

# **A comparative analysis of tax incentives for investors in SMEs between South Africa and selected G20 countries**

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## **ABSTRACT**

**Title:** A comparative analysis of tax incentives for investors in SMEs between South Africa and selected G20 countries

**Key terms:** Tax, Incentives, South Africa, SME, Investors, G20.

In the present economic climate in South Africa, sustained growth in terms of job creation and company expansion is essential. Small businesses in South Africa have the ability to play a big part in the nation's economic destiny, owing to the fact that they are the engines of growth, job creation, and technological innovation in the country. Financing is a significant barrier for these businesses, which is hampered by a limited supply of capital. Access to finance and investors is critical for the success of small and medium-sized enterprises (SMEs).

Giving tax breaks and other government incentives to SMEs account for a significant share of a government's contribution to the expansion of the sector. Many countries in the G20 provide a variety of tax advantages to stimulate investment in small and medium-sized enterprises as a general rule. This includes South Africa.

Small and medium-sized enterprises in South Africa are eligible for tax incentives under section 12E of the Income Tax Act and paragraph 57 of the Eighth Schedule to the Income Tax Act, respectively. In addition, SMEs were eligible for tax benefits under section 12J of the Income Tax Act, which was set to expire on 30 June 2021. This study was prompted by the issue posed by the National Treasury's decision, since SMEs now receive little assistance in the form of tax breaks.

The goal of this research was, therefore, to first conduct an in-depth review of the tax advantages available to investors in SMEs in South Africa and a number of other countries of the G20. A second step was to conduct a critical analysis in order to determine the design features of these incentives and how they relate to one another in terms of scope, eligibility requirements, and administration procedures.

According to the findings of this study, there are several shortcomings in the tax relief measures available to SMEs in South Africa, particularly when considering the history of these incentives, which eventually led to the demise of section 12J and severe criticism of the effectiveness of section 12E, among other things. Furthermore, it was stated that the administrative burden placed on the Government and SMEs had been significantly raised as a result of the many adjustments and anti-avoidance efforts adopted by the South African Government. As a result, the value

provided by this research was to aid in the knowledge of alternative relief measures for investors in SMEs that are already in use by other G20 nations, as well as how they are designed.

In this research, recommendations were given on how to perhaps improve or enhance the design of South African tax relief for investors in small and medium-sized enterprises. Therefore, a thorough evaluation of prior research on the various small company tax discounts offered by South Africa and the G20 countries was conducted in order to inform this study. It was decided to use a post-structural or doctrinal study design for this research approach.

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## LIST OF ABBREVIATIONS

CGT	Capital Gains Tax
CIT	Corporate Income Tax
Commissioner	The Commissioner of the South African Revenue Service (SARS)
DSBD	Department of Small Business Development
DTI	Department of Trade and Industry
Eighth Schedule	The Eighth Schedule to the Income Tax Act, which comprises the CGT legislation
EIS	Enterprise Investment Scheme
ESVCLP / ESVCLPs	Early-Stage Venture Capital Limited Partnership
FDI	Foreign Direct Investment
FIC	Financial Intelligent Centre
FSCA	Financial Services Conduct Authority
FSP	Financial Service Provider
GBP	Great Britain Pound
HMRC	Her Majesty's Revenue and Customs
IT Act	The South African Income Tax Act 58 of 1962
ITC	Investment Tax Credit
National Treasury	The Department of National Treasury: South Africa
OECD	Organisation for Economic Co-operation and Development
RCR	Refundable Compliance Rebate
SARS	South African Revenue Service
SAVCA	Southern Africa Venture Capital and Private Equity Association

SBCs	Small Business Corporations
SEIS	Seed Enterprise Investment Scheme
SITR	Social Investment Tax Relief
SMME / SMMEs	Small, Medium and Micro Enterprises
SME / SMEs	Small and Medium-sized Enterprises
UK	The United Kingdom
VCC / VCCs	Venture Capital Company
VCLP / VCLPs	Venture Capital Limited Partnership
VCT / VCTs	Venture Capital Trust

# 1 Introduction

Tax incentives or advantages for investment in small and medium-sized enterprises (SMEs) are not uncommon in established and transition economies. These incentives are often more geared towards investors who make direct investments in a business. To encourage these investments, developing nations have adopted a slew of incentives. Advising against using tax incentives for investment does not deter or alter policies in the developing economies as much as it does in the developed ones (Benedek *et al.*, 1998:2). Developing countries continue to use these tools in promoting development and growth.

Tax incentives form a large portion of a government's contribution to growth in the SME sector. Governments fund their initiatives either by raising taxes or by incurring debt. There is contradictory data on the effect of fiscal policies, such as tax breaks, on job production and the pace of economic growth. Although some believe that tax incentives are not effective, there is evidence that tax incentives are successful if carried out effectively (European Commission, 2017:3). This is no different in South Africa.

Generally, many jurisdictions in the G20 provide a multitude of tax breaks to help encourage investment through the introduction of tax holidays, percentage-based tax credits and limited period capital gains exemption as an incentive to investors in SMEs (Thompson Reuters, 2019). Reducing barriers to investment and mobilising revenues from both the public and private sectors are critical when it comes to G20 economies, but also the revenue growth of emerging economies. In a discussion paper prepared for the G20 Development Working Group in 2011, it was noted that the challenge is to find the right mix between different tax policies, which would include tax incentives to foster both domestic and foreign investment (IMF *et al.*, 2011:10).

In 2008 the National Treasury introduced section 12J in the Income Tax Act 58 of 1962 to help address this universal challenge small and medium-sized enterprises have in attracting equity investors. The regime was introduced with a sunset date of 30 June 2021. Section 12J allowed for the deduction of expenditure incurred by investors when they acquire shares in an approved Venture Capital Company as defined by the Income Tax Act 58 of 1962 (SARS, 2020:4). Looking back at the progress made, it is evident from the Treasury's comments that the implementation of section 12J did not address the challenge of sustainable growth of the SME sector (National Treasury, 2021:132). This fact was also confirmed by The Davis Tax Committee (2016:6) as the current legislation is oriented mainly towards the establishment and not the growth of SMEs. The committee also confirmed that the National Treasury should consider introducing a special tax incentive for angel investors in SMEs. A 'bad debt allowance' may be introduced in order to allow

for the full write-off of unsuccessful investments in SMEs. In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2019 the National Treasury (2020b) states that:

Over the past two years, Government has endeavoured to end abuse within the VCC tax incentive regime by making changes in the provisions of the VCC tax incentive regime aimed at re-emphasising an incentive for true venture capitalists that saw the same value-add and objectives in the VCC tax incentive regime as Government and not just a tax-efficient way to finance projects that would have been undertaken anyway, especially projects investors were involved in themselves. It has come to Government's attention that some taxpayers are still attempting to undermine the general objectives and principles of the VCC tax incentive regime to benefit from excessive tax deductions. These grotesquely excessive tax deductions undermine the progressive nature in the tax system and cannot be justified when the fiscus is under increasing strain (p. 32).

During its budget speech of 2021, the National Treasury (2021:132) announced that the provisions of section 12J would be discontinued with effect from 30 June 2021. A continued focus is needed to explore new avenues and solutions to attract external investors to SMEs. This has long been a source of debate, with the issue of whether tax breaks truly work to attract investors being the central point of discussion. Numerous proponents of tax incentives say that they are the most cost-effective method of solving this problem (Smith, 1998:17). Others like Calitz (2013:2) have shown that the cost of tax incentives far exceed their worth. Looking at other countries' taxation policies relating to tax incentives for investment in SMEs can shed light on the challenges, obstacles, and solutions available to address this issue.

## **1.1 Background to the research area**

Comparing SMEs across countries is problematic because it is essential to provide a consistent SME definition. Although definitions vary significantly from region to domain to country, national thresholds are usually kept low. This challenge extends to international statistical data on SMEs (OECD, 2019:36). Difficulties are inherent in SME demographics since most SMEs also have minimal resources for tracking their own statistics.

The Organisation for Economic Co-operation and Development (OECD) (2015b:18) defines small and medium-sized enterprises as 'non-subsidary, independent firms which employ fewer than a given number of employees.' The number differs from country to country. Typically, in the OECD countries, an SME would have 250 workers on the upper limit of its staff number (OECD, 2015b:18).

To put it simply, SMEs are engines of growth and are critical for the economy and society's health. Small and medium-sized enterprises account for about 60% of employment and approximately 60% of total value added within the OECD areas (OECD, 2019:3).

While it is a well-known fact that most companies in advanced economies such as the G20 countries are medium or small in scale, it is also noteworthy how few of these are successful. The competitiveness of a nation's economy is related to its SMEs' long-term sustainability (Radelescu, 2007:1).

The European Commission (2017:3) stated in its report about equity investment in SMEs that 'taxation plays a role in supporting or blocking this type of investment.' The report continues to note that stakeholders and investors also expect their investment to produce a return for the long-term. Still, they have different views on the appropriate taxation of profits from those in the earliest stages of a start-up, as they assume it would be difficult for SMEs to pay dividends. Also, the tax status of capital gains or losses earned on an investment's disposition would affect the prospective and existing propensity for risk and thought processes.

The assumption of increased risk and lower rates of return and the difficulties in attracting investors in all these markets, due to perceived lack of awareness about their participation in projects, inhibits growth in these types of investments (Radelescu, 2007:1). Many financing options such as medium-term loans and public equity raising are unavailable to small and mid-sized businesses.

Bergner *et al.* (2017:2) state that the need for providing an enticing market climate for small and medium-sized firms is undisputed, but just how to go about it is less settled on. Understandably, taxation is significant in that it sets the tone and structure for companies to function in.

The economic climate in South Africa needs sustainable growth in job creation and entrepreneurial expansion. In its report to the Government, The Davis Tax Committee (2014:4) highlighted that the Department of Small Business Development (DSBD) had identified five areas that restrain the SME sector's growth. One of these was identified as limited access to finance. For SMEs to flourish, they need access to financiers and investors. As financiers and investors will seek better returns, the taxation of those returns will be crucial to attracting their attention.

Studies have been done around the taxation of small and medium-sized companies in South Africa. However, the emphasis has almost always been on the company's income tax instead of possible incentives available to investors. Studies have also been done on section 12J but do not necessarily take possible alternatives into account. International studies on tax incentives

available to investors in other countries have shed more light on the topic, but these tax incentives' relevance to South Africa remains unknown.

