Venture Capital and section 12J of the Income Tax Act No. 58 of 1962

The new trend of tech start-up companies has seen a rise in the formation of Venture Capital Companies (VCCs) in North America, with exponential expansion in Silicon Valley and New York.[i] Venture funds rely on private investors, government funds and other capital initiatives. According to the illustrious *Midas List* of 2012 the exit of Facebook bolstered top venture capital firms with Jim Breyers of Accel Partners leading the capital race.[ii] Other jaw dropping exits were the acquisition of Instagram by Facebook and the IPOs of Kayak and Yelp, to name but a few.[iii]

In the UK, where such companies are traded as Venture Capital Trusts (VCTs) – a multi million pound industry has come to life. VCTs are funds that invest in small businesses or companies listed on the smaller companies register, with tax incentives for private investors. [iv] The Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS) are also other progressive policies that have been introduced by the UK government to encourage entrepreneurs and investors alike. [v] Tech start-up companies have used these schemes to their advantage and East London Tech City has seen unprecedented growth.

While all of this is happening on the global sphere, what is happening on domestic soil? South Africa and other developing countries have seen some very innovative ideas, especially in the technology fields, but a lack of funding has handicapped the local start-up industry and the venture capital market. Over the past few years the steepest challenge for start-ups, SME's and mining ventures has been to overcome the mountain of equity finance.[vi]

The South African Revenue Service (SARS) has tried to incentivise the system with section 12J of the Income Tax Act No. 58 of 1962 ("the Act"), known as the "VCCs regime".[vii] This is an attempt to provide the same attractive policy as VCTs have done for the UK. As of 1 July 2009, South African investors – individuals and listed companies - can claim for income tax deductions of up to 40 per cent, where they have invested in VCC shares.

The three main parties within this structure are the investor, the VCC and the companies or mining ventures being invested in. The regime hopes to put in place a structure whereby investors can group their funds in a specific vehicle, being the VCC, which would then allocate those funds into small businesses and junior mining ventures.[viii] The qualifying investors will receive certificates from the approved VCCs (*see requirements later*), who in turn will invest in qualifying investee companies, to receive qualifying shares.

The deserted South African milieu

What is the current state of affairs for VCCs and why are we not seeing more start-ups in South Africa making it through the innovation stage with such incentives in place? The answers to these questions are not very positive, since it is now clear that the VCC tax regime did not meet its objective of attracting investment and small business. The *Silicon Cape Initiative Survey* released in April of 2013, indicated that 41 per cent of South African start-ups are actively looking for funding and a mere 8 per cent have received venture capital funding.

There have been so few applications to SARS for VCC status, that not a single company had been operational by the end of 2012.[ix] Sadly though, this was three years after the programme had been rolled out. For the year 2013, only three companies have now been granted VCC status under

section 12J of the Act. Olivewood Resources Limited was granted VCC status in October 2009, but it is currently not operational. Emiscore Limited was approved in February 2012 but is in the process of being sold to another company and is also not actively trading.

The third company, Grovest Venture Capital, is South Africa's first trading venture capital fund incorporated under the Act, with a focus on technological innovation and high growth start-ups.[x] The fund aspires to achieve an internal return rate of between 25 per cent and 37 per cent.[xi]

What seems to be scaring companies from applying for VCC status?

It would appear that initially the financial benefits were just too marginal, and the SARS requirements for qualifying small business and mining ventures were too heavy a burden to carry.[xii] This changed somewhat, with the amendments brought about by the Taxation Laws Amendment Act No. 24 of 2011. Section 12J of the Act was altered in such a way as to do away with over formalistic requirements and incorporate anti-avoidance provisions [xiii]

How strict are the current provisions?

Firstly, the VCC must meet certain preliminary requirements to qualify for an approved VCC status for each year of assessment, as set out in section 12J(5) of the Act. The company must *inter alia* be a South African resident and its main object must be the management of investments in developing companies. Together with any connected person the company must not control any qualifying investee company in which it holds shares and it must be licensed in terms of section 7 of the Financial Advisory and Intermediary Services Act, 2002.

In terms of section 12J(6) the Commissioner can withdraw his approval if the company has not complied with the provisions in subsection (5) and the corrective steps taken by the company are deemed to be unsatisfactory.

