. Introduction

One of the main challenges facing small and medium-sized businesses, as identified in the 2008 South African National Budget Review, is the difficulty in accessing equity finance. Equity financing is essentially a method used by companies to raise capital by issuing company shares to investors. A share in relation to a company means any unit into which the proprietary interest in the company is divided.¹ The holder of the share does not own the assets of the company, but owns the rights in the company, that is, the right to vote, the right to dividends and the right to capital distributions.

The cost of share investments held on capital account is generally not deductible from income. Section 12J was introduced as a tax incentive to encourage equity investment through VCCs in small and medium-sized businesses and junior mining companies. Section 12J allows a holder of shares to claim a 100% deduction of the cost of the shares issued by the VCC, provided certain requirements are met. The section is effective for venture capital shares acquired on or after 1 July 2009 but on or before 30 June 2021.²

Section 12J has requirements at the level of the VCC and at the level of the “qualifying company” whose shares are held by the VCC. A VCC is taxed as a company and does not enjoy any special tax concessions because of its VCC status.

2. Requirements for a venture capital company

Section 12J(1) defines “venture capital company” as –

“a company that has been approved by the Commissioner in terms of subsection (5) and in respect of which such approval has not been withdrawn in terms of subsection (6) or (6A)”.

Under section 12J(5) the Commissioner must approve a VCC if the company has applied for approval and the Commissioner is satisfied that –

- the company is a resident (see **5.1** for information on a “resident”);

¹ See definition of “share” in section 1(1).

² Section 12J(11).

- the sole object of the company is the management of investments in qualifying companies;
- the tax affairs of the company are in order and the company has complied with all the relevant provisions of the laws administered by the Commissioner; and
- the company is licensed under section 7 of the Financial Advisory and Intermediary Services Act 37 of 2002.³

Owing to the sole object requirement, a VCC cannot carry on an active business itself. That is, a VCC cannot, in addition to managing investments in qualifying companies, run another business or manage a trading or long-term investment portfolio in non-VCC investments. For example, a VCC cannot acquire a number of properties for rental purposes. However, if the VCC has excess office space it may rent that excess space to tenants. Whether a VCC is merely renting out excess space or has acquired extra space with the purpose of renting can be determined only on a case-by-case analysis of the investment.

Similarly, although a VCC cannot have a trading or long-term investment portfolio in non-VCC investments, it can invest the funds it receives through the issue of its equity shares in non-VCC investments on a short-term basis before it invests those funds in qualifying companies without transgressing the sole object requirement. The Act does not specify what the funds can be invested in during this interim period. The type of investment and manner of the investment must be in alignment with its sole object of the management of investments in qualifying companies. So, for example, an investment in a non-VCC company without a realistic short-term exit strategy would probably result in a transgression of the sole object requirement. By contrast, an investment in short-term debt instruments or preference shares⁴ is likely to be acceptable. However the terms of the specific investment and all the relevant facts will need to be assessed on a case-by-case basis to determine whether the VCC has met or transgressed the sole object requirement.

A VCC may not have any objective, even if it is subsidiary in nature, other than the management of investments in qualifying companies.

Approval as a VCC is granted only on full compliance with all the requirements.

The process of applying for approval involves the submission of a VCC001 form – Venture Capital Company: Application for SARS Approval. The completed form must be emailed to **vcc@sars.gov.za** or posted to the address provided on the SARS website.

This form must be accompanied by the following documents:⁵

- A tax clearance certificate to verify that the company's tax affairs are in order.
- A certificate from the Companies and Intellectual Property Commission (CIPC) confirming the company's registration number.
- 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.

³ This section relates to the authorisation of financial service providers.

⁴ *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009.*

⁵ See *Venture Capital Companies – External Guide* (Revision 7).

- A copy of the Financial Services Board licence certifying that the VCC is licensed as a financial service provider.

The application form and documents will be assessed by the Commissioner. A successful applicant will be allocated a VCC reference number and an approval letter will be issued to the applicant.⁶ A rejection letter will be issued to an unsuccessful applicant stating the reasons for the rejection.

See 8 for the consequences which may arise if subsequent to obtaining approval as a VCC, a VCC fails to meet any of the requirements discussed above.

3. The role of a venture capital company

In the normal course of events, an approved VCC creates a fund in which all the money invested in the VCC's shares by investors is held. This money is generally known as capital or venture capital. The money received from the investors is then invested in qualifying companies.

“Venture capital” means –⁷

“financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential.

...

“Though it can be risky for the investors who put up the funds, the potential for above-average returns is an attractive payoff. For new companies or ventures that have a limited operating history (under two years), venture capital funding is increasingly becoming a popular – even essential – source for raising capital, especially if they lack access to capital markets, bank loans or other debt instruments. The main downside is that the investors usually get equity in the company, and thus a say in company decisions”.

The term “venture capital share” is defined in section 12J(1) to mean –

“an equity share held by a taxpayer in a venture capital company which is issued to that taxpayer by a venture capital company, and does not include any share which—

- (a)
- (b) would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of ‘hybrid equity instrument’ in that section; or
- (c) constitutes a third-party backed share as defined in section 8EA(1).”

The term “equity share” is defined in section 1(1) to mean –

“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”.

A distribution can take the form of a distribution of profits (dividends) or capital. As long as the right to participate in either of these types of distribution is unrestricted, the share will be an equity share. The share will not be an equity share if both these rights are restricted.⁸

⁶ A list of all approved VCCs with contact details is available on the SARS website.

⁷ www.investopedia.com/terms/v/venturecapital.asp [Accessed 20 June 2018].

⁸ See *Comprehensive Guide to Dividends Tax*.

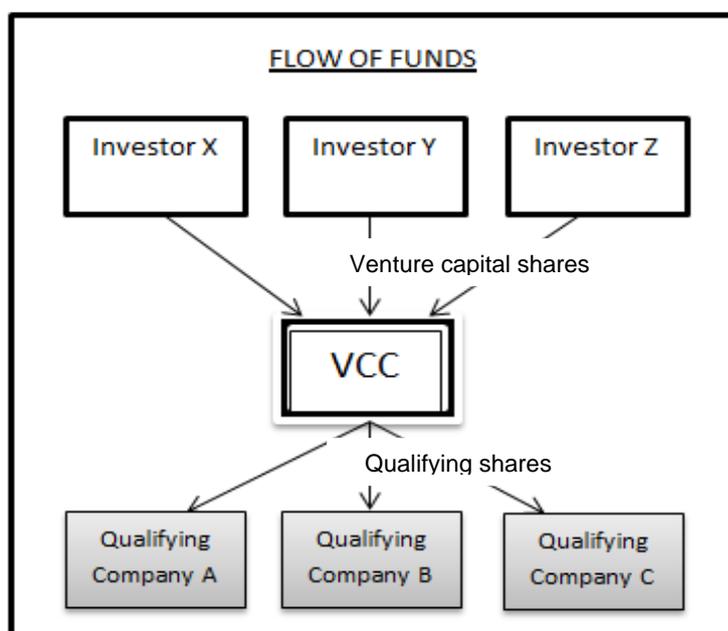
Fundamentally, the venture capital share must be an equity share⁹ and must not be a hybrid debt instrument or constitute a third-party backed share.¹⁰

A qualifying share is a specific share that has been issued by a qualifying company to a VCC and does not include a share in a qualifying company that was purchased by the VCC from a third party. The term “qualifying share” is defined in section 12J(1) to mean –

“An equity share held by a venture capital company which is issued to that company by a qualifying company, and does not include any share which-

- (a) ...
- (b) would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of “hybrid equity instrument” in that section; or
- (c) constitutes a third-party backed share as defined in section 8EA(1)”.

The flow of funds in the VCC environment can be demonstrated as follows:



4. Deduction available to investors

Section 12J(2) allows a taxpayer, subject to certain conditions, to claim a deduction for expenditure actually incurred by that taxpayer in acquiring any venture capital share issued to that taxpayer by a VCC.

The term “taxpayer” is defined in section 1(1) and means –

“any person chargeable with any tax leviable under this Act”.

Therefore, both resident and non-resident taxpayers can potentially benefit from the incentive afforded under section 12J(2).

⁹ See Binding Private Ruling 205 dated 11 September 2015 “Meaning of ‘controlled group company’ and ‘equity share’” and Binding Private Ruling 242 dated 15 June 2016 “Venture Capital Company Investment in Qualifying Companies Carrying on Business as Hotel Keepers” for a ruling on this term.

¹⁰ See the **Annexure** for the definition of “hybrid debt instrument” and “third-party backed share”.

The term “person” is defined in section 1(1) and includes –

- “(a) an insolvent estate;
 - (b) the estate of a deceased person;
 - (c) any trust; and
 - (d) any portfolio of a collective investment scheme,
- but does not include a foreign partnership”.

Subject to sections 12J(3), (3A) and (4) (see **6** and **9**), the deduction is available only for expenditure incurred by a taxpayer to acquire venture capital shares issued to that taxpayer by the VCC. A deduction is not available for venture capital shares purchased from a third party. In addition, no deduction will be allowed in respect of shares acquired after 30 June 2021.¹¹

Only costs directly connected with the acquisition of the venture capital shares are deductible. By contrast, costs such as banking costs and those related to the obtaining of a loan (generally referred to as financing costs) are indirect and not allowable as a deduction. For example, if a taxpayer incurs financing costs of R5 000 on a loan of R100 000 which was used to acquire 100 venture capital shares at a cost of R1 000 per share, only the R100 000 acquisition cost would qualify for the deduction and not the R5 000 financing cost.

5. Requirements for a “qualifying company”

The term “qualifying company” is defined in section 12J(1) and means any company if –

- “(a) that company is a resident;
- (b) the company is not a controlled group company in relation to a group of companies;
- (c) the tax affairs of the company are in order and the company has complied with all the relevant provisions of the laws administered by the Commissioner;
- (d) the company is an unlisted company as defined in section 41 or a junior mining company;
- (e) the company is not carrying on any impermissible trade; and
- (f) the sum of the investment income, as defined in section 12E(4)(c), derived by that company during any year of assessment does not exceed an amount equal to 20 per cent of the gross income of that company for that year”.

A “qualifying company” must comply with all the requirements contained in the definition. These requirements are briefly discussed below.

5.1 The company has to be a resident – paragraph (a) of the definition of “qualifying company”

The term “company” is defined in section 1(1) and includes, among others, –

- companies incorporated inside and outside South Africa;
- co-operatives;
- South African public benefit organisations;

¹¹ Section 12J(11).

- portfolios of foreign collective investment schemes in participation bonds or securities;
- portfolios of collective investment schemes in property qualifying as REITs;¹² and
- close corporations.

Foreign partnerships are excluded from the definition.¹³

Under paragraph (b) of the definition of “resident” in section 1(1), a company will be a resident if –

- it is incorporated, established or formed in South Africa; or
- has its place of effective management¹⁴ in South Africa; and
- a tax treaty does not deem it to be exclusively a resident of another country for purposes of the application of the tax treaty.

5.2 The company must not be a controlled group company in relation to a group of companies – paragraph (b) of the definition of “qualifying company”

The term “controlled group company” is defined in section 1(1) to mean –

“a controlled group company contemplated in the definition of ‘group of companies’”.