Work by Calitz *et al.* (2013:2) on the impact of tax incentives to stimulate investment in South Africa looks at the effectiveness of tax incentives in South Africa with specific reference to their working, benefit and cost. Their paper aims to provide a framework and methodology for tax incentives in South Africa. The researchers set out to examine several existing South African tax incentives available to SMEs. The study concludes that according to an analysis of present tax incentives for manufacturing in South Africa, these incentives are costing the national government a significant amount of money each year.

Tax incentives for small enterprises in South Africa are discussed in a paper written by Ssenyonjo (2019:2), who finds flaws and causes for worry in the country's tax incentive programmes. Small company tax incentives offered by Australia, India, and the UK are compared with those provided by South Africa to uncover parallels and contrasts, and fresh lessons are acquired from other nations' methods.

Benedek *et al.* (1998:1) published a working paper for the International Monetary Fund called 'The Right Kind of Help? Tax Incentives for Staying Small' that 'analyses the relationship between size-related corporate income tax incentives and firm productivity and growth, controlling for other policy and firm-level factors, including product market regulation, financial constraints and innovation.' The study shows that tax incentives for large firms that do not particularly target R&D expenditure may have an impact on productivity and growth. They conclude that it is important to consider the various disincentives that size-based tax incentives may have when creating them.

Richard and Barbour (2005:1) presented a working paper that 'analyses the tax system for small businesses from the standpoint of economic growth. The study presents evidence from three African countries, South Africa, Zambia, and Rwanda, to show that these tax regimes have inhibited growth because of the high effective tax burden stemming from the choice of instruments and administration of the regime.'

The European Commission (2017:3) published a paper called 'Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups' in 2017. The study examined the role that tax incentives play in attracting investors to create growth. The study also recognises the need to broaden the tax base by developing these incentives. It further maintains that these incentives are only one type of policy weapon in a more extensive arsenal of available tools.

Ngwenya's (2014:6) mini-dissertation on section 12J as a means of procuring capital for small, medium and micro enterprises discussed the background and working as well as the shortcomings of section 12J.

By identifying and evaluating tax incentives for investment in SMEs currently used by G20 countries and comparing them to South African legislation, this study identifies weaknesses in our current tax legislation relating to incentives for investors in SMEs and identify possible solutions to address these. This study may benefit the legislators in introducing additional tax legislation and creating new tax mechanisms for SMEs to assist in the Government's growth plan.

## **1.2 Problem statement**

In South Africa, the tax incentives for investors in SMEs are very limited. The misuse of section 12J and its pending demise creates a challenge for the Government to achieve its economic growth goal. What design characteristics do tax incentives used by G20 countries have that can be used by the National Treasury when designing tax incentives for SMEs in South Africa?

## **1.3 Research objectives**

### **1.3.1 Main Objective**

This study aims to compare the current South African legislation on tax incentives for investors in SMEs to those of G20 countries. This study will shed more light on the design of tax incentives in those countries to identify possible tax incentives for introduction into the South African legislation for SME investors.

### **1.3.2 Secondary Objectives**

To achieve the primary objective, the following secondary objectives are formulated:

#### **1.3.2.1 Theoretical Objectives**

- To describe and consider the definition of SMEs and how their capital structures work (Chapter 2).
- To describe and consider the design characteristics of tax incentives for investors in SMEs (Chapter 3).
- To describe the current South African legislation relating to tax incentives for investors in SMEs (Chapter 4).



### 1.3.2.2 Empirical Objectives

- To describe and consider the design characteristics of tax incentives identified in selected G20 countries and how they are distinguished from those in South Africa (Chapter 5).

## 1.4 Research Methodology

### 1.4.1 Study context and paradigmatic assumptions

Paradigms are spheres in which researchers frame their current and future comprehension of a subject. Each paradigm has its own ontological and epistemological assumptions about the nature of reality, and each of these is taken to be right, just as much as any other paradigm. Each one of us has a collection of beliefs about the way the universe works. In every case, regardless of your view on the subject, there is a philosophy to which one subscribes (Kivunja & Kuyini, 2017:26).

The research is conducted as follows:

### 1.4.2 Ontological assumptions

Uncomfortable though it may be, human intelligence in the state of learning is limited and does not extend the power of legitimacy because of it. Crotty (2003:10) defines ontology as 'the study of being'. Its influence is carried across the entire research process and encompasses the objectives as well because the principles of the scientific method include both research production, investigation and analysis.

Before beginning any study, one must have a good conceptual grasp of the subject one wants to research. Assumptions are made on the premise that the world is viewed by people from their own perspectives and perceptions. Understanding and interpreting the same object, or subject, can differ from one person to the next. Understanding one's obligations and beliefs can be achieved by introducing the science of ontology (Hofweber, 2021:2).

Tax legislation, due to its nature, is open to interpretation. The analysis and interpretation of legal rights and obligations from tax law form the basis of this study (Stavropoulos, 2021). Therefore, this study is interpretative in nature. This paradigm is based on the assumption that the subject and researcher share a connection as the researcher gives his view of the subject (McKerchar, 2008:7).

### **1.4.3 Epistemological assumptions**

Following ontology, the epistemological and methodological positions are established. According to Kivunja and Kuyini (2017:27) epistemology attempts to concentrate on information and comprehension that can expand, broaden, and enrich understanding in your field. At this point of the study, the grounds have been extended to include arguments about things that have been believed to exist so far, which enables the argument to shift from statements about things that have been found to claims about things that are suspected. It may include acquiring knowledge about several aspects, ranging from things that are true to those that are less solid (Blaikie, 2000:15).

This study focuses on the South African tax legislation concerned with incentivising investors in SMEs. The reasons and motivation by the Government to introduce tax incentives are fundamental to this. The study also includes an analysis of similar incentives available in selected G20 countries and a comparison to the South African legislation. To enable the researcher to conclude the research, knowledge is derived from various sources, including legislation, reports and other formal and informal publications. Although the researcher concludes on his interpretation, he or she is still held captive by the theory.

### **1.4.4 Theoretical framework and assumptions**

According to Fink (2014:68) a literature review looks at published material, including formal articles and other scholarly resources. When researching a particular topic, literature reviews are meant to present an overview of other relevant sources to your readers.

This study endeavours to reach a conclusion based on examining the tax legislation and legal theories obtained from the literature. The information gained during this study is drawn from a wide variety of previously published academic works, legal and judicial documents and other previously created material sources. The literature review of legislation, OECD reports, academic and press articles, and theses and dissertations is used as secondary data for the study. As this research is based on a review of existing literature, no interviews were conducted.

### **1.4.5 Methodological assumptions**

Through deciding the paradigm of research, the methodological approach of the study is defined. The approach can be either qualitative or quantitative in nature. Quantitative research is based on hard numbers and mathematics, while qualitative research is dependent on the imagination and expertise of the researcher. To ensure that understandings, definitions and interpretations

are correctly tested in their sector of practice, the researcher must explore the best approach in doing so (Liamputtong & Ezzy, 2005:10).

It is generally assumed that qualitative methodologies are associated with interpretivism (Johari, 2009:15). According to Hutchinson and Duncan (2012:34) 'the analytical, legal reasoning aspect of the process is necessarily a qualitative one. The outcome varies according to the expertise of the individual scholar and cannot be replicated exactly by another researcher.'

Interpretivism, as a school of thought, is based on the belief that reality can only be grasped by the process of building personal understandings. The human experience can only be translated through interpreting what is provided to us by the external world. As this study analyses and compares South African tax legislation to those of other comparable countries, this study makes use of a qualitative approach.

Expressed within the philosophy of science, the methodology has much to do with the kind of thoughts that the researcher brings to bear when looking at a situation or making sense of a phenomenon. According to Crotty (2003:3) the term methodology refers to 'the strategy, plan of action, process or design lying behind the choice and use of particular methods and linking the choice and use of the methods to the desired outcomes.'

As an introduction, this study gives an overview of the Government's challenges in developing SMEs with reference to the 2030 development plan. It analyses the problem with specific regard to the availability of SME funding and the necessity thereof. It further considers how the South African Government uses tax incentives to stimulate growth in SMEs. The relevant tax legislation relating to these tax incentives is analysed and discussed together with the legislation's implementation and subsequent changes. This endeavours to shed light on the challenges identified by the Government of the current legislation and the reason for these changes. This study also identifies, analyses and discusses the various tax incentives available to investors in selected G20 countries. The influence of these tax incentives and their importance in creating growth for SMEs is also analysed.

This study explores tax incentives in G20 countries due to their contribution of more than 85% of the world's GDP (OECD, 2021). The G20 countries include Argentina, Australia, Brazil, Canada, China, France, Germany, Japan, India, Indonesia, Italy, Mexico, Russia, South Africa, Saudi Arabia, South Korea, Turkey, the United Kingdom and the United States. Specifically incentives in the United Kingdom, Germany and France are looked at more closely as tax incentives in these countries have been rated highly in the study done by the European Commission (2017:3) and the OECD (2015b).

A qualitative approach is used as the objective to identify the types of tax incentives used by these countries. These countries are analysed to create a list of best practices, which are extracted from their observations. South Africa is selected as a developing country that is part of the G20. Also, the goal of the research is to recommend tax incentives for investors in SMEs that are proving valuable to G20 countries, and which may be introduced by the National Treasury in the South African legislation.

A comparison is made to ascertain the tax incentive strategies used by these countries and whether the same strategies can be applied in South Africa. This information was sourced from the annual reports, scholarly and other publications on related documents generated by the tax authorities, as well as peer-reviewed literature.

#### **1.4.6 Study design**

The current literature was thoroughly explored in accordance with the study objectives. This study uses a critical literature review as its research strategy. The research approach used for this study is the most appropriate since the objective is to get a thorough knowledge of the tax relief options available to investors in SMEs in South Africa and other G20 nations.

Various internet databases were searched for terms that would be relevant to the study's goals. The databases include EBSCOHost, Emerald, Google Scholar, Sa ePublications and Google. The various government websites of countries, including those of the tax legislators, were searched for relevant data. The tax legislation of other countries was also incorporated to assist in comparing that of South Africa. The following search terms were used: tax incentives, investors, small and medium-sized enterprises, South Africa and G20.

Suitable tax legislation relevant to South Africa was identified by an analysis of empirical data obtained from G20 countries. The effectiveness and benefits of these incentives were assessed with reference to studies done by the International Monetary Fund (2009:3) and the United Nations (2018:4).

#### **1.5 Ethical considerations**

With regards to the ethical considerations, it is of importance to note that this study adheres to minimal ethical standards in academic research.