After the preliminary requirements have been met, the company must satisfy further conditions in subsection (6A). Within 36 months from the date of SARS approving the VCC, a minimum of 80 per cent of the cost incurred by the VCC to ascertain assets, must be for qualifying shares. Each investee company must hold assets not exceeding R300 million in any junior mining company or R20 million in any other qualifying company. Subsection (5)(c) requires that not more than 20 per cent of the company's expenses were as result of the shares bought in one qualifying company.

If these further obligations are not met, SARS will also withdraw the company's VCC status. The withdrawal of the VCC status can mean that in terms of subsection (8), the Commissioner can include in the company's income in the year of assessment, an amount equal to 125 per cent of the expenses incurred to issue shares. This is possibly one of the most drastic regulations included in the regime and it is clear how this can scare off possible VCCs.

Qualifying investee

Entities which qualify to be investees are placed under strict rules and section 12J(1) explains the various requirements for "qualifying companies". The investee must also be a domiciled locally, not be a controlled group company in relation to a group of companies and the company must be an unlisted company or a junior mining company. A junior mining company may, however, be listed on the Alternative Exchange Division (AltX) of the JSE Limited. In terms of paragraph (f) "the sum of the

investment income…derived by that company during any year of assessment (should) not exceed an amount equal to 20 per cent of the gross income of that company for that year."

Responsibilities of an approved VCC

After getting the approval of SARS, the VCC has certain obligations to maintain.[xiv] The company must keep a record of all its investors and investees and submit the reports to SARS. The VCC also has to ensure that it invests in companies that satisfy the requirements and issue certificates to qualifying investors.

Anti-avoidance provisions

Three new anti-avoidance provisions have been introduced after the initial legislation. The first being subsection (3A) that prohibits tax deductions where investors became "connected persons" as a result of the investment. The second anti-avoidance provision allows deductions only if the investments in the VCC is a pure equity investment with no elements of debt.

Thirdly, subsection (3)(b) requires that the investor must clearly be "at risk". Invested funds which are derived from a loan or credit facility must be subject to the economic risks of the project. Flowing from this provision, the VCC may in terms of subsection (3)(bb) also not be a part to the credit provided for the expenditure.

Assessment of the status quo

Erika van der Merwe, the CEO of the South African Venture Capital and Private Equity Association (SAVCA) has been quoted as to say that high level investors are needed, because the "investing public" are at harm. [xv] However, she feels that the incentives and policies are not bringing in the investment sought.[xvi]

The current legislation still seems to be too onerous and some are of the view that we should follow the system in UK where investors do not have to channel their money through VCCs, but can invest in firms of their own choice.[xvii]

Individuals and investors seem to be very cautious to put their money into this new asset class, and the numerous requirements show how laborious it can become.[xviii] It is, nonetheless, a step in the right direction and showing the South African government's efforts to bring change to the current startup landscape.

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[i] Law firms advising venture capital companies have also increased, with the likes of recently incorporated Jag Shaw Baker in the UK and more established US firms such as Wilson Sonsini Goodrich and Rosati and Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP.

[ii] Geron, T. 8 May 2013. Forbes: The Top Ten in Venture Capital today – Midas list. Available online at: http://www.forbes.com/sites/tomiogeron/2013/05/08/the-top-ten-in-venture-capital-today-midas/

[iii] Ibid

[iv] Hunter, T. 12 Feb 2013. Telegraph: VCTs provide steady income if you play it safe. Available online at: http://www.telegraph.co.uk/finance/personalfinance/investing/9862238/VCTs-provide-steady-income-if-you-play-it-safe.html

[v] Walker, S (ed). 2012. TW TechFocus: Starting a tech business – A legal guide. TaylorWessing.

[vi] External Guide - Venture Capital Companies. 1 October 2012. SARS. GEN-REG-48-G01-FAQ01.

[vii] No. 58 of 1962

[viii] PWC. August 2012. The venture capital tax regime. Issue 155. Available online at: http://www.saica.co.za/integritax/2012/2093._The_venture_capital_tax_regime.htm

[ix] Ibid

[x] Hubbard, J. 6 May 2013. Grovest: SA's new venture capital fund. Finweek

[xi] Lamprecht, I. 7 May 2013. Venture Capital: A Sensible Investment? Moneyweb. Available online at: http://m.moneyweb.co.za/moneyweb-tax/venture-capital-a-sensible-investment

[xii] See note 8

[xiii] See note 8

[xiv] See note 6

[xv] See note 11

[xvi] See note 11

[xvii] Timm, S. 30 August 2013. Bitter end of tax restrictions for micro businesses. Mail & Guardian.

[xviii] See note 15