Under section 1(1), “group of companies” is defined to mean –

“two or more companies in which one company (hereinafter referred to as the ‘controlling group company’) directly or indirectly holds shares in at least one other company (hereinafter referred to as the ‘controlled group company’), to the extent that—

- (a) at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- (b) the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company”.

A company which is a controlled group company will not constitute a “qualifying company” as defined. The potential qualifying company may not be a controlled group company in relation to a VCC or any other company.

¹² A REIT would not meet the requirement of being an unlisted company or junior mining company.

¹³ See **Annexure** for the definition of “company”.

¹⁴ See Interpretation Note 6 “Resident: place of effective management (companies)” for more information on companies and effective management.

The determination of whether a potential qualifying company is a controlled group company is based on whether the percentage of the number of equity shares held by the various companies described in the definition of “group of companies” in the potential qualifying company is at least 70% of the total number of equity shares. It is not based on the monetary amount of share capital subscribed for. Thus, a company will not be a controlled group company if the various companies described in the definition of “group of companies” subscribe for more than 70% of the aggregate monetary value of that company’s equity share capital but less than 70% in number.¹⁵

It may happen that a company which initially meets the definition of a qualifying company subsequently becomes a controlled group company owing to, for example, the acquisition of additional shares by a VCC, or another company, which results in the VCC, or that other company, holding at least 70% of that company’s equity shares. If this happens, it means the company will no longer constitute a “qualifying company” under section 12J and the VCC would need to assess if it still met the requirements of a VCC (see 2).

5.3 Administrative compliance of the company – paragraph (c) of the definition of “qualifying company”

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.¹⁶

A failure to fulfil any duty as required by any law administered by the Commissioner will result in the company not being regarded as a “qualifying company” under section 12J.

5.4 Classification as an unlisted company or a junior mining company – paragraph (d) of the definition of “qualifying company”

In order to comply with the requirements of paragraph (d) of the definition of “qualifying company”, the company must be an unlisted company as defined in section 41 or a junior mining company.

Unlisted company

The term “unlisted company” is defined in section 41(1) to mean –

“any company which is not a listed company as defined in this subsection”.

The term “listed company” is defined in section 41(1) and means a company contemplated in paragraph (a) of the definition of “listed company” in section 1(1).

¹⁵ See also Binding Private Ruling 205 dated 11 September 2015 “Meaning of ‘controlled group company’ and ‘equity share’, Binding Private Ruling 242 dated 15 June 2016 “Venture Capital Company Investment in Qualifying Companies Carrying on Business as Hotel Keepers”, Binding Private Ruling 264 dated 3 February 2017 “Venture Capital Company Shares” and Binding Private Ruling 274 dated 6 June 2017 “Venture Capital Company Investing in a Company Providing and Expanding Plants for the Generation of Solar Electricity”.

¹⁶ Under section 169(4) of the TA Act, SARS need not recover a tax debt of less than R100 or any other amount that the Commissioner may determine by public notice. The amount must be carried forward in the taxpayer’s account.

The relevant part of the definition of “listed company” in section 1(1) stipulates that a “listed company” means –

“a company where its shares or depository receipts in respect of its shares are listed on—

- (a) an exchange as defined in section 1 of the Financial Markets Act and licensed under section 9 of that Act ...”.

The term “exchange”¹⁷ means a person who constitutes, maintains and provides an infrastructure –

- for bringing together buyers and sellers of securities;
- for matching bids and offers for securities of multiple buyers and sellers; and
- under which a matched bid and offer for securities constitutes a transaction.

The JSE, ZARX (Pty) Ltd and 4 Africa Exchange (Pty) Ltd are the only exchanges currently licensed under section 9 of the Financial Markets Act.

To fall within paragraph (d) of the definition of “qualifying company”, a company other than a junior mining company must not be listed on an exchange.

Junior mining company

The term “junior mining company” is defined in section 12J(1) to mean –

“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”.

Under this definition, the company must solely carry on a trade of mining exploration or production. In other words, it must not carry on any other trade. It must also either be an unlisted company or be listed on the alternative exchange division of the JSE. The alternative exchange division refers to an alternative exchange, also known as AltX, which specifically caters for small and medium-sized companies and allows these types of company to raise capital on the JSE. This board is distinct from the JSE’s main board of exchange.

The requirement that the junior mining company may be listed only on the alternative exchange of the JSE and that any other type of company must be unlisted ensures that only those persons who invest in small and medium-sized qualifying companies will benefit from the deduction provided under section 12J.

5.5 Impermissible trades – paragraph (e) of the definition of “qualifying company”

Under paragraph (e) of the definition of “qualifying company”, the company may not carry on any impermissible trade. For example, if a company conducts two trades, one which constitutes an impermissible trade and the other which does not, the company will not meet the requirements of a qualifying company even if the impermissible trade is the subsidiary trade.

¹⁷ Section 1 of the Financial Markets Act 19 of 2012.

The term “impermissible trade” is defined in section 12J(1) to mean –

- “(a) any trade carried on in respect of immovable property, other than a trade carried on as an hotel keeper;
- (b) any trade carried on by 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 any trade carried on in respect of money-lending or hire-purchase financing;
- (c) any trade carried on in respect of financial or advisory services, including trade in respect of legal services, tax advisory services, stock broking services, management consulting services, auditing or accounting services;
- (d) any trade carried on in respect of gambling;
- (e) any trade carried on in respect of liquor, tobacco, arms or ammunition;
- (f) . . .
- (g) any trade carried on mainly outside the Republic”.

The respective trades are discussed in **5.5.3**.

5.5.1 Meaning of “trade”

The term “trade” is defined widely in section 1(1) and includes –

“every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature”.

In ITC 770¹⁸ it was held that the definition of trade should be widely construed and is obviously intended to embrace every profitable activity. In *Burgess v CIR*¹⁹ the court noted that the definition of “trade” should be given a wide interpretation and that the definition was not necessarily exhaustive.

Although “trade” has been given a wide meaning, it does not cover all activities that might produce income. For example, in contrast to a business of money-lending²⁰ or a business of investment in shares,²¹ the watching over investments²² and the earning of interest on funds advanced by a holding company to its subsidiary²³ have been held not to constitute the carrying on of a trade.

When considering whether a person is “carrying on a trade”, factors such as the continuity of the activity as well as profit motive must be considered. These factors are, however, not necessarily prerequisites for carrying on a trade. In *Modderfontein Deep Levels Ltd & another v Feinstein*²⁴ it was held that “as a rule a trade or business is carried on for the purpose of making a profit, but profit-making is not of the essence of trading.”

¹⁸ (1953) 19 SATC 216 (T).

¹⁹ 1993 (4) SA 161 (A), 55 SATC 185 at 196 and 197.

²⁰ *Solaglass Finance Company (Pty) Ltd v CIR* 1991 (2) SA 257, 53 SATC 1 (A).

²¹ ITC 1170 (1953) 19 SATC 216 (T).

²² ITC 1275 (1978) 40 SATC 197 (C).

²³ ITC 496 (1941) 12 SATC 132 (U).

²⁴ 1920 TPD 288 at 294.

The test to be applied in determining whether a trade is being carried on is an objective test and if objective factors indicate that the taxpayer is trading, the trade requirement will be satisfied. The facts and circumstances of each case must be evaluated when determining whether a trade is being conducted.²⁵

5.5.2 “In respect of”

The definition of “impermissible trade” in section 12J(1) contains several references to trades which are carried on “in respect of” listed items. The meaning of “in respect of” is considered below before the meaning of “impermissible trade” is considered in 5.5.3.

The words “in respect of” have been considered in many cases. Steyn CJ in *SBI v Raubenheimer* considered various cases which dealt with the term and commented as follows:²⁶

“In these different remarks I cannot find a common position that indicates to the effect that ‘in respect of’ always indicates a direct relationship. ... In *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301 it is said at p. 320 ... that although the expression ... in the latter case can point to a causal relationship, this is not necessarily or always the case, and that in the said section the meaning of ‘in relation to’ or ‘in reference to’ must be ascribed to the words. So too in *Israelsohn v CIR* a wider meaning was attached to ‘in respect of’, while in *Montesse Township and Investment Corporation Ltd v Gouws NO & another* it was pointed out that they have a very wide and not very precise meaning and can be compared with expressions such as ‘in connection with’, ‘arising out of’, ‘with reference to’, ‘in relation to’ and ‘touching and concerning’. ... From these references it seems conclusive in my view that ‘in respect of’ is susceptible to a wider meaning, subject to the context, than that represented by an immediate or direct relationship.”

(Translated from the Afrikaans.)

Viviers J in *ITC 1340* summarised the position as follows:²⁷

“As was pointed out by Solomon JA in *CIR v Crown Mines Ltd* 1923 AD 121 at 128, the expression ‘in respect of’ may be used in various senses, and in each case it is necessary to examine the context in order to ascertain the sense in which it is used. Of the numerous decided cases in which the interpretation of the words ‘in respect of’ was discussed, I need refer only to two of the more recent decisions in which the earlier decisions are referred to: *SBI v Raubenheimer* 1969 (4) SA 314 (A) at 320 (31 SATC 209) and *SIR v Wispeco Housing (Pty) Ltd* 1973 (1) SA 783 (A) where Ogilvie Thompson CJ said the following at 792:

“No doubt the expression ‘in respect of’ must, in certain contexts, be restricted to a direct or causal relationship (cf eg *De Villiers v CIR* 1929 AD 227 at 229); but, as was pointed out in *CIR v Butcher Bros (Pty) Ltd* 1945 AD 301 at 320, the expression ‘in respect of’ does not necessarily or invariably indicate such relationship. In that case, it was held to be used in the sense of ‘in relation to’ or ‘in reference to’. (Cf also *SBI v Raubenheimer*) The expression ‘in connection with’ prima facie extends the ambit of matters comprehended *in casu*, the consideration upon which duty is payable. As Kitto J put it in *Berry’s case* . . . at 658,

‘a consideration may be “in connection with” more things than that “for” which it is received’.

²⁵ For more information on the “trade” requirement, see Interpretation Note 33 “Assessed Losses: Companies: The ‘Trade’ and ‘Income from Trade’ Requirements”.

²⁶ 1969 (4) SA 314 (A), 31 SATC 209 at 216. See also *Barnard NO v Regspersoon van Aminie and another* [1999] 4 All SA 451 (T) at 455.

²⁷ (1980) 43 SATC 210 (C) at 212.

As appears from all the foregoing, the context wherein the expressions ‘in respect of’ and ‘in connection with’ occur is of vital importance. The true position was, in my opinion, happily summarized by Schreiner JA, in *Rabinowitz and another v De Beer’s Consolidated Mines Ltd and another* 1958 (3) SA 619 (A) at 631, as follows:

‘Expressions like “in respect of” and “in connection with”, though they may sometimes be used to cover a wide range of association, must in other cases be limited to the close or more direct forms of association indicated by the context.’ ”

The conclusion of these cases is that, bearing in mind that section 12J is an incentive and that there was a clear intention that the incentive should not be extended to trades in specified industries, the term “in respect of” must be widely interpreted in the context²⁸ of section 12J along the lines of “in connection with” and “in relation to”. Notwithstanding the wide interpretation, there are situations in which the connection with a listed item will be considered too remote to result in it falling within the ambit of “in respect of” (see **5.5.3**).