### **1.5.1 Permission and informed consent**

No specific ethical approval was required for the sources utilised in this research since all of them are publicly accessible. Copyright infringement and plagiarism were taken into consideration over the course of this research.

### **1.5.2 Anonymity**

No specific interviews or responses were obtained from individuals.

### **1.5.3 Confidentiality**

Confidential data obtained was treated as such and was not shared in a singular manner but rather through an aggregate or by means of a summarised assimilation into this study.

## **1.6 Chapter Overview**

### **Chapter 1: Introduction, background, problem statement, objectives and research design and methodology**

This chapter discusses the background of the current tax legislation and the factual circumstances around the future of tax incentives for investors. The relevance of this study is defined, and the problem statement is described. An outline of the research objectives and research method to address the problem statement is included.

### **Chapter 2: SMEs and their capital structures**

This chapter focuses on the definition of SMEs as well as the capital financing structures available to them. The challenges related to the structuring and obtaining of finance for SMEs are also discussed.

### **Chapter 3: Tax incentives for investors and their design**

In this chapter, the design of tax incentives is discussed. The criteria used for design is evaluated and how they apply to the design of tax incentives for investors.

### **Chapter 4: Tax incentives available to investors in South African SMEs**

In this chapter, the current tax legislation relating to the various tax incentives available for SME investors in South Africa is analysed. Direct and indirect incentive tax initiatives are discussed with reference to the relevant legislation.

## **Chapter 5: The characteristics of tax incentives identified in selected G20 countries and how they compare to those in South Africa**

This chapter focuses on the various tax incentives available to investors in SMEs in selected G20 countries. The different types of instruments used for investment with their accompanying legislative tax frameworks are analysed. This chapter also compares the tax incentives from the G20 countries to those in South Africa with reference to studies done by the European Commission (2017), Thompson Reuters (2019) and the United Nations (2018).

## **Chapter 6: Summary and conclusion**

This chapter serves as the conclusion of the study. It contains an executive and overall summary of the various chapters.

## **2 SMEs and their capital structures**

### **2.1 Introduction**

SME problems and their financial structures are examined in order to better understand the particular difficulties faced by SMEs. It is the aim of this chapter to define SMEs as well as discussing the limitations of defining them.

For the examination and comparison of tax incentives to follow in Chapters 3, 4 and 5, this chapter will serve as a starting point. It will be examined how equity financing ideas might be used in the design of tax incentives for SMEs in South Africa and other G20 nations.

The capital financing structures available to SMEs, together with their risk profile, are explored. Finally, the general tax treatment of debt, equity and hybrid instruments are discussed.

### **2.2 Defining an SME**

Small and medium-sized enterprises have been frequently mentioned in the formulation of economic policy over the last 25 years (OECD, 2004:43). This has led some to believe the group of companies that exists between micro-enterprises and large corporations have unique opportunities and problems that are not shared by the other two groups.

The Small Enterprise Development Agency's (2020:2) most recent quarterly report puts the number of South African SMMEs at 2.61 million. The research includes an assessment of the SMME sector's situation prior to the COVID-19 pandemic outbreak. The SMME sector developments reflected the negative impact on the nation's economy and retained their pessimistic nature. Participation has seen an increase in recent years, but the sector is under severe stress and showing no signs of recovery. Small and medium-sized enterprises contributed 37.3% of the turnover of all enterprises in South Africa.

The number of full-time workers employed in the SME sector decreased from 10.8 million in 2018 (66% of the total workforce) to 10.4 million in 2020 (63% of the total workforce). According to the Department of Statistics (2021:1), in the first quarter of 2021, the unemployment rate in South Africa was 32.6%. The report also states that the SME employment crisis and the changes that happened in the sector were indications of a yet-worse catastrophe that would likely have happened had the pandemic not hit.

There was, however, a rebound in the third quarter of 2020, which gave much relief after the stagnation of the economy in the second quarter. To address market failure, policies should be aimed at the SMME sector while also encouraging the development of a market-friendly

environment. This is a route that we should be on since these measures are in accordance with re-industrialization efforts, infrastructure projects, and combined private-public partnerships in the areas of energy, logistics, and communication that we should be pursuing (Small Enterprise Development Agency, 2020:31).

Previously, it was claimed that there is no standard definition for SMEs in South Africa (OECD, 2019:36). Therefore, it follows that the uncertainty surrounding the phrase 'small and medium-sized businesses' makes it difficult to conduct a thorough examination of tax-related and other problems such as management and financing.

The statement 'Small and medium-sized enterprises are the backbone of the economy' has become a virtual cliché when speaking of them in the context of a country's economic development (Uribe *et al.*, 2018). However, this claim is made nearly every time without any evidence to support it and without any consideration of what a small and medium-sized enterprise (SME) is.

According to Gibson and van der Vaart (2008:4) the redundant phrase 'there seems to be no generally accepted definition of SMEs' used in conjunction with the 'backbone' statement above has been used in various presentations, papers and articles over the years. The acceptance of these two points is correct, but it has hurt the cause of private sector growth in developing nations rather than helped it. Small and medium-sized enterprises have become difficult to define as a segment of the private sector and as a problem in economic development plans because of the ambiguity with which government and private sector organisations have structured the concept of SMEs. To distinguish SMEs from their bigger competitors, a variety of qualitative and quantitative measures may be used (Crawford & Freeman, 2010:1035).

A first step in creating tax incentives for small companies as well as in discussing their appropriateness is to define SMEs. In line with the view held by Makgalemele (2017:6) the terms SME and small business have many definitions. While small companies are believed to be businesses with owners and no or very few employees, some smaller public corporations may also be included in this classification. Depending on how it is defined and what it is being used for, the meaning of 'small' and 'medium-sized' changes from circumstance to scenario.

To provide tax and regulatory clarity for taxpayers and tax administrations, the design of SME tax incentives should be defined using specific, clear-cut criteria for companies with a specific focus. Several qualitative and quantitative approaches may be used to tell SMEs apart from their larger rivals. Company size measures, which differ by industry and country, offer the risk of increasing subjectivity in classifying companies by size (Crawford & Freeman, 2010:1035).



The European Commission (2015:1) has established a definition of a small and medium-sized business (SME) that is the most prominent and often used. It is possible to divide the population into four distinct size groups, which are differentiated by three numerical factors. Enterprises are classified as micro, small, medium-sized, or large based on the number of employees, annual revenue, and the size of their balance sheets. To be classified as a small or medium-sized enterprise (SME) under the European Commission's definition, companies must meet the employment criteria, as well as either the turnover threshold or the maximum balance sheet total, to be assigned to the proper size category.

In 2019 South Africa's then Small Company Development Minister, Lindiwe Zulu, released a new Government Gazette that updated micro, small and medium-sized business classifications (Department of Small Business Development, 2019). The publication states that the recent change in the threshold was made to accommodate inflation, as the last time it was amended was in 2003. The updated table includes two new proxies to define small companies: 'total full-time equivalent of paid workers' and 'total annual turnover' have replaced the third proxy of 'total gross asset value'.

In the Eighth Schedule to the Income Tax Act, small and medium enterprises are defined by 'total full-time equivalent of paid workers' as those ranging between 11 – 250. Revenue requirements vary significantly from turnover smaller than R220 million for the wholesale sector to the agricultural sector at turnovers of less than R17 million. Globally and in the local market, both these criteria seem to be the most preferred measure.

The lack of clarity in the SME definition is mainly because the size of a business differs depending on the size of the economy. The OECD (2019:4) defines SMEs as businesses with no more than 249 workers, which may be categorised as follows: micro 1 to 9, small 10 to 49, and medium-sized 50 to 249. This is similar to South Africa.

The International Finance Corporation (2012:1) defines small and medium enterprises as those with employees ranging from 10 to 300 and turnover ranging from \$100,000 to \$15 million. Again, this is very comparable to the criteria used in South Africa.

In its report to the Government, the Davis Tax Committee (2014:9) described entrepreneurial businesses with growth potential as the 'missing middle'. The committee estimated the number of these companies to be around 165,000, with tax collections at that stage of R1,3 billion per annum.

## 2.3 Capital Structures of SMEs

When it comes to the corporate world, the ability to structure transactions is critical. Profit and loss objectives, as well as balance sheet objectives, are achieved via well-planned transactions. All of this contributes to more profitable companies, more earnings, and a stronger balance sheet, according to Dreyer (2010:12). When putting up these kinds of leveraged financing agreements, parties must always keep several factors in mind. The types of investors who are involved have an impact on the variables mentioned above. In the context of leverage finance, traditional operational investors and financial investors have been separated from one another. In contrast to financial investors, operational investors are more concerned with generating value via the creation of new financial products, while financial investors are more concerned with creating value through the improvement of real company operations.

Seeing these investors as opposing extremes on a continuum, with all investors falling somewhere in the middle, can help one grasp the distinctions between them more clearly. To describe a business' capital structure, consider the mix of debt and equity that the company uses to finance its operations. According to Addae *et al.* (2013:215) it is one of the most challenging decisions a business will have to make when determining its capital structure. When businesses make bad capital structure decisions, they may pay excessive capital expenses and experience decreased profitability.

For the Pecking Order Theory, there is no optimum capital structure for a company, according to Myers (1984:576). Management wants to use internal money instead of external funding when making financial decisions. When a company is obliged to rely on outside funding, managers prioritise the sources that are the least hazardous and time-consuming to get money from. Debt is favoured over the creation of new shares of capital when obtaining funds from outside sources is required.

External finance usage by SMEs is heavily influenced by many variables, and the decisions they make while securing funding are affected by those aspects as well (Berger & Udell, 2008:159). Also, firm-specific elements, sector-specific determinants, and country-specific factors, such as macroeconomic conditions, the financial development level, or the regulatory framework of the country in which the firm operates, can contribute to SME growth.

To concentrate on financial requirements such as asset needs, an entrepreneurial organisation must first define the key elements of the market opportunity and its plan for realising it (Winton & Yerramilli, 2008:52). Small and medium-sized enterprises need finance throughout their life cycle, from the beginning when they are seed-funded, through their development stage, and up to their

later stages. These organisations have difficulty in obtaining the financing they need, which limits their capacity to expand out of the SME category and therefore prevents their economic development (Peterhoff *et al.*, 2014:2).

Research has shown that even while SMEs are key to economic growth in Africa, they are in need of financing, which has previously limited their growth. The London Stock Exchange Group (2018:1) states that 40% of African SMEs rank getting finance as the most significant restriction on their growth. A current deficit of approximately \$140 billion is thought to exist. Even if they have good ideas, businesses with no funding have to close up shop in only a few months, leaving them unable to reach their full potential.

