Venture Capital Companies: a birds-eye view

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The 2008 Budget Review identified the challenges faced by small and medium-sized businesses in accessing equity finance i.e., the acquisition of finance by way of the issue of shares to investors. As the cost of share investments held on capital account is ordinarily not deductible, a tax incentive in the form of section 12J was enacted to encourage equity investment through venture capital companies ("VCCs") in small and medium-sized business as well as junior mining companies. Provided certain requirements are met, an investor may obtain a 100% deduction for the cost of shares subscribed for in a VCC.

The VCC incentive was inserted into the Income Tax Act No. 58 of 1962 ("the Act") with effect from 1 June 2019 – subject to a sunset clause of 30 June 2021. The purpose of such sunset clause is to allow a review of the effectiveness of the VCC regime to establish whether it should be continued beyond June 2021.

It was indicated in the 2021 Budget Review, however, that National Treasury had determined that this incentive did not sufficiently achieve its objectives of *"developing small businesses, generating economic activity and creating jobs".* Rather, it was indicated that the VCC regime provided a significant tax deduction to wealthy taxpayers for investments into businesses which would have attracted funding – even in the absence of the VCC regime.

More specifically, statistical information sourced by National Treasury from research performed over a one-year period in relation to 100 VCCs and 360 qualifying companies (i.e., the operating companies underlying a VCC) includes the following:

- R11.5 billion had been invested at VCC level (in respect of which a 100% tax deduction was claimed) – of which R4.2 billion were invested at qualifying company level.
- The total tax contributions from qualifying companies were R207 million for the 2020 year of assessment, half of which consisted of VAT collections.
- Qualifying companies employed 8239 people, of which 4035 individuals were in direct employment.
- After receiving VCC funding only 37% of qualifying companies added new jobs to the market.
- More than 50% of the investments appeared to relate to low-risk moveable asset rental structures, income-producing investments and guaranteed-return real estate investments (i.e., not the types of high-risk ventures initially envisaged to attract VCC investment by virtue of section 12J).
- Since the 2016 year of assessment, the total tax revenue foregone due to the VCC incentive was R1.8 billion – of which R1.7 billion was revenue foregone to individuals who has a taxable income and VCC investment above R1.5 million per year.
- Revenue foregone in the 2019 year of assessment was R745 million (before a deduction limit was introduced).

On the basis of the above, the 2021 Budget Review indicated that the limited economic impact of the incentive cannot justify what appears to be the significant tax deduction it affords to high net-worth individuals. As such, it was confirmed that the VCC incentive will not be extended beyond 30 June 2021.

Accordingly, investors have until 30 June 2021 to subscribe for shares in VCCs with the benefit of being entitled to a deduction of the cost of any shares subscribed for in the VCC – subject to a limitation, per year of assessment, of R5 million for an investor which is a company and R2.5 million for any other investor.

All provisions relating to the requirements for VCCs and qualifying companies will remain in place after 30 June 2021. Accordingly, investors who made use of this regime during its operation should ensure that the various requirements of section 12J continue to be adhered to and, simply stated, should be appreciative of the potentially significant tax deductions they were entitled to under section 12J as it is clear the provision did not otherwise reach the goals for which it was enacted.

Please do not hesitate to contact your closest PKF office in relation to the various requirements for the VCC incentive to be applicable.

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Should you have any queries on this matter, please feel free to contact your PKF relationship partner or firm.

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