The determination of whether a particular trade is “in respect of” one of the items listed in the definition of “impermissible trade” in section 12J can be done only on a case-by-case basis. It is therefore not possible to provide a list of trades which do and do not fall within an impermissible trade. In some cases the determination will be easy but in other cases it will be difficult. Some examples, which may assist taxpayers in determining whether their trades will be considered to be an “impermissible trade”, are discussed in **5.5.3**. Taxpayers requiring certainty regarding SARS’s interpretation based on their facts may apply for an advanced tax ruling if they meet the requirements.²⁹

5.5.3 List of impermissible trades

In assessing whether a trade constitutes an impermissible trade it is necessary to consider whether the particular trade falls within the ambit of any of the paragraphs below.

(a) Any trade carried on in respect of immovable property, other than a trade carried on as a hotel keeper

The distinction between movable and immovable property is made on common-law principles.³⁰ The significance of the distinction lies primarily in the fact that different legal rules apply to immovable and movable property. A thing is considered movable if it can be moved from one place to another without being damaged and without losing its identity. Examples of movables are furniture, motor vehicles, wheelbarrows and ships. Things that can move on their own, such as animals are also considered to be movables. Immovable property, on the other hand, comprises things which cannot be moved from one place to another without damage or change of form.³¹

²⁸ The principle established in *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) is that the ordinary grammatical meaning should be given to a term taking into account the context in which it appears and the purpose to which it is directed.

²⁹ See section 79 of the TA Act and the *Comprehensive Guide to Advanced Tax Rulings* for more information on how to apply for an advanced tax ruling.

³⁰ Binding Private Ruling 274 dated 6 June 2017 “Venture Capital Company Investing in a Company Providing and Expanding Plants for the Generation of Solar Electricity”.

³¹ CG van der Merwe “Movables and Immovables” 27 (Second Edition Volume) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 51.

The following are examples of immovable property:³²

- A piece of land as indicated on a diagram in the deeds registry.
- Geological components of the land, for instance the soil and minerals under the surface.
- Organic products of the land, such as vegetation, trees, ungathered fruits and unharvested crops.
- Artificial annexures to the land, such as buildings and other installations.
- Things permanently attached to a building or other constructions, such as plumbing, heating, cooling, electrical or other installations.
- Certain movables, such as the keys of a house, the cover of a well and a heap of manure on the land, which are destined to serve an immovable indefinitely.

Incorporeal things are also classified as movable or immovable. The criterion for determining whether an incorporeal thing is movable or immovable is the nature of the object to which it pertains.³³ Personal servitudes such as usufruct, use and habitation or life rights over immovable property, for example, acquire the character of immovable property on registration against the title deed of land.³⁴

Under this category, except for carrying on the trade of a hotel keeper, trades such as the letting of immovable property,³⁵ refurbishment or development³⁶ of immovable property as well as trading in such property will be considered impermissible trades.

Arguably a person carrying on the trade of a plumber or electrician fixing the plumbing or electrical equipment in a building is conducting a trade in respect of immovable property because plumbing and electrical installations in a building are part of the immovable property. However, taking the purpose and context of the section into account and the work that the plumber or electrician does in conducting the repairs, it is considered that this interpretation would be too restrictive and unintended and should not be adopted.³⁷

The term “hotel keeper” is defined in section 1(1) to mean –

“any person carrying on the business of hotel keeper or boarding or lodging house keeper where meals and sleeping accommodation are supplied to others for money or its equivalent”.

³² CG van der Merwe 27 “Examples of Movables and Immovables” (Second Edition Volume) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 53.

³³ CG van der Merwe “Incorporeal movables and immovables” 27 (Second Reissue Volume) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 52.

³⁴ CG van der Merwe “Examples of movables and immovables” 27 (Second Reissue Volume) *LAWSA* [online] (My LexisNexis: 31 January 2014) in paragraph 53.

³⁵ See the *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008*.

³⁶ See the *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008*.

³⁷ See *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA).

The business of a hotel keeper, boarding house keeper or lodging house keeper in its ordinary sense primarily involves the provision of accommodation, with or without food,³⁸ while the definition of “hotel keeper” goes further and makes the supply of meals compulsory.³⁹ Both meals and sleeping accommodation must be provided by the hotel keeper in the same premises. The hotel keeper need not necessarily prepare the meals but must supply them and derive money or its equivalent for such supply. For example, a hotel keeper could make use of an external caterer to supply the meals, pay the caterer and then bill the patrons for the meals. A taxpayer who lets a portion of the hotel premises to a third party for the purpose of operating a restaurant or fast-food outlet does not derive consideration for the supply of meals but rather derives rental income. While there is nothing to prevent a taxpayer from letting a portion of the premises in this way, such letting will not qualify the taxpayer as a hotel keeper. To qualify as a hotel keeper it is necessary for the taxpayer to supply sleeping accommodation and at least some meals, for example, breakfast in a bed-and-breakfast establishment, for money or its equivalent.

A hotel keeper does not conduct an impermissible trade under paragraph (a) of the definition of impermissible trade. However, hotel keepers must still consider the other paragraphs of the definition to assess whether their trades or one of their trades falls within the definition. For example, a hotel keeper may provide accommodation and have a restaurant on the premises in which the hotel keeper supplies meals and alcohol. That hotel keeper will not fall within paragraph (a) of the definition of impermissible trade but will fall within paragraph (e) because the trade is conducted in respect of the supply of liquor, even if that supply of liquor constitutes a minor part of the trade.

(b) Any trade carried on by banks, insurers and any trade carried on in respect of money-lender or hire purchase financing

This exclusion applies to any trade carried on by a bank as defined in the Banks Act,⁴⁰ a long-term insurer as defined in the Long-term Insurance Act⁴¹ and a short-term insurer as defined in the Short-term Insurance Act.⁴² It also applies to any trade carried on in respect of money-lending or hire-purchase financing.

The word “money-lender” is not defined in the Act. The *Oxford Dictionaries* defines it as –⁴³
“a person whose business is lending money to others who pay interest”.

This word has also been considered in case law.

³⁸ <http://www.dictionary.com/browse/lodging-house?s=t>;
<http://www.dictionary.com/browse/board?s=t>; <http://www.dictionary.com/browse/hotel?s=t>;
<http://www.dictionary.com/browse/boarding--house?s=t>; [Accessed 20 June 2018].

³⁹ See Draft Interpretation Note “Deductions in respect of Buildings Used by Hotelkeepers”.

⁴⁰ A “bank” in section (1) of the Banks Act 94 of 1990 means “a public company registered as a bank in terms of this Act”.

⁴¹ A “long-term insurer” in section 1 of the Long-Term Insurance Act 52 of 1998 means “a person registered or deemed to be registered as a long-term insurer under this Act”.

⁴² A “short-term insurer” in section 1 of the Short-Term Insurance Act 53 of 1998 means “a person registered or deemed to be registered as a short-term insurer under this Act”.

⁴³ <https://en.oxforddictionaries.com/definition/moneylender> [Accessed 20 June 2018].

In *Sentra-Oes Koöperatief Bpk v CIR*,⁴⁴ Nicholas AJA held that both a bank and a money-lender are in the business of dealing in money as their stock-in-trade. The Court explained the position as follows:⁴⁵

“Whether a person is a money-lender is a question of fact. It is not enough that a person has on several occasions lent money at interest. To qualify as a money-lender it is requisite that he should be in the business of money-lending. That imports a certain degree of system and continuity about the transactions and that he is a person who is ready and willing to lend to all and sundry if they are acceptable to him.”

Nicholas AJA referred with approval to the judgment of Friedman AJA in *Solaglass Finance Company (Pty) Ltd v CIR*⁴⁶ in relation to what constituted a money-lender. In addition to the points above, Friedman noted that the obtaining of security for a loan was usual for a money-lender but not essential and that the proportion of income from loans to total income was important but not decisive.⁴⁷ The fact that money had been lent at interest on several occasions was also insufficient in the absence of a degree of system and continuity to the lending.⁴⁸

The wording “any trade carried on in respect of money-lending or hire-purchase financing” is wide and, consistent with all the paragraphs of the definition of “impermissible trade”, is not qualified with words like mainly or ancillary. This fact means that if a company is engaged in any form of supply of credit, it will be considered to be carrying on an impermissible trade, even if the supply of credit is only an ancillary part of its activities. The supply of credit includes, but is not limited to, finance leases, instalment sale agreements and trade credit.

Example 1 – Money-lending ancillary to the main trade

Facts:

Company A’s main activity, in terms of focus and revenue and profit contribution, is the manufacture and sale of machinery to customers. Sales are concluded on a cash or credit basis. The company charges interest if machinery is sold on credit. The provision of credit is ancillary in terms of the resources allocated to the activity and its contribution to revenue and profit.

Result:

Notwithstanding the fact that the supply of credit is ancillary, Company A is still conducting a trade in respect of money-lending or hire-purchase financing and therefore an impermissible trade.

- (c) Any trade carried on in respect of financial or advisory services, including trades concerning legal services, tax advisory services, stock broking services, management consulting services, auditing or accounting services**

⁴⁴ 1995 (3) SA 197 (A), 57 SATC 109.

⁴⁵ At SATC 117.

⁴⁶ 1991 (2) SA 257(A), 53 SATC 1.

⁴⁷ At SATC 15.

⁴⁸ At SATC 15.

(d) Any trade carried on in respect of gambling

An example of a trade in respect of gambling is the operation of a casino or national lottery. Trades in respect of gambling are, however, wider than just the operation of the gambling activity itself. For example, if a company develops a new game of chance which it patents and sells to casinos, it will be conducting an impermissible trade. Although indirect, the activity is in respect of gambling because it is inextricably linked to and directly facilitates gambling. This is not to suggest that everyone who sells anything to a casino will be conducting an impermissible trade, since in some cases the connection with gambling may be too remote. For instance, the connection between a supplier manufacturing potato crisps which are sold to retailers, hotels, casinos, pubs and school tuckshops will be viewed as being too remote and will not lead to the supplier's trade being regarded as an impermissible trade.

These principles also apply to the other paragraphs of the definition of impermissible trade.

(e) Any trade carried on in respect of liquor, tobacco, arms and ammunition

These trades include the manufacturing, buying or selling of liquor and tobacco products as well as the manufacturing, buying or selling of arms or ammunition.

A company's trade does not have to only or primarily involve the sale of liquor to fall within this paragraph. For example, if a company sells liquor in a supermarket or in its restaurant business, it will be conducting an impermissible trade because its trade is carried on in respect of liquor.

(f) Any trade carried on⁴⁹ mainly outside South Africa

In *SBI v Lourens Erasmus (Eiendoms) Bpk*,⁵⁰ in the context of determining whether total net profit was derived solely or mainly from dividends, Botha JA held that the word "mainly" prescribed a purely quantitative standard of more than 50%. This meaning of "mainly" is also applicable in the context of paragraph (f) of the definition of impermissible trade.