The research by the OECD (2015a:9) showed that SMEs in Africa's capital markets do not understand or have access to the variety of financing options available to them. Small-scale lending, angel investing, venture capital, private equity, and other stock market listing methods are only a few of the many choices. This lack of knowledge means local stock markets are underdeveloped, which means domestic participation is very limited for these companies. The state of underdevelopment of domestic capital markets is due to the low liquidity and shallow depth of the domestic capital markets.

The domestic capital markets of African nations do not adequately serve SMEs, which make up the bulk of businesses in those countries (OECDa, 2015:43). The primary purpose of capital markets is to finance company growth, development, and innovation, leading to the creation of new jobs. Instead of being limited to the enormous, established corporations, the money must flow from investors to businesses, including the large blue chips, small and medium-sized firms, and even individual entrepreneurs. Despite the South African Government's efforts to help entrepreneurs, their efforts have been thwarted by excessive lending rates and entrepreneur inexperience. Business development has therefore slowed since entrepreneurs have little access to finance or other resources.

Schwienbacher and Larralde (2010:9) point out that the types of finance obtainable to SMEs can be classified mainly into two categories, direct or indirect. Direct financing is done through investment in the SME by way of equity and would include investors such as the business owner, friends and family, angel investors, venture capitalists and other strategic partners. Indirect financing would be in the form of lending or debt, which would include borrowings from banks, micro-lending companies, government agencies and other types of finance houses.

When determining whether a company's capital structure is appropriate, one of the most important factors to examine is the cost of capital. It may be necessary for the business to extend its capital

structure by issuing more stock if it is having difficulties selling its debt on the open market. The type of funding best appropriate for a company at a certain stage in its existence depends on the nature of the firm's business needs. The impact of a lack of bank debt financing on SMMEs is greater than it is on bigger companies, which may be able to access debt and equity capital via public offerings. Because of the restricted variety of financing alternatives available to them, smaller and medium-sized businesses are more susceptible to credit market fluctuations. Even if there are more options for excellent bank funding in countries with more dynamic, fast-growing businesses, financial alternatives are generally more limited and do not fulfil the requirements of these economies (SME Finance Forum, 2014:5).

There are a variety of reasons why this is important. Most of the SMEs in South Africa are initially financed by the owners themselves and will only convert or incorporate debt into their capital structures when the business has developed a track record that would give an acceptable risk profile to financing institutions. From thereon, debt may be preferred above equity for various reasons.

According to Cheris (1970:851) in the first place, tax savings are possible since interest is considered an expenditure of the company, while dividends are not. Secondly, loans and mortgages may also be customised to meet the specific needs and appetites for risk of both lenders and borrowers. Thirdly, both partners' cashflows may be planned and realistically predicted, allowing for more efficient planning. Furthermore, debt does not diminish an owner's ownership stake in the firm, and the impact of gearing may significantly increase the return on investment for a business owner if it is handled correctly.

An additional measure to consider when an entrepreneur is in search of finance is how much risk they are willing to take. Shareholders will endure the biggest risk in investing as they stand to lose their whole investment if unsecured. Equity finance diffuses risk if spread among many stakeholders. The financial structures of companies are therefore influenced by the initial riskiness of the ideas and the level of risk-taking on the part of the entrepreneur.

Debt and equity have quite different business qualities from one another. The difference between debt and equity is that debt takes precedence over equity as a creditor claim in a company and often produces a return in the form of interest payments. Equity is subservient to debt and is entitled to a share of the company's residual profits and value at the conclusion of the fiscal year in which it is invested (Ross *et al.*, 2001:10).

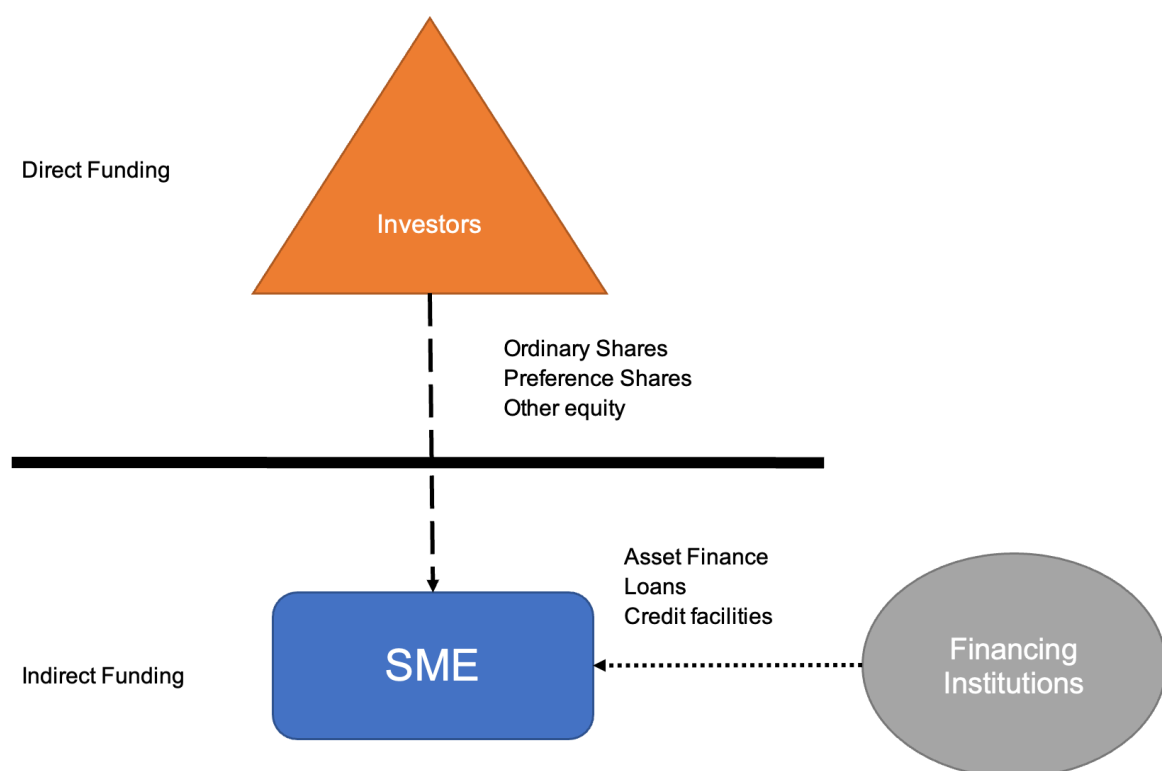
With respect to equity, debt is usually a lower-risk investment vehicle, and it offers a more predictable but lower-yielding return in the form of periodic interest payments. A higher-risk

vehicle (as opposed to debt) with more variable returns and the potential for larger rewards in the form of capital appreciation and/or increasing dividends is usually considered to be equity. According to Modigliani and Miller (1963:443) earnings that are not distributed as dividends should contribute to the increase in the value of the company's equity position since equity benefits from the residual value of the firm.

Compared to debt holders, equity investors carry a larger proportion of the risk connected with the corporation. For as long as it has an impact on investors' views about the likelihood of future profitability for a company, the value of a stock is often much more price-sensitive to business risk factors and economic data than is the value of debt. This makes the value of debt less sensitive to these factors since a reduction in future profitability will almost always have no impact on the company's ability to service its debt or repay the primary loan at maturity in this situation.

The different funding methods can be seen in the following diagram.

**Figure 1 : Funding method**

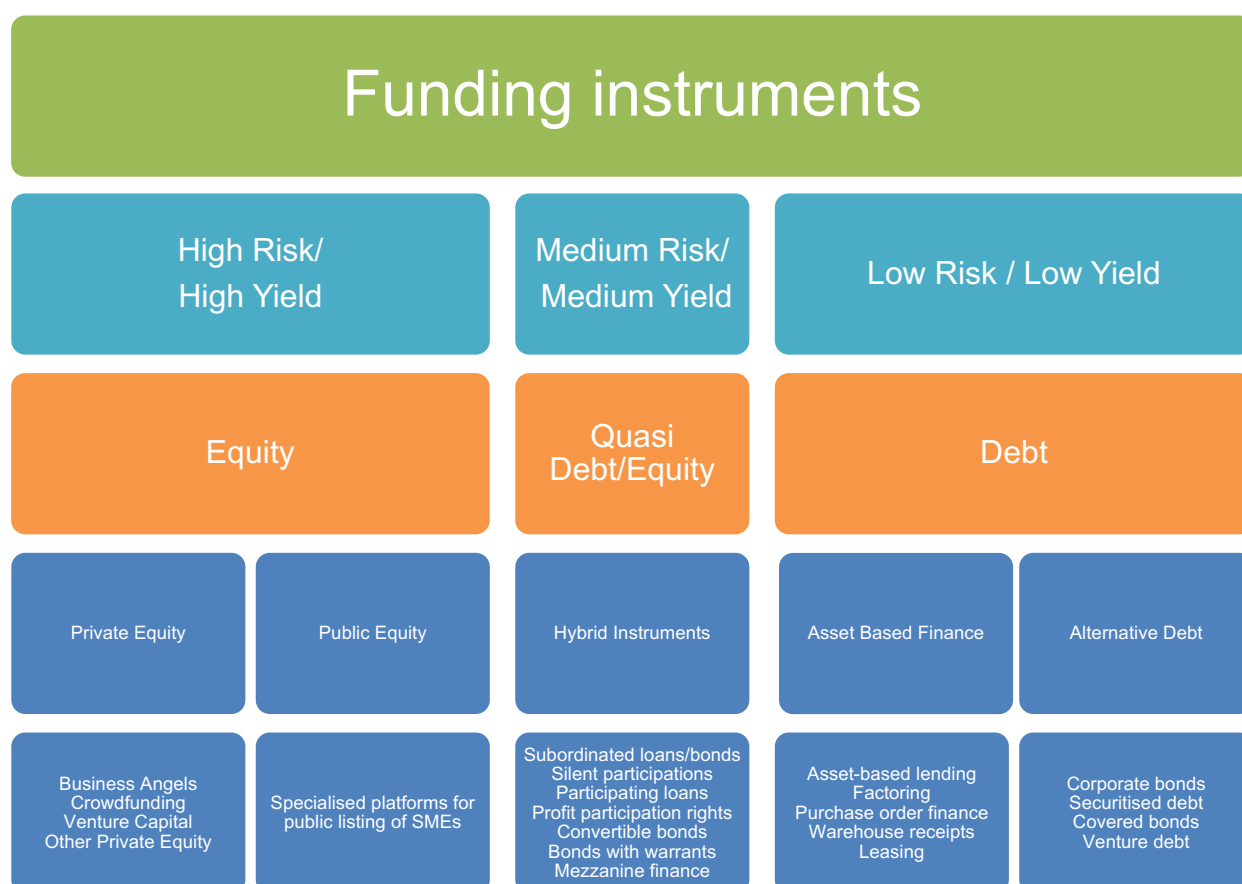


In the last decade, the features of financial instruments have changed in tandem with changes in the financial structure of companies. Following the financial crisis of 2008, there has been significant growth in the usage of mezzanine financing, which is comprised of junk bonds, preferred stock variations, yield enhancements, warrants, and other instruments (International Monetary Fund, 2014a:605).

More importantly, in addition to the new options for previously known financial instruments, the potential risk and returns of all securities have changed, particularly as derivative securities and other swap agreements have become more widely used as financial instruments, as previously mentioned. The conventional distinction between debt and equity has been thrown into disarray as a result of these developments.

The availability of new methods for SMEs to raise money has grown over the past decade, while some of them are still in the early stages of development or are only available to a limited number of SMEs. Alternative financing tools, on the other hand, alter the traditional risk-sharing mechanism by providing high returns to lenders while also being appropriate for companies with low to moderate risk profiles, such as those with stable cash flow, modest growth, proven business models, and access to collateral or guarantees, among other characteristics. The following table sets out various instruments and risk profiles as proposed by the OECD (2015a:17).

**Table 1 : Funding Instruments**



According to the OECD (2015a:16) the financing options available to SMEs are diverse and include asset-based financing, alternative loan forms, hybrid instruments, and equity instruments, among others. Nevertheless, not all of these options will be suitable or acceptable for all

businesses since the risk-return profile, the stage of the company's life cycle, the company's size, scale, management structure, and financial acumen are just a few of the factors to take into consideration.

Risky financing instruments may have a greater opportunity to succeed when they are supported by collateral or guarantees supplied by the company, as well as when credit data is lacking and thus less complete, clear, and uniform (Stulz & Johnson, 1985:501). When the creditworthiness of the firm is taken into account when financing is acquired through asset-based lending, it is the liquidation value of the underlying asset that is given the most weight. More entrepreneurs also tend to use and recognise these instruments, according to surveys, as compared to more risky financial products.

It is important to note that the tax implications of returns on debt and equity are different, and this is reflected in their respective tax repercussions. The IT Act provides that interest (which represents the return on debt) may be deducted as a deduction, while dividends (which reflect the return on equity) are ineligible for the same comparable deduction under the same provisions. The income produced by a shareholder in connection with an equity transaction is exempt from normal taxation under section 10(1)(k) for the same reasons that interest paid on debt is excluded from taxable income. When both debt and equity are seen merely to be alternative methods of financing, it becomes difficult to explain why their returns should be taxed differently.

According to Olivier and Honiball (2011:66) the corporate and shareholder taxes in South Africa are not combined but instead utilise a hybrid dual rate structure. In addition, the corporation is required to pay income tax on the amounts it receives, and a second level of taxes, called dividend withholding tax, is imposed on the beneficial owner when the company distributes earnings to shareholders.

Since debt and equity returns are treated differently under the tax code, taxpayers are able to arrange their capital requirements as either debt or equity and choose the tax treatment that best meets their needs. According to Tredoux and van Zyl (2018:2) it is a common principle that everyone has the right to arrange their financial affairs in such a way that their tax obligation is kept to a bare minimum. The interests of all participants in a structured transaction are inextricably linked to their desire to maximise their position in relation to the other parties involved. If someone wants to reduce their tax burden, they have the option to do so legally. The imposition of taxes is not dictated by natural law but rather by legislative decree. In order to do this, the legislature has passed legislation to prohibit tax evasion on the part of the general public.

These kinds of scenarios are particularly common with hybrid securities that combine the features of debt and equity to a considerable degree. The fact that taxpayers have the ability to construct financial instruments that have the legal form of debt but have the commercial features of equity, and vice versa, maybe a source of difficulty (International Monetary Fund 2014b:606). Unlike other tax instruments, the legal status and label of debt and equity returns are not solely determined by the law. Rather, special provisions of the Income Tax Act exist to fight alleged tax avoidance and to tax instruments based on their content rather than the law. The various funding structures and their respective general tax treatment will be discussed.

## **2.4 Direct funding (Equity Investment)**

It is common for SMEs to get their first funding from inside their own organisation (Kozarevic *et al.*, 2015:112). External investors will be able to learn more about the business's track record and creditworthiness as the company gets older. Companies that have a strong reputation are more likely to be able to obtain short-term financing sources like trade credit and bank overdrafts, which may help offset the effects of asymmetric knowledge. The creditworthiness of a new company seeking outside financing will be improved by internal equity.

For small, riskier companies that are young and creative, equity funding is an advantage in some respects. According to Pedchenko *et al.* (2018:174) seed and early-stage funding may provide a lifeline to enterprises as they begin and grow, while other equity instruments, such as specialist platforms for small and medium-sized enterprise (SME) public listings, can assist enterprises seeking to expand their operations to get the capital they need. SME financing may be greatly impacted by business angel investment, but it is hard to measure their influence due to data constraints.

According to Wieczorek-Kosmala *et al.* (2020:1544) when equity financing is utilised, investors get partial ownership of the business in exchange for capital. An equity instrument can be defined as any financing instrument that provides the owner with a residual claim on the company and does not generate a tax benefit from its payments; has an unlimited duration and is not prioritised during bankruptcy and allows the owner to exercise managerial control over the company. Business owners have several people to turn to for start-up cash: wealthy angels, relatives, and venture capitalists.

According to Barkoczy and Wilkinson (2019:3) venture capital might be divided into two distinct types: informal and formal. 'Angel investors', who are often well-off individuals with extensive business and entrepreneurial experience, offer informal venture capital in the form of angel loans or equity stakes. Formal venture capital originates from 'venture capitalists', who are professional



fund managers who have collected money from a pool of investors by creating venture capital funds on their behalf. There is no obligation to repay borrowed money with equity financing. Because of this, the investors expect an increase in the value of their stake due to the future profits of the company. A fledgling business may get credibility from high-profile investors who pour their money into it.

According to Mason and Stark (2004:227) the disadvantage of equity financing is that investors are part-owners of the business, which means they have a say in corporate decisions. Investors in equity desire to collaborate with a business and make a financial contribution. When ownership stakes are decreased, business owners may experience a loss of autonomy or power, which may be problematic. A business's reliance on debt financing may be an indication that the firm is not making the most use of its available financial resources.

Many options exist for SMEs to acquire outside financing, yet access to outside equity remains a significant obstacle for such companies. As stated by Harding and Cowling (2006:115) a scenario where businesses lack equity investments in the early stages of their existence is referred to as an equity gap.

External equity, to put it simply, is money raised from sources other than the company itself. Examples of these sources include business angels, venture capitalists, and investors on the stock market. Investors in high-risk, high-return start-ups are known as venture capitalists. Companies that invest in venture capital are closely monitored by formal corporate organisations known as venture capitalists, who have a defined exit plan in place for when they want to withdraw their funds.

Even though business angels are a diverse group of high-net-worth individuals who invest a portion of their assets in entrepreneurial ventures with a high risk/high return, according to Mason and Harrison (2015:3), business angels differ from traditional angels in their target audience and investment focus. Individuals with a lot of money are usually willing to invest it in start-ups in exchange for a share of the business. Companies benefit greatly from the skills and experience that equity partners bring to the table.

The problem is that SMEs seldom have access to external equity funding in the form of venture capital or business angels to help them grow their companies. Unless a business satisfies all the minimum listing requirements, which are more rigorous than those for the main market, it will be denied admission to the stock market. Many new SMEs, according to Blumberg and Letterie (2008:1), are forced to rely on loan financing due to a lack of external equity capital.

Information asymmetry is also one of the most frequent issues, in which the flow of information between parties in a transaction is unequally distributed (Myers & Majluf, 1984:189). The use of crowdsourcing may exacerbate this problem. Given the limited amount of information available to them, investors are increasingly dependent on the counsel of other people to make investment decisions for them. Because these types of investors represent a large portion of the investing community and are also inexperienced, entrepreneurs are even more hesitant to share information with them. Therefore, because the entrepreneur is obligated to reveal important information to a broader audience, intellectual property theft may pose an even greater danger in this scenario. In addition, investors who make investments in borrowers have differing expectations about the amount of information that the borrowers will give to them. A greater level of information is usually demanded by stock buyers compared to lenders since they are taking on a larger level of risk than lenders. The research of Ueda (2004:601) has shown that entrepreneurs who seek venture capital are more likely to utilise intellectual property rights to protect their ideas, which is a clear indication that the entrepreneur's legal environment affects his or her decision to seek funding.

Taxation has the ability to influence the behaviour of investors in a number of different ways. It is likely that taxation, as well as the kind of investor or investment, will have an effect on the result. Individuals, for example, will be liable for personal income tax, as well as wealth and/or inheritance taxes on their investment profits. In the case of venture capital companies, corporate income taxes and capital gains taxes will certainly be important concerns.

The reason for this is because the entrepreneur must share information with a larger audience than is required by conventional fundraising methods, which is especially important in this case. As financiers are normally not aware of the performance of a business on a day-to-day basis, the risk of 'not knowing' is incorporated into the return (interest rate) related to the financial instrument. The conventional bank lending system is hindered by the fact that small and medium enterprises face many unique obstacles. These problems are more serious for lenders when it comes to SMEs and is most often linked to the issues that come with judging and tracking them (Cusmano & Thompson, 2018:24).

A shareholder is defined under section 1 of the Companies Act 71 of 2008, as a person who owns shares in a business and has been registered as such in the company register. Section 1 of the Income Tax Act states that the word 'share' refers to any unit into which a company's proprietary interest is divided. The taxable income of a corporation is computed for its fiscal year in the same manner that the taxable income of any other person is determined. The need to pay corporate income tax starts with the receipt or accumulation of the first rand of taxable income; as a result,

corporate income tax is levied at a set rate. Normal tax is paid at a rate of 28% on a business's taxable income computed for the fiscal year in which the company is in operation.