Thus, a company conducting the majority of its trade outside South Africa will meet the 50% test and its trade will be impermissible. However, if the majority of the company's trade is performed in South Africa, it will not meet the 50% test and its trade will be permissible. It will therefore be classified as a qualifying company provided that all other requirements are met.

The appropriateness of the method applied to determine whether a trade is carried on mainly outside South Africa will be assessed on a case-by-case basis.

5.6 Investment income must be less than 20% of gross income – paragraph (f) of the definition of "qualifying company"

Under paragraph (f) of the definition of "qualifying company", the "investment income", as defined in section 12E(4)(c), earned by the company during any year of assessment must not be in excess of 20% of the gross income⁵¹ of that company for that year.

A company will not meet the requirements of a qualifying company if its "investment income" exceeds the 20% limit. The 20% limitation is calculated as a percentage of the sum of investment income in relation to gross income.

⁴⁹ See **5.5.1**.

⁵⁰ 1966 (4) SA 434 (A), 28 SATC 233.

⁵¹ See **Annexure** for the definition of "gross income".

The term “investment income” is defined in section 12E(4)(c)⁵² as –

- “(i) any income in the form of dividends, foreign dividends, royalties, rental derived in respect of immovable property, annuities or income of a similar nature;
- (ii) any interest as contemplated in section 24J (other than any interest received by or accrued to any co-operative bank as contemplated in paragraph (a)(ii)(ff)), any amount contemplated in section 24K and any other income which, by the laws of the Republic administered by the Commissioner, is subject to the same treatment as income from money lent; and
- (iii) any proceeds derived from investment or trading in financial instruments (including futures, options and other derivatives), marketable securities or immovable property”.

With regard to rental derived from immovable property in the definition of “investment income” (paragraph (i) of the above definition), SARS holds the view that the “income” earned from providing serviced accommodation on a short-term basis in, for example, a guesthouse or a hotel, will not be regarded as rental derived from the letting of immovable property. However, when a person has the exclusive use of property or a portion of property on a long-term basis, a portion of the income earned may be regarded as rental derived in respect of immovable property.⁵³ All the facts and circumstances will need to be taken into account when determining whether a portion of the income relates to rental in respect of immovable property. Separate to the question of what constitutes investment income and the 20% limit, taxpayers have to consider whether they are conducting an impermissible trade as defined (see 5.5). For example, taxpayers running hotels which provide serviced accommodation on a short-term basis may not be viewed as having investment income but still need to consider whether they are conducting an impermissible trade.

Although the amount envisaged in paragraph (iii) of the above definition, namely, *proceeds* derived from investment or trading in certain financial instruments, could be interpreted to include amounts of a capital nature, the words must be considered in the context of section 12J in which investment income is calculated as a percentage of gross income. Gross income includes amounts received by or accrued to a person but excludes amounts of a capital nature. Therefore, for purposes of the 20% calculation, “proceeds” under paragraph (iii) of the definition of “investment income”, includes only amounts of a revenue nature.

Example 2 – Calculation of the 20% limitation

Facts:

Company A carried on a manufacturing business. During the year of assessment, Company A’s gross income totalled R5 million. Included in gross income was interest received of R275 000.

Company A also sold a piece of land for R1,5 million which had been bought for investment purposes.

⁵² Section 12E relates to deductions for small business corporations.

⁵³ See Interpretation Note 9 “Small Business Corporations” for more detail.

Result:

In order for Company A to constitute a qualifying company, amongst other requirements, its investment income as defined in section 12E(4)(c) must not exceed 20% of gross income for the year of assessment.

Interest received is “investment income” as defined. Since “proceeds” for purposes of the calculation in paragraph (iii) of the definition of “investment income” includes only amounts of a revenue nature, the proceeds from the sale of Company A’s land must not be included in this amount, since they are of a capital nature.

20% limit calculation = Investment income R275 000 / gross income R5 000 000 = 5,5%

Since Company A’s investment income constitutes only 5,5% of its gross income, it meets the requirement of paragraph (f) of the definition of “qualifying company” in section 12J(1).

The intention of section 12J is to encourage investment in small or medium-sized businesses and to promote active business operations instead of merely funding companies which generate passive income. An investment in a company not meeting the 20% limitation requirement is unlikely to meet these objectives and therefore falls outside of the ambit of paragraph (f) and ultimately section 12J.

6. Anti-avoidance provisions

The deduction of expenditure incurred by a taxpayer in the acquisition of venture capital shares (see 4) is subject to the anti-avoidance provisions in section 12J(3) and section 12J(3A).

6.1. Limitation of a deduction – section 12J(3)(a)

The *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011* provides the following explanation for section 12J(3)(a) and (b):

“...the deduction will only be allowed if the investments in the VCC are pure equity investments (investments with debt-like features will be completely disallowed). In essence, the channeled funds must bear the economic risk and loss associated with the profit model of the VCC.

...the investment must place the investor genuinely ‘at-risk.’ No issue arises if the investor funds the investment from the investor’s own resources. However, if the investment stems from a loan or a credit facility, the investor must bear the risk of the loan or the credit facility (i.e. the loan or credit facility must be a fully recourse loan that must be repaid even if the VCC does not reach the investment objectives intended). Moreover, a loan or credit facility will not be deemed to satisfy the ‘at-risk’ criteria if the loan or credit facility is directly or indirectly provided by the VCC. Loans or credit facilities must also be repayable within 5 years to avoid ‘time-value of money’ schemes (schemes where the repayment is delayed for so long that the repayment is meaningless after inflation is taken into account).”

Section 12J(3)(a) provides that the amount qualifying for a deduction under section 12J(2) (see **4**) is limited to the amount for which the taxpayer is deemed to be at risk under section 12J(3)(b) (see **6.2**) on the last day of the year of assessment⁵⁴ if –

- the taxpayer made use of a loan or other form of credit during a year of assessment to pay or finance the whole or a portion of the expenditure incurred in acquiring venture capital shares; and
- a portion of that loan or credit is still owed on the last day of the year of assessment.

Section 12J(3) will therefore potentially find application when a taxpayer acquires or funds the venture capital shares or part of the venture capital shares by way of some form of credit. An investor who acquires the shares with that investor's own funds will not be subject to any limitation under section 12J(3)(a) on the deduction.

The limitation test must be applied if the taxpayer used credit during a year of assessment to finance the expenditure actually incurred in acquiring venture capital shares and there is any amount still owing on the last day of the year of assessment.

The excess of the expenditure actually incurred in acquiring the venture capital shares above the amount for which the taxpayer is deemed to be at risk is forfeited and will not qualify for deduction. The excess is not carried forward to future years of assessment.

Example 3 – Deduction of expenditure incurred by an investor

Facts:

During the 2017 year of assessment, Investor X invested R250 000 in a VCC in return for the issue of venture capital shares. The sum of R250 000 was financed through a loan obtained from the VCC and had to be repaid within three years from date of issue, which coincided with the date on which the loan was advanced. The loan agreement stipulated that if Investor X was required to dispose of the shares for less than the acquisition price, a portion of the loan equal to the difference between proceeds on disposal and the acquisition price would be waived.

On the last day of the 2017 year of assessment, the outstanding balance on the loan was R200 000. Investor X still held all of the venture capital shares purchased on the last day of the year of assessment.

Result:

Subject to the limitations in section 12J(3), Investor X is allowed to claim a deduction during the 2017 year of assessment under section 12J(2) for the expenditure incurred in acquiring the venture capital shares.

Under the limitation, a deduction may be claimed only for the amount that Investor X is deemed to be at risk on the last day of the year of assessment (see **6.2**). A taxpayer is deemed to be at risk to the extent that the incurral of expenditure or repayment of a loan or credit to finance that expenditure, would result in an economic loss if the venture capital shares were disposed of for no consideration. In assessing whether an economic loss would arise in this situation, any income received as a result of holding the shares is ignored.

⁵⁴ The term "year of assessment" is defined in section 1(1) and for a company is its financial year.

Investor X would incur an economic loss of R50 000 if Rnil consideration was received on disposal of the shares because the balance of the loan of R200 000 would not be repaid. Consequently, Investor X is deemed to be at risk to the extent of R50 000 under section 12J(3)(b) and, owing to section 12J(3)(a), the amount of the deduction under section 12J(2) is limited to R50 000. The excess of R200 000 (R250 000 – R50 000) is forfeited and may not be carried forward and claimed in future years of assessment.

The proviso to section 12J(3)(b) is inapplicable, since the loan is repayable within five years (see 6.3).

6.2 When a taxpayer is deemed to be at risk – section 12J(3)(b)

A taxpayer is deemed to be at risk under section 12J(3)(b), if the expenditure incurred in acquiring any venture capital shares or the repayment of the loan or credit used to acquire the shares would result in an economic loss to the taxpayer were no income to be received by or accrue to the taxpayer in future years from the disposal of the venture capital shares issued to the taxpayer as a result of the incurral of that expenditure.

For example, if a taxpayer that financed the purchase of venture capital shares with a loan, disposed of the shares and did not receive any income from the disposal but was still required to repay the outstanding amount of the loan, the taxpayer would be exposed to financial risk and would be deemed to be at risk under section 12J(3)(b). This outcome assumes that the proviso to section 12J(3)(b) does not apply (see 6.3). If the taxpayer was not required to repay the loan, the taxpayer would not be exposed to an economic loss and would not be deemed to be at risk. In assessing whether the taxpayer would incur an economic loss, section 12J(3)(b) requires a comparison between the expenditure incurred and proceeds of nil on disposal. Any income, such as dividends received or accrued or expected to be received or to accrue from the date the shares were acquired until the hypothetical disposal, must be ignored.

In the process of determining whether a taxpayer will be deemed to be at risk, regard must be had to all relevant surrounding circumstances including any transactions, agreements, arrangements, understandings or schemes that were entered into before or after the expenditure was incurred on the acquisition of the venture capital shares.

Example 4 – Taxpayer not at risk

Facts:

A taxpayer entered into two transactions with a lender. The first transaction was a loan obtained to acquire venture capital shares in a VCC that bore interest at prime and was repayable over five years. The second transaction was an understanding with the lender that upon final repayment of the loan, the lender would compensate the taxpayer to the extent that –

- the value of the venture capital shares is less than the expenditure incurred to acquire them (assuming the shares are still held); or
- the value of the proceeds on disposal of the venture capital shares is less than the expenditure incurred to acquire them (assuming the shares are disposed of).

Result:

Taking the effect of the purchase of the venture capital shares, the loan and the understanding into account, the taxpayer is not at financial risk and will not be deemed to be at risk under section 12J(3)(b).

See **Example 3** in **6.1**.

6.3 When a taxpayer is deemed not to be at risk – proviso to section 12J(3)(b)

The proviso to section 12J(3)(b) stipulates that a taxpayer must not be deemed to be at risk under section 12J(3)(b) to the extent that –

- the loan or credit does not have to be repaid within a period of five years from the date on which the funds were advanced to the taxpayer; and
- any loan or credit used by the taxpayer for the payment or financing of the whole or any portion of any expenditure incurred in acquiring venture capital shares is granted directly or indirectly to the taxpayer by the venture capital company by which the qualifying shares are issued as a result of the incurral of that expenditure.⁵⁵

An indirect loan includes, for example, a scenario in which the VCC grants a loan to a financial intermediary or other party that on-lends those funds to the taxpayer. The funds can then be said to have been indirectly loaned to the taxpayer by the VCC.

Both requirements must be met for the taxpayer “not to be deemed to be at risk”. In the event that only one of the requirements is met, the taxpayer will be deemed to be at risk if the requirements in section 12J(3)(b) are met (see **6.2**).

Since the proviso states that the taxpayer will not be deemed to be at risk *to the extent* that the requirements of paragraphs (aa) and (bb) are met, it indicates that a portion of the loan could meet the “deemed to be at risk” requirement with the result that only a portion of the expenditure incurred will be allowable assuming the other requirements of the section are met.

In making the determination, consideration must be given to any relevant transactions, agreements, arrangements, understandings or schemes entered into by the taxpayer before or after the expenditure was incurred (see **6.2**).

Example 5 – Deduction of expenditure incurred by an investor

Facts:

During the 2017 year of assessment, Investor X invested R300 000 in a VCC in return for the issue of venture capital shares. This amount was financed through a loan obtained from the VCC and had to be repaid in six equal instalments over six years from date of issue which coincided with the date on which the loan was advanced. The loan agreement stipulated that Investor X bore the full risk and that the loan was repayable regardless of the outcome of the investment. On the last day of the 2017 year of assessment, the outstanding balance on the loan was R250 000.

⁵⁵ In this regard, section 40(5) of the Companies Act 71 of 2008 permits a company to finance the acquisition of its own shares, subject to various restrictions.

Result:

Subject to the limitation in section 12J(3), Investor X is allowed to claim a deduction during the 2017 year of assessment under section 12J(2) for the expenditure incurred in acquiring the venture capital shares. Under the limitation, a deduction may be claimed only for the amount that Investor X is deemed to be at risk on the last day of the year of assessment.

By the end of the 2017 year of assessment, R50 000 had already been paid on the loan and therefore Investor X is deemed to be at risk for that amount under section 12J(3). In relation to the remaining four instalments of R50 000 which are repayable within five years from the date on which the loan was advanced, Investor X is deemed to be at risk under section 12J(3) because the repayment of the instalments (ignoring any income which may be received while holding the shares) will lead to an economic loss for Investor X if no income is received on the disposal of the shares.

In relation to the final instalment of R50 000, the proviso to section 12J(3)(b) provides that Investor X is not deemed to be at risk because that instalment is not repayable within five years (paragraph (aa) of the proviso) and the loan was granted directly by the VCC issuing the qualifying shares as a result of the expenditure (paragraph (bb) of the proviso).

Consequently, Investor X will qualify for a deduction of R250 000 [R50 000 paid in 2017 + (R50 000 x 4)] under section 12J(2). The excess of R50 000 is forfeited and Investor X will not be allowed to claim any deduction in respect of that amount.

6.4 Connected persons – section 12J(3A)

For expenditure incurred in years of assessment commencing on or after 1 January 2012 but before 1 January 2017, in acquiring venture capital shares issued by a VCC, no deduction was permitted under section 12J(2) if the taxpayer was a connected person⁵⁶ in relation to the VCC –

- immediately after the acquisition of the venture capital share; or
- as a result of the acquisition of such share.

This strict measure created problems for VCCs because there are often a limited number of investors who are able to provide seed funding at the outset.⁵⁷ Accordingly, it was not uncommon for initial investors to hold more than 20% of shares in a VCC, which would generally make the investor a connected person in relation to the VCC⁵⁸ and therefore ineligible to claim a deduction. This ineligibility resulted in potential investors opting out of making investments thus defeating the purpose of section 12J.

⁵⁶ See the **Annexure** for paragraph (d) of the definition of “connected person” in section 1(1). See also Interpretation Note 67 “Connected Persons” for a discussion of the definition of “connected person”.

⁵⁷ See the *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2016*.

⁵⁸ See the definition of “connected person” in section 1(1).

With effect from 1 January 2017,⁵⁹ the connected-person test is performed at the end of every year of assessment which is more than 36 months after the first issue of venture capital shares by the VCC. If at the end of any of these years of assessment, a taxpayer had previously incurred expenditure on venture capital shares issued by the VCC to that taxpayer⁶⁰ and that taxpayer is a connected person in relation to the VCC, the Commissioner must give due notice to the VCC that the company's approval as a VCC under section 12J(5) will be withdrawn if corrective steps to rectify its non-compliance⁶¹ are not taken within the period stated in the notice.

The end of the year of assessment referred to is the end of any year of assessment after the 36-month period of any taxpayer who has incurred expenditure contemplated in section 12J(2) in that year of assessment or a previous year of assessment. If corrective steps acceptable to the Commissioner are not taken within the period stated in the notice period, the following consequences arise:

- No deduction will be allowed under section 12J(2) for any expenditure incurred by a taxpayer in acquiring venture capital shares which are issued by the VCC to that taxpayer during the year of assessment in which the connected-person test was met by that taxpayer at the end of the year of assessment.
- The Commissioner must withdraw the VCC approval with effect from the date that the VCC was approved.
- In the year of assessment in which the approval is withdrawn, the VCC must include in its income an amount equal to 125% of the expenditure incurred by any investor to acquire venture capital shares issued by that VCC to that investor. If there is more than one investor, the 125% will be calculated on the aggregate of all the amounts invested by investors who acquired shares issued by the VCC.

The reference to "a taxpayer" in the introductory words of section 12J(3A) makes it clear that the connected-person test will be met even if only one taxpayer who previously incurred expenditure on venture capital shares issued by that VCC to that taxpayer is still a connected person in relation to the VCC after the 36-month period. In such event, only that taxpayer would be denied a deduction for any expenditure incurred under section 12J(3A)(a) in the year of assessment in which that taxpayer met the connected-person test. Other taxpayers who incurred expenditure contemplated in section 12J(2) would not be denied a deduction unless they met the connected-person test at the end of their relevant year of assessment and corrective steps were not taken by the VCC as required by the Commissioner under section 12J(3A)(a).

In determining whether a taxpayer is a connected person in relation to the VCC, the taxpayer must not have regard to only the VCC's shares acquired from an issue of shares by the VCC to that taxpayer. Rather, the definition of connected person⁶² must be considered and shares acquired from a third party must also be taken into consideration.

⁵⁹ Section 12J(3A) was amended by section 32(1) of the Taxation Laws Amendment Act 15 of 2016 with effect from 1 January 2017.

⁶⁰ Section 12J(3A) refers to expenditure contemplated in section 12J(2).

⁶¹ Non-compliance refers to the need to ensure that no taxpayer who incurred expenditure as contemplated in section 12J(2) is a connected person in relation to that VCC at the end of any year of assessment after 36 months of the first issue of venture capital shares by the VCC.

⁶² See Interpretation Note 67 "Connected persons".

If the approval as a VCC is withdrawn with effect from the date it was granted, it could mean that, with retroactive effect, investors who previously claimed a deduction under section 12J(2) would not be entitled to the deduction, since the company was not a VCC. This action would require income tax returns previously submitted to be amended and re-submitted. However, in interpreting the wording of section 12J(3A) within the context of section 12J, if the approval is withdrawn under section 12J(3A)(b), the investors are not required to amend their tax returns with retrospective effect.

However, an investor who had submitted a tax return and claimed a deduction under section 12J(2) in the year of assessment in respect of which the connected-person test was met at the end of the year must correct and re-submit that return in order to comply with section 12J(3A)(a) which provides that no deduction is allowed under section 12J(2) for that year. The investor would not have to correct and re-submit earlier returns for earlier years of assessment in respect of which a deduction was claimed under section 12J(2).

The amended 36-month rule means that even if a taxpayer who incurred expenditure on venture capital shares issued by the VCC to that taxpayer was a connected person in relation to that VCC at the time, that taxpayer would not be precluded from claiming a deduction in the first three years from the issue of the first venture capital shares by the VCC. The VCC has 36 months to find additional investors before the connected-person test is performed at the end of years of assessment ending after that 36-month period.

The calculation of a period expressed in weeks, months or years is done by using the civil method of calculation.⁶³ The period so expressed will thus expire at the end of the day preceding the corresponding calendar day. For example, if the VCC issues venture capital shares on 15 July 2017, the 36 months will lapse at the end of 14 July 2020. This means that the connected-person test would need to be performed at the end of any year of assessment which ends on or after 15 July 2020 because section 12J(3A) refers to the end of the year of assessment after the expiry of the 36-month period.

Example 6 – Connected-person test when shares issued on formation of VCC

Facts:

On 5 January 2017, Investor Z, an individual, invested R300 000 in a VCC in return for venture capital shares issued by the VCC. This date was also the date on which the VCC first issued any venture capital shares. As a result of the acquisition of the shares, Investor Z held 35% of the VCC's shares and thus became a connected person in relation to the VCC.

The VCC did not issue any further shares.

Result:

Provided that all the requirements of section 12J were complied with on 5 January 2017, Investor Z would be entitled to a deduction of R300 000 in that year of assessment under section 12J(2), even though Investor Z was a connected person in relation to the VCC under paragraph (d)(iv) of the definition of "connected person". Similarly, other investors would be entitled to a deduction under section 12J(2) for expenditure incurred on venture capital shares issued to them by the VCC, even if Z remained a connected person in relation to the VCC during the 36-month period.

⁶³ *Ex parte Minister of Social Development & others* 2006 (4) SA 309 (CC).

Once the 36-month period ends, the connected-person test must be performed at the end of every year of assessment after that date. If Investor Z were still a connected person at the end of Investor Z's year of assessment ending after the 36-month period, and corrective steps were not taken by the VCC within the period stipulated by the Commissioner in the notice issued to the VCC, the VCC's approval as a VCC would be withdrawn from the date it was granted.

No deduction would be available to future VCC investors in respect of new issues of shares and the VCC would need to include an amount of 125% of expenditure previously incurred by any person to acquire shares issued by the VCC in income.

If Investor Z had made the investment in 2016 and was a connected person at that time, no deduction would have been allowed to Investor Z under the previous wording of section 12J(3A), since the connected-person test was applied at the time the investment was made.

The connected-person test must be performed at the end of the relevant years of assessment for all investors, not just Investor Z.

Example 7 –Connected-person test involving initial issue of venture capital shares followed by acquisition of additional shares from another holder of shares

Facts:

On 5 January 2017, Investor Z, an individual, invested R300 000 in a VCC in return for venture capital shares issued by the VCC. This date was also the date on which the first venture capital shares were issued by the VCC. The VCC's year of assessment ends on 31 December.

Investor Z subsequently purchased shares in the VCC from Investor Y on 20 February 2018 for R220 000.

The initial investment of R300 000 represented a holding of 15% of the VCC's shares and the shares purchased from Investor Y on 20 February 2018 represented a holding of 10%. Investor Z therefore became a connected person in relation to the VCC under paragraph (d)(iv) of the definition of "connected person" as a result of acquiring the shares from Investor Y on 20 February 2018.