In South Africa, distributions of issued shares by domestic corporations are either considered as dividends or as capital returns. There is a tax on dividends paid by both resident and non-resident companies. The dividend tax is paid by the shareholder or, more precisely, by the 'beneficial owner', as specified in section 64D(1) of the IT Act, which is defined as 'the person who is entitled to the benefit of a share's dividend.' The tax is calculated at a rate of 20% or at any other rate specified by the Minister in the annual national budget, whichever is greater.

It is the 'beneficial owner', defined as the person who is entitled to the dividend connected to a share, which is subject to dividends tax. So even though the shareholder is personally liable for tax, the business entity is obliged to withhold the tax on his or her behalf. Although the form of the dividend must be taken into account, if it is in cash, the beneficial owner is responsible; if it is in specie, the business that declares and pays the dividend is liable, but only to the extent that the company is a resident company.

In contrast to other withholding taxes, the dividends tax is applied to both resident and non-resident shareholders, with the exception of intra-group dividends, which are often exempt from taxation. Multiple Double Taxation Agreements exist between South Africa and other countries, which provide for a lower tax rate to be applied where the dividend's 'beneficial owner' is a corporate resident of the other Contracting State and a specific level of ownership has been achieved in the other Contracting State. Certain dividends are exempt from taxation. The exception that is most often seen is when the beneficial owner is a resident company.

For the receiver of the dividend, the term 'gross income', as defined in section 1 of the IT Act, includes any sum received or accrued in the form of dividends. The term 'dividend', as defined in section 1, includes any sum received or accumulated in the form of dividends. The dividend received, whether in cash or in kind, is included in a shareholder's total income under paragraph (k), which has a wide interpretation. As previously stated above, dividends are included in gross income, with the exception of certain dividends that are exempt from income under section 10(1)(k)(i) of the IT Act.

For the investor, any gains or losses on shares held as a capital asset (as opposed to short-term trading) will be recorded as capital gains or losses for the owner. Capital gains on the disposal of shares are taxed at a lower rate than income gains. If you sell shares held as trading stock, any gains or losses you realise will be considered as revenue for income tax purposes. An

investor may be subject to a tax on capital gains at the time of disposal, depending on his or her tax bracket.

For business entities and trusts, the capital gains tax rate is higher than for individuals. They need to include 80% of their net capital gains in taxable income compared to the 40% for natural persons. They also do not qualify for the annual exclusion on capital gains granted to natural persons. An effective capital gains tax rate for a company is 22.4%, calculated by multiplying 80% by the tax rate of 28%. For all non-special trusts, the effective capital gains tax rate is 36%.

The effective tax rate for an investor in a company can be represented by the following table.

**Table 2 : Effective tax rate for an investor in a company**

Company	The effective tax rate for the Investor
Taxable Income	1,000
Tax	(280)
<b>Net Profit After Tax</b>	<b>780</b>
Dividend Tax	(156)
<b>Net Amount Received</b>	<b>624</b>
Total Tax Paid	(436)
<b>Effective Tax Rate</b>	<b>43.60%</b>

To help small businesses, the South African Government has prioritised the implementation of legislation like section 12E of the country's IT Act. Entities are eligible for the relief if they satisfy all of section 12E's criteria. There has been an overarching aim of reducing taxes on small businesses by granting them lower tax rates, as opposed to the generally uniform 28% corporate tax rate. A more detailed view of these relief measures is given in Chapter 4.

## **2.5 Indirect funding (Debt)**

Investment options under South Africa's Corporate Income Tax (CIT) are distorted by a number of rules. In addition, South African businesses are very partial to taking on debt. According to Salman and Munir (2012:293) the preference for debt financing over equity financing is not an issue in South Africa alone; rather, most tax regimes favour debt financing over equity financing since interest payments are tax-deductible.

It was proposed by Modigliani and Miller (1963:438) that the tax benefits of debt increase the value of a business while simultaneously reducing the cost of borrowing money. The tax treatment of debt financing also offers a tax shield since interest on debt is regarded as an expense that may be deducted from taxable income, which has the effect of lowering the firm's

taxable income. It is thought that using this method to deal with loan capital will increase the value of the business while also incentivising investors to maximise the use of debt and equity in the capital structures of companies that are involved in acquisitions.

Conventional loan financing provides lenders with modest returns and is thus suitable for borrowers with low-to-moderate risk profiles according to Billett *et al.* (1995:702). Most SMEs rely on this kind of funding for their regular operations and short-term requirements since it is characterised by steady cash flow, moderate growth, tried-and-true business practices, and has the ability to secure collateral or guarantee money. Small companies typically depend on bank loans yet banking institutions do not provide much support to these enterprises. Loans are often difficult for SMEs to obtain, especially start-ups and creative companies, who face a higher risk-reward profile.

Corporations that are already profitable may procure more capital by taking on debt that is tax-deductible (Hovakimian *et al.*, 2001:1). A small-to-medium company that needs money to finance expansion will not have the same luxury. If they fail, a company that obtains a bank loan will be left with nothing. Therefore, it will place the repayment of the debt above everything else. Despite the emergence of other financial sources, banks will continue to play a key role in SMME financing.

While conventional external funding sources like bank loans, overdrafts, credit lines and credit cards are an option for small and medium-sized enterprises and entrepreneurs, they are not the only ones available (Mutezo, 2015:164). Direct debit instruments are unique in that they provide an absolute right to repayment to the lender in the form of interest, independent of the company's financial position or investment performance. The interest rate may be adjusted based on a reference rate, and it may be established or modified at regular intervals. In the case of bankruptcy, banks' claims are prioritised above any extra features of the default obligation. In traditional credit financing, the amount of time given to a company to pay back a loan is based on the lender's estimates about the firm's credit and the firm's expected future cash flow. The purpose of all these various techniques used to assess and monitor the firm's creditworthiness is to correct the information asymmetry problem.

There are several disadvantages to using debt financing. When a company's cash flow is irregular, it may be difficult for new businesses to make regular loan payments; this is particularly true for start-ups. Consequently, businesses that depend on debt financing may be more vulnerable to economic downturns or interest rate hikes. Overextending one's ability to acquire more funds is a problem since it increases the perceived risk associated with a business, makes

the company unattractive to investors, and makes the company's ability to raise additional funds in the future more challenging (Baltaci & Ayaydin, 2014:47).

A number of considerations, including bankruptcy expenses, interest rate fluctuations, and taxes in the context of other variables, may have an impact on a company's choice to utilise debt financing. For example, when business is poor and SMEs are facing financial problems, they are more inclined to turn to debt finance for assistance (Deesomsak *et al.*, 2004:3). Debt financing has a variety of disadvantages that are quite significant for anybody who is in a state of financial distress.

Small and medium-sized enterprises that borrow money are taking a risk regarding their ability to pay back the money they have borrowed. Alternatively, it is conceivable that the company could have tough times or that the economy will see another collapse. Subsequently it is likely that the business may not grow as fast as first expected. The cost of debt is a necessity, and in order for a company to grow, it must make regular payments on all of its expenditures. If a business is in debt, it may have a negative impact on its ability to expand.

According to Shadab (2014:1080) asset-based finance is asset-centric, with accounts receivable, inventories, machinery, equipment, and real estate all being common features. Traditional financing techniques, in contrast, tend to concentrate on the financial health of the business as a whole. This provides smaller and younger companies with the financial assistance they need. Even in countries with established legal frameworks and competent financial services, asset-based lending has grown as an alternative to collateral-based lending.

In general, allowing interest to be deducted from taxable income provides an advantage to businesses that use debt-based finance. If taxes are not imposed in the first place, this distortion in allocation efficiency may be substantial, and it may lead to the development of projects that would not have been feasible otherwise. Consequently, when it comes to the composition of a transaction, the financing of the transaction is very significant.

The South African Government adopts a traditional approach to income tax treatment for debt and equity (Tettey, 2016:84). Debt financing has tax advantages since it allows companies to deduct interest payments from taxable income. The prevalence of leveraged finance transactions has increased because of the benefit of debt. From a contractual standpoint, the agreement defines who is responsible for interest, what the debtor's obligation to pay interest is, and whether or not the creditor has the right to collect that interest.

Regardless of whether the interest is capital in nature or not, the interest linked to the holder of an instrument is included in the gross income of that person. Additionally, it is important to

remember that section 24J of the IT Act allows for the deduction of interest if the income is derived through the trading of a company and the interest was incurred in the process of generating the revenue. Section 24J is complicated, with many specified terms included. These ideas are interpreted in different ways, and that affects when and how much interest is deducted.

This section does not place any limitations on the nature of the interest in order for it to be deducted as an expenditure. The amount of interest that may be deducted is calculated by dividing the yield to maturity rate by the number of years until the loan is paid off in full. This rate of compound interest is applied throughout each accrual period in order to guarantee that the current value of all payments due or payable, in connection with the instrument during its term, equals the issue price or transfer of the instrument at the time of the transfer.

As mentioned, the interest accrued by an investor (lender) is deemed to be gross income of that person for tax purposes. Section 10(1)(h) of the IT Act provides a tax exemption for interest paid or accumulated by non-residents. A basic exemption from taxes is also given under section 10(1)(i) to natural persons. Any interest income generated from a domestic source will qualify for the basic exemption. In the 2021/2022 year of assessment, the taxable interest amount is the amount of interest that was earned or accumulated minus the exempt amount applicable.

- Any person who was 65 or older on the last day of the year of assessment would qualify for R34 500.
- All other persons will qualify for an exemption of R23 800.

## **2.6 The grey area in between called Hybrid Instruments**

It is apparent from Figure 1 that companies have a diverse range of financing alternatives available to them for their investors. This category of instruments includes, not only the conventional forms of debt and equity, but it may also contain a combination of the two. Because of the wide definition of a hybrid debt instrument, it is possible to construct one by combining a variety of terms and conditions from various sources. According to Essop (2016:24) the contractual terms included inside various hybrid debt instruments may change significantly, and these clauses can grow very complicated as time goes on.

There are many distinct types of financial instruments, but a hybrid equity instrument combines features from all of them into a single asset. If one goes by this logic, a hybrid debt instrument is both a legal debt instrument and a debt instrument with certain equity features (National Treasury, 2014:24). While 'hybrids' are termed hybrids because they include both debt and equity characteristics, in reality they represent a unique kind of financial instrument in their own right. It is necessary to take into account the risks and benefits that are unique to hybrid securities. New

types of hybrid securities are continuously being created as a way of providing a more personalised service to sophisticated investors. Some of these products are so complicated that they cannot be classified as either debt or equity.