On 31 January 2020 the VCC issued additional shares. Investor Z subscribed for some of the additional shares issued at a subscription price of R100 000. The other additional shares were issued to persons who were not and did not become connected persons in relation to the VCC.

The three purchases detailed above represented a holding of 26% for Investor Z in the VCC's shares. These shareholdings remained unchanged on 31 December 2020.

Result:

Provided that all the requirements of section 12J were complied with on 5 January 2017, Investor Z would be entitled to a deduction of R300 000 in the year of assessment ending on 28 February 2017 under section 12J(2).

No deduction is available under section 12J(2) for the shares purchased by Investor Z from Investor Y on 20 February 2018 in the year of assessment ending on 28 February 2018, since the shares were not issued to Investor Z by the VCC.

A deduction for the R100 000 expenditure on shares issued by the VCC to Investor Z on 31 January 2020 will initially be allowed as a deduction under section 12J(2) in the year of assessment ending 28 February 2020. However, if the income tax return is submitted, Investor Z will need to re-open the return to reverse the deduction if the corrective steps referred to below were not taken as required because the deduction would not be allowed under section 12J(3A)(a). If Investor Z had claimed a deduction under section 12J(2) for the initial purchase of shares in 2017, Investor Z would not be required to re-open this return if the corrective steps were not taken.

The 36-month period from the date of the first issue of shares ends on 4 January 2020. The connected-person test must therefore be performed at the end of the 2020 year of assessment which ends for Investor Z on 28 February 2020. On 28 February 2020 Investor Z is a connected person to the VCC as a result of the shares previously acquired from the VCC (5 January 2017 and 31 January 2020) and Investor Y (20 February 2018), a total shareholding of 26%. The connected-person test in section 12J(3A) is also met on 28 February 2020 because Investor Z had incurred expenditure contemplated in section 12J(2) (R300 000 for shares issued to Investor Z by the VCC in the 2017 year of assessment and R100 000 incurred in the 2020 year of assessment) and Investor Z is a connected person to the VCC on 28 February 2020.

The Commissioner must therefore issue a notice to the VCC notifying it that its approval as a VCC will be withdrawn with effect from the date it was initially granted if corrective steps are not taken by a date specified in the notice. If the corrective steps are not taken by the date indicated, the following consequences will follow:

- Investor Z will not be allowed a deduction in the year of assessment ending 28 February 2020 for the R100 000 expenditure incurred in respect of the venture capital shares acquired on 31 January 2020, since the connected-person test was met at the end of the year of assessment.
- The Commissioner must withdraw the VCC's approval with effect from the date it was granted.
- The VCC must include an amount equal to 125% of the expenditure incurred by any person to acquire shares issued by the VCC in the VCC's income in the year of assessment in which the Commissioner withdraws the approval. This inclusion will take into account expenditure incurred by any investor to acquire shares issued by the VCC to that investor and, although not limited to, it would include the amounts of R300 000 and R100 000 incurred by Investor Z. The calculation must include the R100 000 paid by Investor Z to the VCC, even though Investor Z will be denied a deduction for the R100 000 (see above). The calculation will not include the R220 000 paid by Investor Z to Investor Y, since that expenditure is not expenditure contemplated in section 12J(2) but it will include the amounts Investor Y and other investors paid to the VCC for shares issued to them.
- No deductions will be available under section 12J(2) for expenditure incurred in respect of the future issue of shares by the company which will no longer have approval as a VCC.

- Expenditure previously incurred by investors which qualified for a deduction under section 12J(2) will not be reversed in those investors' hands. However, as noted above, Investor Z will not qualify for a deduction for the R100 000 expenditure incurred in respect of the venture capital shares acquired on 31 January 2020.

7. Recoupments

General recoupments are provided for in section 8(4)(a). Under this section any amounts allowed as a deduction under specified sections, which have subsequently been recovered or recouped by a taxpayer, are included in the taxpayer's gross income under paragraph (n) of the definition of "gross income" in section 1(1).

The sale of venture capital shares by an investor may therefore potentially result in the inclusion in gross income of an amount previously allowed as a deduction under section 12J that is subsequently recouped or recovered by the taxpayer.

However, section 12J(9) provides that, despite section 8(4), no amount shall be recovered or recouped in respect of the disposal of a venture capital share or in respect of a return of capital⁶⁴ if that share has been held by the taxpayer for a period longer than five years.

Section 9C deals with circumstances in which certain amounts received or accrued from the disposal of shares are deemed to be of a capital nature. Section 9C(2) deems any amount (other than a dividend or foreign dividend) received or accrued or any expenditure incurred in respect of an equity share to be of a capital nature if that equity share had, at the time of the receipt or accrual of that amount or incurral of that expenditure, been held for a period of at least three years. However, section 9C(2A) provides that section 9C(2) does not apply to the extent that the amount received or accrued on disposal of venture capital shares does not exceed the expenditure allowed as a deduction on those shares under section 12J(2). This rule applies irrespective of whether the shares are held for five years or less [and hence potentially subject to recoupment under section 8(4)(a)] or longer than five years [and hence not subject to recoupment by virtue of section 12J(9)]. The capital or revenue nature of any amount not exceeding the expenditure allowed under section 12J(2) which is not subject to recoupment because the shares have been held for more than five years must be determined by applying common-law principles.

The amount exceeding the expenditure and which is not subject to recoupment will, however, fall under section 9C(2) provided the shares have been held for at least three years.⁶⁵

⁶⁴ The reference to a return of capital was inserted by the Taxation Laws Amendment Act, 2017 with effect from 1 January 2018 and applies in respect of years of assessment commencing on or after that date.

⁶⁵ The information on section 9C in relation to section 12J and Example 8 has been extracted from Interpretation Note 43 "Circumstances in which Certain Amounts Received or Accrued from the Disposal of Shares are Deemed to be of a Capital Nature".

A return of capital of a capital nature received or accrued on the venture capital shares more than five years after they were issued must be dealt with under paragraph 76B(3) of the Eighth Schedule, since it will exceed the base cost of the venture capital shares.⁶⁶ It will thus result in a capital gain.

Example 8 – Application of section 9C(2A) to disposal of venture capital shares

Facts:

Company A, which has a financial year ending on the last day of February, acquired shares in an approved VCC on 1 March 2014 for R400 000. On 30 September 2017 Company A sold the shares for R900 000.

Result:

Ordinary income

2015 year of assessment

Company A qualified for a deduction of R400 000 under section 12J(2).

2018 year of assessment

Upon disposal of the shares, R400 000 is recouped under section 8(4)(a) [that is, the amount previously allowed as a deduction under section 12J(2)].

The amount deemed to be of a capital nature under section 9C is equal to the amount received or accrued in excess of the amount recouped under section 8(4)(a), namely, R500 000 (R900 000 – R400 000). This amount is subject to CGT.

CGT

	R	R
Amount received or accrued		900 000
<i>Less:</i> Amount recouped under section 8(4)(a) [paragraph 35(3)(a)]		<u>(400 000)</u>
Proceeds		500 000
<i>Less:</i> Base cost		
Cost	400 000	
<i>Less:</i> Deduction under section 12J(2) [paragraph 20(3)(a)]	<u>(400 000)</u>	-
Capital gain		<u>500 000</u>
Taxable capital gain (80% × R500 000)		<u>400 000</u>

⁶⁶ Since the expenditure incurred in acquiring the VCC shares would have been allowed as a deduction against income under section 12J(2), it will be reduced to nil for purposes of determining the base cost of the VCC shares under paragraph 20(3)(a).

8. Withdrawal of venture capital company approval

Apart from the instances mentioned in 6.4, the Commissioner must, under section 12J(6), withdraw the approval of a VCC if satisfied that during a year of assessment the company has not complied with any requirement in section 12J(5) (see 2). Due notice must, however, first be given and the VCC has an opportunity to take corrective steps acceptable to the Commissioner within a period stipulated in the notice before its status is withdrawn. The company's VCC status must be withdrawn with effect from the commencement of the year of assessment in which the VCC failed to comply with the provisions of section 12J(5).

Section 12J(6A) contains two additional tests (see 8.1 and 8.2) which, if met, can result in a VCC's approval as a VCC being withdrawn after due notice has been given and acceptable corrective steps have not been taken by the VCC within a period stipulated in the notice. The tests must both be performed at the end of every year of assessment ending more than 36 months after the first date of the issue of venture capital shares by the VCC. Under section 12J(6A), if the corrective steps are not taken within the stipulated time, the Commissioner must withdraw the VCC approval with effect from the date of approval of the company as a VCC. However, the intention is not to retroactively deny any deduction in the hands of a VCC investor but rather to penalise the VCC under section 12J(8).

In addition to no longer meeting the requirements of section 12J once approval as a VCC has been withdrawn, a VCC incurs additional liabilities under section 12J(8) (see 8.3).

8.1 80% test – section 12J(6A)(b)

In the normal course of events, investors invest in a VCC in return for venture capital shares. The VCC, in turn, invests the money received in qualifying companies in return for qualifying shares in those companies. The VCC will therefore have to incur expenditure in order to acquire shares in qualifying companies. A VCC's sole object must be the management of investments in qualifying companies. However, this does not mean the VCC may never hold assets other than shares in qualifying companies. The VCC may, for example, have office premises or place funds in an interim investment or bank account whilst locating the correct qualifying company in which to place an investment (see 2).

The 80% test under section 12J(6A)(b) will be met if, at the end of the relevant year of assessment (see 8), *less than 80%* of the expenditure incurred to acquire assets held by the VCC was incurred to acquire qualifying shares issued to the VCC by a qualifying company which, immediately after the issue, held assets with a book value not greater than –

- R500 million if the qualifying company is a junior mining company; or
- R50 million⁶⁷ if it is any other type of qualifying company.

Expenditure on qualifying shares issued to a VCC by a qualifying company that exceeds these values immediately after the share issue would be included in total expenditure on assets but would not be included as “expenditure on acceptable qualifying companies” (see **Example 9**). Expenditure on qualifying shares issued to a VCC by a qualifying company will be “expenditure on acceptable qualifying companies” only if the qualifying company holds assets not exceeding the book value thresholds in section 12J(6A)(b).

⁶⁷ Binding Private Ruling 242 dated 15 June 2016 “Venture Capital Company Investment in Qualifying Companies Carrying on Business as Hotel Keepers”.

The purpose of these limits is to ensure that the VCC does not invest in large established companies. The relevant point in time for testing the book value of the qualifying companies is immediately after the issue of the shares. Subsequent changes in the book value of the assets, irrespective of how funded, are irrelevant unless a new issue of shares to a VCC is under consideration.

The book value of an asset is the amount at which the asset is reflected in the books of the owner of the asset which would generally be its cost adjusted for depreciation (if applicable) and valuation adjustments (if applicable).⁶⁸ The book value of an asset is distinguishable from the book value of a business, since the latter represents the net book value of assets and liabilities.

Example 9 – 80% test

Facts:

2018 (Year 4)

ABC VCC raised R100 million from its first and only issue of equity shares to investors on 13 July 2014 (Year 1). The cumulative expenditure at the end of the 2018 year of assessment was as follows:

Investment in Qualifying Company A	R40 million
Investment in Qualifying Company B	R30 million
Investment in Qualifying Company C	R5 million
Investment in Qualifying Company D	R5 million
Bank account (pending identification of additional appropriate investments)	R18,5 million
Acquisition of office premises	R1 million
Payment of operating expenses	R0,5 million

None of the qualifying companies were mining companies and immediately after the qualifying companies issued shares to ABC VCC, the book value of their assets was less than R50 million.

2019 (Year 5)

During the 12-month period covered by the 2019 year of assessment, Qualifying Company A increased the book value of its assets from R40 million to R85 million through organic growth, use of debt and the issue of additional shares. ABC VCC did not subscribe for additional shares in Qualifying Company A.

Qualifying Company B issued more equity shares, which raised additional share capital of R55 million. The accounting records reflected the same increase (R55 million) in the book value of its assets. ABC VCC subscribed for R17,5 million of the R55 million increase in share capital.

⁶⁸ See <https://www.collinsdictionary.com/dictionary/english/book-value>;
<https://legal-dictionary.thefreedictionary.com/Book+Value>;
<https://www.investopedia.com/terms/b/bookvalue.asp>;
https://www.en.wikipedia.org/wiki/Book_value#Asset_book_value.

Qualifying Company C and Qualifying Company D increased the book value of their assets to totals of less than R50 million each through organic growth, use of debt and the issue of additional shares. ABC VCC did not subscribe for additional shares in Qualifying Company C or Qualifying Company D. However, ABC VCC purchased some shares in Qualifying Company C for R1 million from Investor Y.

The cumulative expenditure incurred by ABC VCC at the end of the 2019 year of assessment was as follows:

Investment in Qualifying Company A	R40 million
Investment in Qualifying Company B	R47,5 million
Investment in Qualifying Company C	R6 million
Investment in Qualifying Company D	R5 million
Bank account (pending identification of additional appropriate investments)	RNil million
Acquisition of office premises	R1 million
Payment of operating expenses	R0,5 million

Result:

2018 (Year 4)

ABC VCC must perform the 80% test under section 12J(6A)(b) because the end of its 2018 year of assessment is more than 36 months after the first issue of its shares.

Expenditure on total assets = R99,5 million (R100 million – R0,5 million because the only expenditure on non-assets was the operating expenses).

Expenditure on shares in qualifying companies with an asset book value of less than or equal to R50 million immediately after issue = R80 million (R40 million + R30 million + R5 million + R5 million).

Therefore, expenditure on acceptable qualifying companies / total expenditure on assets = R80 million / R99,5 million = 80,4%. ABC VCC is not disqualified by the test because 80% or more of the expenditure incurred in acquiring its assets has been invested as required under section 12J(6A)(b). ABC VCC is therefore not at risk of having its VCC approval withdrawn under section 12J(6A)(b) at the end of its 2018 year of assessment.

2019 (Year 5)

Expenditure on total assets = R99,5 million (R100 million – R0,5 million because the only expenditure on non-assets was the operating expenditure).

In determining whether the investment by a VCC in a qualifying company is expenditure on an acceptable qualifying company, section 12J(6A) looks at the book value of the qualifying company's assets immediately after the issue of the shares to the VCC concerned. Therefore, the following expenditure totalling R80 million will qualify as expenditure on shares in an acceptable qualifying company:

- (a) Qualifying Company A – even though the book value of Qualifying Company A's assets exceeded R50 million during the period covered by ABC VCC's year of assessment, immediately after ABC VCC subscribed for R40 million of shares in the company in 2018 the asset value was less than R50 million as required.

- (b) Qualifying Company B – the initial investment of R30 million is expenditure on an acceptable qualifying company under section 12J(6A)(b) because immediately after the subscription during the 2018 year of assessment, the book value of the qualifying company's assets did not exceed R50 million. The additional subscription for new shares during the current year of assessment is considered separately (see below).
- (c) Qualifying Company C – the initial investment of R5 million is expenditure on an acceptable qualifying company under section 12J(6A)(b) because immediately after the subscription during the 2018 year of assessment, the book value of the qualifying company's assets did not exceed R50 million. However, the additional purchase of shares from Investor Y does not qualify as expenditure on an acceptable qualifying company because it was not used to acquire qualifying shares issued by Qualifying Company C to ABC VCC (see below).
- (d) Qualifying Company D – the initial investment of R5 million is expenditure on an acceptable qualifying company under section 12J(6A) because immediately after the subscription during the 2018 year of assessment, the book value of the qualifying company's assets did not exceed R50 million.

However, the expenditure of R17,5 million incurred in acquiring additional shares in Qualifying Company B does not constitute expenditure on an acceptable qualifying company under section 12J(6A)(b) because immediately after the subscription of shares by ABC VCC, the book value of the qualifying company's assets exceeded R50 million. In addition, the purchase of additional shares in Qualifying Company C from Investor Y does not constitute expenditure on an acceptable qualifying company under section 12J(6A)(b) because that expenditure must be in respect of an issue of shares by the qualifying company to the VCC.

Therefore, expenditure on acceptable qualifying companies / total expenditure on assets = R80 million / R99,5 million = 80,4%. ABC VCC is not disqualified by the test because 80% or more of the expenditure incurred in acquiring its assets has been invested in acceptable qualifying companies specified under section 12J(6A)(b). ABC VCC is therefore not at risk of having its VCC approval withdrawn under section 12J(6A)(b) at the end of its 2019 year of assessment.

A VCC has approximately 36 months⁶⁹ from the date on which the venture capital shares are first issued to make sure it has invested the proceeds from the share issue in acceptable qualifying companies specified in section 12J(6A)(b) so that 80% or more of its expenditure incurred in acquiring assets is incurred on investments in such companies. If the VCC fails to make the required level of investment in those qualifying companies, the VCC's approval as a VCC (see 8) may be withdrawn.

8.2 20% test – section 12J(6A)(c)

The 20% test under section 12J(6A)(c) will be met if at the end of the relevant year of assessment (see 8) a VCC has spent more than 20% of any of the amounts received in respect of the issue of its shares to acquire qualifying shares issued to the VCC by any one qualifying company. If the 20% limit is exceeded, the VCC's approval as a VCC (see 8) may be withdrawn. This requirement ensures that more qualifying companies benefit from VCC funding.

⁶⁹ The connected-person test is performed at the end of every year of assessment which is more than 36 months after the first issue of venture capital shares by the VCC.

8.3 Effect of withdrawal of status – section 12J(8)

A consequence of a VCC status withdrawal under section 12J(6) and (6A) is that the company must include in income an amount equal to 125% of the expenditure incurred by any person for the issue of shares held in that company. This inclusion in income must take place in the year of assessment in which the status is *withdrawn* by the Commissioner.

8.4 Reapplying for approval as a venture capital company – section 12J(7)

Section 12J(7) enables a company that has had its VCC status withdrawn under sections 12J(6) or 12J(6A) to reapply for approval. The company must meet all the requirements of section 12J(5) (see **2**) and must apply for approval in respect of the year of assessment following the year of assessment in which its approval as a VCC was withdrawn.⁷⁰ For example, if a company's VCC status is withdrawn in the 2017 year of assessment, the request for re-approval must be made in respect of the 2018 year of assessment.

VCC status will be granted again only if the non-compliance which resulted in the withdrawal has been rectified to the satisfaction of the Commissioner. The re-approval does not affect the inclusion in income under section 12J(8) which would already have taken place in the previous year of assessment.

9. Venture capital company investor certificate – section 12J(4)

In order to claim the deduction under section 12J(2) (see **4**), the taxpayer must obtain a VCC investor certificate which supports the amount of the deduction.⁷¹ A VCC investor certificate is a certificate issued by the VCC stating the amounts invested in it and that the Commissioner has approved the VCC under section 12J(5). These certificates must be issued by the approved VCC during the year in which the investment is received by the VCC and must reflect the following:⁷²

- The VCC's taxpayer reference number.
- The VCC approval reference number which was issued by SARS after the approval of the VCC status.
- The name and address of the VCC that issued the certificate to which enquiries may be directed.
- The date of receipt of the investment.
- The name and address of the investor.
- The investor's taxpayer reference number.
- The amount of the investment made by the taxpayer into the VCC.

⁷⁰ The year of assessment in which approval is withdrawn differs from the year of assessment in which that withdrawal is effective – see **8**).

⁷¹ Section 12J(4) of the TA Act.

⁷² See *Venture Capital Companies – External Guide* (Revision 7) in paragraph 7.

The VCC investor certificate for an investment in a VCC by a partnership can be a single certificate which includes all the partners' details and each partner's proportionate share of the investment. Alternatively, individual certificates can be issued to each partner showing the partner's respective details and proportionate share of the investment⁷³ and a notation that the investment was made via the partnership.

A taxpayer must submit a copy of the VCC certificate to SARS when requested by SARS to do so.⁷⁴ A taxpayer has a duty to retain records for a period of five years from the date of the submission of a return.⁷⁵

10. Tax administrative requirements

10.1 Reporting arrangements

Section 12J(10) places an obligation on a VCC to submit a report to the Minister of Finance containing the information that the Minister may prescribe. The Minister is, however, not obligated to issue such a notice and to date has not done so.

VCCs are required to maintain and submit records on their investors and investees to SARS – see *Venture Capital Companies – External Guide* (Revision 7) for detail.

10.2 Objection and appeal

Section 3(4)(b) stipulates that any decision made by the Commissioner under sections 12J(6), (6A) and (7) is subject to objection and appeal as provided for in Chapter 9 of the TA Act.⁷⁶

A company will therefore be entitled to object and appeal against the Commissioner's decision to withdraw a VCC's status under sections 12J(6) or (6A) as well as a decision to not accept a subsequent application for re-approval as a VCC.

10.3 Income tax return

The income tax return requires information relating to investments in VCCs. The taxpayer must, therefore, indicate whether any investments were made to approved VCCs in exchange for venture capital shares during the year of assessment. Information is also required on the number of investments made as well as the amount of expenditure incurred in acquiring the shares.

As mentioned in **9**, the taxpayer may be requested by SARS to produce the VCC investor certificate in order to verify the information mentioned above.

⁷³ See Binding Class Ruling 057 dated 24 July 2017 "Section 12J(2) Deduction by Partners".

⁷⁴ Section 46 of the TA Act.

⁷⁵ Section 29 of the TA Act.

⁷⁶ See *Dispute Resolution Guide: Guide on the Rules Promulgated in terms of section 103 of the Tax Administration Act, 2011* for more information on the objection and appeal process.

11. Conclusion

Taxpayers who invest in VCCs may claim a deduction on the amount incurred in acquiring venture capital shares provided that all the requirements of section 12J have been complied with.

Before a company can be regarded as a VCC, the requirements of section 12J must be met. Failure to comply with the relevant requirements may result in the VCC's approval being withdrawn. If withdrawn, a VCC must include in income an amount equal to 125% of the expenditure incurred by any person for the issue of shares held in that company. This inclusion in income must take place in the year of assessment in which the status is withdrawn by the Commissioner. In the event of a withdrawal, the VCC will be given a chance to reapply for approval if non-compliance is remedied to the Commissioner's satisfaction.