The terms and conditions that are associated with a financial instrument determine its classification as debt or equity. This is done by applying the domestic law principles in its jurisdiction (Essop, 2016:27). The legal framework in a given country may consist of corporate, civil, insolvency, accounting or other applicable laws. Each collection of laws is classified according to a distinct set of criteria, and each collection has the authority to choose its own classification.

According to Essop (2016:24) hybrid debt could include any of the following characteristics:

- A financial instrument that includes a provision that allows the business to postpone the payment of interest until later. Instruments with variable interest rates.
- Loans that allow interest to be paid at a variable rate. Often, the contract includes a formula for determining the amount of interest that will be paid out in the future.
- Debt instruments having interest rates that shift at predetermined intervals throughout the life of the loan.
- Subordinated debt which is a kind of debt that is below the level of other debts.
- Financial instruments in which capital automatically changes to equity if certain conditions are met, or certain events occur, known as contingent capital.
- Debt that will never be paid off.
- A participatory loan, in which the lender receives compensation based on the performance of the business or a specific project.

Because the objective of tax legislation is to tax debt and equity returns separately, determining the tax consequences of a business's distribution of a return on a hybrid instrument may be challenging. Taxes on investment returns are often divided into two categories: those paid on shares and those paid on debt. The company that pays the interest is generally able to deduct the payments; however, the business that pays the dividend is not. It is possible to exploit this difference in taxation to construct hybrid financial instruments, which often results in a preference for debt financing.

A number of anti-avoidance provisions for hybrid instruments were put in place by the National Treasury (2011) and are particularly targeted at financing agreements that are structured differently than the norm. Sections 8E and 8F describe hybrid equity and hybrid debt instruments respectively, while sections 8EA and 8FA discuss variable debt-to-equity distinctions based on



definitions and criteria contained in each instrument or the distributions on it. These have the effect that, depending on the type of instrument, dividends are treated as interest, and interest is treated as dividends for tax purposes.

## **2.7 Conclusion**

The evaluation of the capital structures of SMEs revealed various often encountered obstacles to SMEs fully benefitting from a more diversified financing environment. Long-term corporate investment, sustaining innovation, value creation, and growth are all dependent on the performance of the SMEs over the long term. There are many interpretations of what constitutes an SME, both locally and globally. There have been many studies that point to the difficulties faced by small businesses due to varying definitions. The challenges faced by SMEs are however not necessarily different to those of other sized entities. The challenges come mainly from the environment in which they operate.

A variety of financial instruments may be used to fund the various stages of a company's growth. Business start-ups are often funded by debt or venture capital at the start of their operations. Entrepreneurial equity financing, often known as venture capital, is given to new, start-up, and smaller trading companies. There are many people, investment institutions, and financial organisations that provide venture capital funding (Hayes, 2021). The Venture Capital Company (VCC) is aimed squarely at individual investors, with the goal of attracting them as a new source of investment money. This has the additional benefit of getting money into the hands of small and medium-sized enterprises (Osher & Zuccollo, 2018).

The availability of equity financing is critical for companies with a high risk/return profile, such as start-ups and creative enterprises, as well as firms in rapid growth. It is becoming increasingly difficult for SMEs to obtain finance from traditional institutions like banks and finance houses. On the investor side of the market, monitoring costs are prohibitively costly when compared to the amount of money invested, and liquidity for the general public to engage in SME stocks is severely restricted. Furthermore, there have been recent reductions in tax investment incentives for small businesses, which may have had a chilling effect on the expansion of SMEs. Before implementing a small company tax incentive, thorough study is required to ensure its effectiveness. The concepts discussed in this chapter will serve as foundation for the discussion and comparison of the various tax incentives and their design in chapters 3, 4 and 5. Specifically the application of the principles of equity finance for SMEs to the design of tax incentives and how they relate to tax incentives found in South Africa and other G20 countries will be explored. In the next chapter, tax incentives and their design will be discussed.

### **3 Tax incentives for investors and their design**

#### **3.1 Introduction**

The major focus of this chapter is this study's goal to define and analyse the design components of tax incentives for investment in SMEs. The qualities of a successful tax incentive are first explored. Following that, an outline of the aspects that must be addressed in the creation of a tax incentive is offered. These introductions serve as a foundation for a study of the different forms of incentives available in South Africa and other G20 nations in the following chapters.

As opposed to the general tax system, incentive tax advantages are tax benefits which are specific to a certain set of taxpayers and which are not available to the general public. The term 'tax incentives' refers to specific provisions that provide a person or organisation with a reduction in their tax liability. The term 'tax incentives', according to Zolt (2014:4), is used to describe specific exceptions, exclusions, or deductions that provide special credits, lower tax rates, or the ability to defer paying taxes.

According to Calitz *et al.* (2013:4) tax benefits are available in a wide range of shapes and sizes. Tax incentives may be used to completely or partially relieve tax responsibilities or provide preferred rates, deductions, or exemptions, and can be applied to a single tax or a number of taxes. In most cases, tax incentives are designed to benefit certain sectors or businesses. But this is not the case when considering a comprehensive tax system that applies to all residents and provides a wide range of tax benefits, ranging from lower tax rates to greater deductions for charitable contributions and other expenses. A variety of factors contribute to the establishment of investment incentives in developing and transitional markets and economies (Holland & Vann, 1998:1).

It has been the topic of heated discussion, and there has been little agreement on whether or not tax incentives are effective. The rapid economic development seen by many emerging nations has been attributed to investment incentives. Majavu and Kapingura (2016:130) conducted an investigation to distinguish the determinants of foreign domestic investment (FDI) inflows into the South African economy. They applied the model to a variety of factors including the exchange rate, the inflation rate, the openness of the market, and corporate tax.

The results of the experiment revealed that these variables are major drivers of FDI inflows into the South African financial system, with corporation tax having a detrimental effect on both the short- and long-term outcomes. Khrawish and Siam (2010:67) maintain that foreign direct investment flows into Jordan's economy have been shown to have a statistically significant and

positive connection with economic and financial factors. According to the findings of the research, further FDI promotion should be carried out via tax breaks to attract new investments. According to the OECD (2007a:18) international best practices argue against the use of special tax incentives to attract foreign direct investment, instead favouring tax rates that benefit both existing and newly acquired capital while avoiding the traps of other forms of relief and relieving the domestic base of tax planning burdens.

Other studies done by scholars have claimed that there is little evidence to support the effectiveness of such incentives. Bird and Zolt (2008:9) maintain that no matter how widely they are used, tax breaks and incentives always end up being counterproductive, since they complicate and degrade our fiscal system while failing to achieve the goals they set out to. This is true even if an incentive works to influence investors to behave differently than they would have under normal market conditions. The resulting behaviour is often inefficient and diverts valuable resources away from their most lucrative applications. Holland and Vann (1998:2) hold that tax breaks have often proven ineffective in attracting investment, particularly foreign direct investment (FDI). This reinforces the conclusion that tax breaks alone will not be sufficient to solve the other, more basic issues that prevent investment from taking place.

Due to the reality that tax and non-tax incentives are just one of the numerous variables that affect the profitability of investments, these divergent viewpoints are not unexpected. The belief that incentives can offset the negative effects of the overall tax system's investment disincentives is common in transition countries that have not fully reformed their tax systems. Many difficulties exist for investors, including a lack of infrastructure, confusing and outdated laws, bureaucracy, and ineffective government management. In order to compensate for these challenges, tax breaks are sometimes provided. Countries generally seek growth-related reforms via a mix of methods, including macroeconomic policies, improvements to the investment environment, and changes to industrial policy, including investment incentives, to achieve their goals.

Studies done by the OECD (2003:188) shows that investors do not consider tax incentives as important in making investments decisions. Investing was discouraged because of the perception that tax incentives promoted dishonest behaviour by tax officials, resulting in higher project costs and more uncertainty for the investors. More important factors were market dynamics, relative manufacturing costs, and the availability of resources, among others. Many investors prefer transparency, simplicity, stability, and certainty in the application of tax legislation and in the administration rather than the benefits of tax incentives and other special tax provisions.

Regardless of a country's economic stage, investment attraction has appeal in all types of nations, from developed to emerging or even developing ones, since it improves employment

opportunities and gives access to new technology to all these countries. Job creation or protection, such as for suppliers to foreign business and for local enterprises and future start-ups with access to world-leading technology, may occur as a result of the direct impact on employment (OECD, 2020:25). In order to compete for different types of investments, such as corporate headquarters and service businesses, mobile light assembly factories, and automobile manufacturing sites, it is conceivable that nations would compete against one another.

The use of tax breaks to compensate for a market failure caused by the externality of a specific economic activity is one of the most often stated reasons for tax incentives. Jordan and Turnpenny (2015:3) maintain that besides being a conventional justification for giving incentives, tax breaks are often the result of policymakers' subjective evaluations of the requirements of their particular jurisdictions, in addition to the traditional justification. According to these authorities, a small but critical group of taxpayers is so important to the economy that they should be granted an exclusive tax exemption.

There are many benefits to using the tax system rather than providing direct subsidies to businesses. Lerner (2009:186) maintains that governments should refrain from attempting to choose winners since doing so may result in regulatory capture. Governments have developed a wide range of investment incentives in an attempt to entice investors to make investments. The fact is that tax incentives, in one form or another, are used by virtually every nation in the globe, regardless of their political affiliation. The ability of businesses to operate under a regulatory framework that includes efficient taxation is critical to their success. It is a major and inevitable cost problem for all businesses, regardless of their size or industry.

Taxation is a particularly significant aspect of the business environment for policymakers to examine and evaluate since it may have a direct impact on and be controlled by legislation. It should be noted that the implementation of tax incentive programmes is also associated with a number of costs, and these expenses have the potential to exceed whatever advantages could have been realised had the programme not been created in the first place. James (2013:3) mentions that when governments establish tax incentive programmes, they must take into account both the probable costs and the possible benefits.

Using tax credits helps to maintain incentives in the market, which in turn pushes industry experts to back up their claims with action. Additionally, the cost of tax subsidies is relatively low when it comes to administrative burdens. According to Keuschnigg and Nielsen (2002:3) new companies should be encouraged to start up by providing them with subsidies that reduce the costs of entering the market. It has the benefit of being a much more targeted subsidy than the capital gains tax reduction, which is applied to a wide range of investments. The investor tax credit also

has the advantage of being a much more focused subsidy than the capital gains tax cut (Poterba, 1989:375).