Annexure – The Law

Definition of “company” in section 1(1)

“company” includes—

- (a) any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic or in any part thereof, or any body corporate formed or established or deemed to be formed or established by or under any such law; or
- (b) any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law; or
- (c) any co-operative; or
- (d) any association (not being an association referred to in paragraph (a) or (f)) formed in the Republic to serve a specified purpose, beneficial to the public or a section of the public; or
- (e) any—
 - (i)
 - (ii) portfolio comprised in any investment scheme carried on outside the Republic that is comparable to a portfolio of a collective investment scheme in participation bonds or a portfolio of a collective investment scheme in securities in pursuance of any arrangement in terms of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act) are invited or permitted to contribute to and hold participatory interests in that portfolio through shares, units or any other form of participatory interest; or
 - (iii) portfolio of a collective investment scheme in property that qualifies as a REIT as defined in paragraph 13.1 (x) of the JSE Limited Listings Requirements; or
- (f) a close corporation,

but does not include a foreign partnership;

Paragraph (d) of the definition of “connected person” in section 1(1)

“Connected person” means—

- (d) in relation to a company—
 - (i) any other company that would be part of the same group of companies as that company if the expression “at least 70 per cent of the equity shares in” in paragraphs (a) and (b) of the definition of “group of companies” in this section were replaced by the expression “more than 50 per cent of the equity shares or voting rights in”;
 - (ii)
 - (iii)
 - (iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of—
 - (aa) the equity shares in the company; or
 - (bb) the voting rights in the company;
 - (v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company;

- (vA) any other company if such other company is managed or controlled by—
 - (aa) any person who or which is a connected person in relation to such company; or
 - (bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and
- (vi) where such company is a close corporation—
 - (aa) any member;
 - (bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme) which is a connected person in relation to such member; and
 - (cc) any other close corporation or company which is a connected person in relation to—
 - (i) any member contemplated in item (aa); or
 - (ii) the relative or trust contemplated in item (bb); and

Definition of “gross income” in section 1(1)

“gross income”, in relation to any year or period of assessment, means—

- (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
- (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature...

Definition of “hybrid debt instrument” in section 8E(1)

“hybrid equity instrument” means—

- (a) any share, other than an equity share, if—
 - (i) the issuer of that share is obliged to redeem that share in whole or in part; or
 - (ii) that share may at the option of the holder be redeemed in whole or in part, within a period of three years from the date of issue of that share;
- (b) any share, other than a share contemplated in paragraph (a), if—
 - (i) (aa) the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share;
 - (bb) that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or
 - (cc) at any time on the date of issue of that share, the existence of the company issuing that share—
 - (A) is to be terminated within a period of three years; or
 - (B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time; and
 - (ii) (aa) that share does not rank *pari passu* as regards its participation in dividends or foreign dividends with all other ordinary shares in the capital of the relevant company or, where the ordinary shares in such company are divided into two or more classes, with the shares of at least one of such classes; or

- (bb) any dividend or foreign dividend payable on such share is to be calculated directly or indirectly with reference to any specified rate of interest or the time value of money;
- (c) any preference share if that share is—
 - (i) secured by a financial instrument; or
 - (ii) subject to an arrangement in terms of which a financial instrument may not be disposed of,
 unless that share was issued for a qualifying purpose;

Definition of “third-party backed share” in section 8EA(1)

“**third-party backed share**” means any preference share or equity instrument in respect of which an enforcement right is exercisable by the holder of that preference share or equity instrument or an enforcement obligation is enforceable as a result of any amount of any specified dividend, foreign dividend, return of capital or foreign return of capital attributable to that share or equity instrument not being received by or accruing to any person entitled thereto;

Section 12J

12J. Deductions in respect of expenditure incurred in exchange for issue of venture capital company shares.—(1) For the purposes of this section—

“**impermissible trade**” means—

- (a) any trade carried on in respect of immovable property, other than a trade carried on as an hotel keeper;
- (b) any trade carried on by 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 any trade carried on in respect of money-lending or hire-purchase financing;
- (c) any trade carried on in respect of financial or advisory services, including trade in respect of legal services, tax advisory services, stock broking services, management consulting services, auditing or accounting services;
- (d) any trade carried on in respect of gambling;
- (e) any trade carried on in respect of liquor, tobacco, arms or ammunition;
- (f)
- (g) any trade carried on mainly outside the Republic;

“**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;

“**qualifying company**” means any company if—

- (a) that company is a resident;
- (b) the company is not a controlled group company in relation to a group of companies;
- (c) the tax affairs of the company are in order and the company has complied with all the relevant provisions of the laws administered by the Commissioner;
- (d) the company is an unlisted company as defined in section 41 or a junior mining company;

- (e) the company is not carrying on any impermissible trade; and
- (f) the sum of the investment income, as defined in section 12E(4)(c), derived by that company during any year of assessment does not exceed an amount equal to 20 per cent of the gross income of that company for that year;
- (g)

“qualifying share” means an equity share held by a venture capital company which is issued to that company by a qualifying company, and does not include any share which—

- (a)
- (b) would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of “hybrid equity instrument” in that section; or
- (c) constitutes a third-party backed share as defined in section 8EA(1);

“venture capital company” means a company that has been approved by the Commissioner in terms of subsection (5) and in respect of which such approval has not been withdrawn in terms of subsection (6) or (6A);

“venture capital share” means an equity share held by a taxpayer in a venture capital company which is issued to that taxpayer by a venture capital company, and does not include any share which—

- (a)
- (b) would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of “hybrid equity instrument” in that section; or
- (c) constitutes a third-party backed share as defined in section 8EA(1).

(2) Subject to subsections (3), (3A) and (4), there must be allowed as a deduction from the income of a taxpayer expenditure actually incurred by that taxpayer in acquiring any venture capital share issued to that taxpayer by a venture capital company.

- (3) (a) Where, during any year of assessment—
 - (i) any loan or credit has been used by a taxpayer for the payment or financing of the whole or any portion of any expenditure contemplated in subsection (2); and
 - (ii) any portion of that loan or credit is owed by the taxpayer on the last day of the year of assessment,

the amount which may be taken into account as expenditure that qualifies for a deduction in terms of subsection (2) must be limited to the amount for which the taxpayer is in terms of paragraph (b) deemed to be at risk on the last day of the year of assessment.

- (b) For the purposes of paragraph (a), a taxpayer must be deemed to be at risk to the extent that—
 - (i) the incurral of the expenditure contemplated in subsection (2); or
 - (ii) the repayment of any loan or credit used by the taxpayer for the payment or financing of any expenditure contemplated in subsection (2),

would (having regard to any transaction, agreement, arrangement, understanding or scheme entered into before or after such expenditure is incurred) result in an economic loss to the taxpayer were no income to be received by or accrue to the taxpayer in future years from the disposal of any venture capital share issued to the taxpayer as a result of the incurral of that expenditure: Provided that the taxpayer must not be deemed to be at risk to the extent that—

- (aa) the loan or credit is not repayable within a period of five years from the date on which that loan or credit was advanced to the taxpayer; and
- (bb) any loan or credit used by the taxpayer for the payment or financing of the whole or any portion of any expenditure contemplated in subsection (2) is (having regard to any transaction, agreement, arrangement, understanding or scheme entered into before or after such expenditure is incurred) granted directly or indirectly to the taxpayer by the venture capital company by which the qualifying shares are issued as a result of the incurral of that expenditure.

(3A) If, at the end of any year of assessment, after the expiry of a period of 36 months commencing on the first date of the issue of venture capital shares a taxpayer has incurred expenditure as contemplated in subsection (2) and that taxpayer is a connected person in relation to that venture capital company—

- (a) no deduction must be allowed in terms of subsection (2) in respect of that year of assessment in respect of any expenditure incurred by the taxpayer in acquiring any venture capital share issued to that taxpayer by that venture capital company;
- (b) the Commissioner must, after due notice to the venture capital company, withdraw any approval in terms of subsection (5) with effect from the date of that approval by the Commissioner of that company as a venture capital company in terms of that subsection; and
- (c) the Commissioner must withdraw the approval of that company in terms of subsection (5) and an amount equal to 125 per cent of the expenditure incurred by any person to acquire shares issued by the company must be included in the income of the company in the year of assessment in which the approval is withdrawn by the Commissioner,

if corrective steps acceptable to the Commissioner are not taken by the company within a period stated in the notice contemplated in paragraph (b).

(4) A claim for a deduction in terms of subsection (2) must be supported by a certificate issued by the venture capital company stating the amounts invested in that company and that the Commissioner approved that company as contemplated in subsection (5).

(5) The Commissioner must approve a venture capital company if that company has applied for approval and the Commissioner is satisfied that—

- (a) the company is a resident;
- (b) the sole object of the company is the management of investments in qualifying companies;
- (c)
- (d)
- (e) the tax affairs of the company are in order and the company has complied with all the relevant provisions of the laws administered by the Commissioner;
- (f)
- (g) the company is licensed in terms of section 7 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002).

(6) If the Commissioner is satisfied that any venture capital company approved in terms of subsection (5) has during a year of assessment failed to comply with the provisions of that subsection, the Commissioner must, after due notice to the company withdraw that approval from the

commencement of that year if corrective steps acceptable to the Commissioner are not taken by the company within a period stated in that notice.

(6A) If, at the end of any year of assessment, after the expiry of a period of 36 months commencing on the first date of the issue of venture capital shares—

- (a)
- (b) less than 80 per cent of the expenditure incurred by the company to acquire assets held by the company was incurred to acquire qualifying shares issued to the company by qualifying companies, each of which, immediately after the issue, held assets with a book value not exceeding—
 - (i) R500 million, where the qualifying company was a junior mining company; or
 - (ii) R50 million, where the qualifying company was a company other than a junior mining company; or
- (c) more than 20 per cent of any amounts received in respect of the issue of shares in the company was utilised to acquire qualifying shares issued to the company by any one qualifying company,

the Commissioner must after due notice to the company withdraw that approval with effect from the date of approval by the Commissioner of that company as a venture capital company if corrective steps acceptable to the Commissioner are not taken by the company within a period stated in the notice.

(7) A company may apply for approval in terms of subsection (5) in respect of the year of assessment following the year of assessment during which approval was withdrawn in respect of that company in terms of subsection (6) or (6A) if the non-compliance which resulted in the withdrawal has been rectified to the satisfaction of the Commissioner.

(8) If the Commissioner withdraws the approval of a company in terms of subsection (6) or (6A), an amount equal to 125 per cent of the expenditure incurred by any person for the issue of shares held in the company must be included in the income of the company in the year of assessment in which the approval is withdrawn by the Commissioner.

(9) Notwithstanding section 8(4), no amount shall be recovered or recouped in respect of the disposal of a venture capital share or in respect of a return of capital if that share has been held by the taxpayer for a period longer than five years.

(10) A venture capital company must submit to the Minister a report providing the Minister with the information that the Minister may prescribe.

(11) No deduction shall be allowed under this section in respect of shares acquired after 30 June 2021.