Various government efforts over the past few years have concentrated on a wide variety of programmes, including some that are particularly geared towards assisting new entrepreneurial start-up businesses in their early stages. Start-ups are critical components of a country's innovation system since they are the source of many innovative business ideas, products, and services that help the economy (Sopjani, 2019:10). Many entrepreneurs, on the other hand, find that venture financing is their sole option for expanding their operations and growing their company. It is necessary for start-ups to get venture capital funding in order to succeed. One method that a local government might take to encourage angel investment is to utilise the tax code to assist local businesses in their growth. The government offers tax incentives to investors in order to assist businesses in raising capital. The aim is to increase the after-tax return on SME investments in order to make them more attractive.

### **3.2 The characteristics of a sound tax incentive**

A well-designed tax system may aid in the achievement of both social welfare and financial stability at the same time. A government's ability to attract investment that might otherwise leave for a different area or nation depends on whether it offers tax advantages. Economic decision-making is influenced by tax incentives, which may be very generous but can also result in a more complex tax structure. Furthermore, a certain group of taxpayers is given preference over the rest. According to Calitz *et al.* (2013:5) there is not a lot of nuance when it comes to the use of tax breaks and how they impact the economy. Tax breaks may reduce capital costs either directly or indirectly, resulting in greater investment.

Holland and Vann (1998:3) claim that when developing their investment tax incentive programmes, governments must consider who would be benefited, how much revenue they will lose, and if any monetary limitations or other restrictions should be put on the amount of incentives taxpayers may claim. In comparison to tax incentives, prospective investors put a greater value on the overall features of the tax system such as the tax base and tax rates. As a result of changes in tax laws that are not clearly defined and subject to frequent adjustment, the perceived risk for investors increases. These changes make long-term planning for businesses more difficult, thus raising the perceived risk for investors. It is obvious that tax administrations in developing and transition nations often struggle to keep up with sophisticated investors, whether it is in terms of delivering timely and consistent interpretations of the law or in terms of executing the law in the most suitable way.

According to Bergner *et al.* (2017:5) incentives are unique tax law provisions that offer favourable treatment for certain activities, investments, or contributions. Three major criteria will influence the range of options available to policymakers:

- Do tax incentives apply to the enterprise or the company owner?
- Is the incentive intended to address the actual tax debt, or is it intended to address the compliance expenses that are incurred throughout the process of calculating and resolving the tax obligation?
- What factors influence the size of the relief? Is it based on the amount of money invested or the outcome of the investment?

According to Bergner *et. al* (2017:13) tax incentives should usually show four key qualities to truly achieve and maximise a net benefit:

- Effectiveness: There is a need to reduce the effects of taxes and provide more economic advantages. It is crucial that a thorough explanation of the reasons for the implementation of an incentive and the anticipated effects of it be documented to ensure the effectiveness of the incentive.
- Simplicity and transparency: Simple rules that taxpayers and tax administrations can comprehend and comply with are the most effective approach to minimise compliance costs while also streamlining administrative burdens. Because small companies pay a disproportionately large share of the compliance expenses, keeping things simple is critical when it comes to SME tax benefits. Transparency, for example, is strongly linked to the requirement for operational simplicity. Taxpayers must, among other things, be able to accurately anticipate the benefits they will get and account for these advantages in investment choices if they are to succeed.
- Neutrality: A tax break for certain businesses at the expense of others reduces the overall fairness of the tax code by favouring some enterprises over others. On the other hand, tax incentives should be crafted so as to cause the least amount of distortion. Investing choices should not be influenced by the possibility of a tax deduction. Growth should not be discouraged for SMEs due to the loss of a tax advantage.
- Efficiency: The connection between tax incentive outcomes and their costs is essential. The tax administration and taxpayers must work together to reduce implementation and compliance costs to a bare minimum in order to maximise savings. Small and medium-

sized company tax breaks must be provided to enterprises who exhibit the necessary characteristics while also avoiding the waste of public funds by eliminating businesses that may be tempted to take advantage of the system.

To qualify for a tax incentive, the investor and the asset must meet the requirements set out in the applicable tax legislation. It is reasonable to expect that this kind of benefit is only beneficial if it brings in investments that are both profitable and would not have otherwise been made. A business tax incentive programme should specify the kinds of investments it intends to encourage from the outset. In terms of how tax incentives are designed, there are three main areas to consider according to the G20 Development Working Group (2015:19). The areas to consider are those related to the scope or choice of the incentive instrument, those linked to qualifying criteria, and the last category, those related to reporting, administration and monitoring requirements of the incentive. This view is also held by the European Commission (2017:68). As stated by the International Monetary Fund (2015:19), tax incentive policies involve three key design issues, including the choice for investment incentives of the tax instrument (Scope), eligibility criteria for selecting qualifying investments (Qualifying criteria) and the reporting and monitoring requirements (Administration) at various stages of the tax incentive life cycle.

The scope of a tax incentive can generally be described as the type of incentive and when and how it is applied. The European Commission (2017:68) refers to this as the form and timing of the incentive. The qualifying criteria refers to the targeting mechanism in the design of tax incentives and serves the purpose of including specific taxpayers while excluding others (IMF, 2015:19). Finally, the administration of a tax incentive in general is concerned with the continuous monitoring and reporting of the tax incentive and includes the compliance aspect thereof (Holland & Vann, 1998:12).

### **3.3 Scope of tax incentives**

When it comes to the function of tax incentives, the scope of the incentives is a critical element or the primary determinant, and their selection is guided by the underlying policy goals of a government. According to Maskin and Riley (1985:2) tax incentives are given for small and medium-sized enterprise investments in a variety of ways, including immediate deductions (input-based deductions) and capital gains or dividend incentives (output-based). Some countries provide up-front tax advantages to investors and company owners who engage in SMEs. Most of them are presented as a reduction of personal income tax and are only applicable to investments in start-up or very small SMEs. The aim of these actions is to improve the availability of funding for early-stage companies.

For this reason, a lot of these programmes are intended to help new businesses by making the initial investment less expensive and by creating a better environment for businesses with creativity. Tax advantages that are dependent on inputs, such as deductions for capital investments, seem to be more appealing to investors than capital gains and dividend exemptions because the benefit can be obtained at the start of the investment life. In fact, output-based tax incentives may even promote disinvestment since an investor would only qualify for the incentive when they remove their money from the market (Auerbach, 1979:589). The goal of venture capital investments is not to make money quickly, but to work with investee businesses to help them grow and enhance the value of their own companies.

One additional important distinction between output-based tax incentives, such as a capital gains tax credit, and an input-based tax incentive, such as an investment tax credit, is that the former is only available if the investment results in a capital gain, while the latter is not reliant on whether the investment was successful or not. Capital gains are profits realised by an investor on the sale of the investment held. The profit is realised as a consequence of a rise in the company's worth over the period of the investment.

In contrast to input-based tax incentives, which provide investors with an immediate advantage, output-based incentives, which are delayed and are typically only available in connection with financially successful investments, may be desirable from a government's perspective because the tax expenditure is delayed.

The majority of tax regimes exclude dividends and capital gains from taxes if the underlying ownership is in a small or medium-sized enterprise (SME). On the other hand, investments in SMEs may be depreciable or qualify for immediate tax deductions and credits. Certain nations will only accept investments in small firms, while others would consider both small and medium-sized enterprises. Typically, the regimes include additional eligibility requirements, such as minimum holding periods, or company characteristics, such as the firm's age and participation in creative activities.

Additionally, some regimes impose limits on the amount of investment, such as limiting absolute amounts or maximum ownership holdings in certain businesses. It must be noted that venture capital and business angel financing, as compared to other kinds of funding, has the benefit of being medium to long-term, which means that investors do not necessarily anticipate to make money from the trading of its shares in the near term, but rather expect to make money from capital gains after a set length of time (OECD, 2007b:32). According to the European Commission (2017:69) tax incentives in general would include the following:



## Input-based incentives

- **Investment Allowances:** To reduce taxable income, investment allowances are subtracted as a percentage of new investment. Accelerated depreciation allows companies or investors to recoup their capital expenditures faster than the asset's useful economic life requires. Businesses may claim deductions for qualified capital costs that are a multiple of the actual cost under an enhanced deduction programme.
- **Investment tax credits:** An investment tax credit (ITC) enables an individual, or corporate investors, to deduct a certain proportion of their investment-related expenses from their tax obligation. The relief is in the form of a reduction of the tax obligation as opposed to a deduction from taxable income.

Investing allowances and tax credits may be easily implemented in a straightforward and automated way, according to the International Monetary Fund (2009:14), and they are directly related to new investment.

## Output-based tax incentives

- **Tax reductions on dividends and interest income received:** Taxes, including withholding tax on interest and dividends, are reduced or exempted.
- **Taxation of capital gains on investments held for a minimum term are reduced or exempted:** Investments in long-term capital gains are given favourable tax treatment in order to encourage investors to hold onto their investment for a longer length of time. The taxation of capital gains on assets held for a length of time greater than the minimum duration is often lowered, while short-term capital gains are typically taxed as regular income.
- **Loss Relief:** Losses incurred on the investment can be set-off against other related investment income. Some governments allow for the set-off against other types of taxable income or capital gains.

New investors are often enticed by tax reduction that is depending on the amount of money contributed (input-based). At this stage of the investment life cycle, tax relief may help reduce investor risk aversion, which is a prevalent issue today. Tax relief tied to the initial investment may offer greater certainty and stronger incentive effects for investors due to the nature of investments in SMEs and start-ups, which are typically more hazardous than bigger companies. Input-based incentives are generally given at the start of the investment and is based on the amount invested whereas output-based incentives focusses on the return on investment during and at the end of the investment period (Maskin & Riley, 1985:2).

According to Mohlomi (2017:4) dividends and interest received from investments may also be eligible for tax reductions if they are earned over the investment's lifespan (output-based). This may seem to have a positive incentive impact in principle, but the specific features of start-ups and SMEs may negate any potential incentive effect. This is because dividend distribution policies among SMEs differ vastly. Being able to claim tax benefits for profits realised on disposal (output-based) may provide an incentive for investors to promote the growth and professionalisation of their investments. This may imply that tax incentives provided on disposal may contribute to the overall improvement in the quality of the investment.

Another type of output-based incentive is the exemption of capital gains and the relief of setting off capital losses against other investment related income. According to the European Commission (2017:71) adding a performance-related component to a tax incentive scheme by reducing the tax liability for gains realised on the sale of an investment is a common practice. Depending on the scope of the incentive, various outcomes can be expected when considering the effect they have on promoting investments in SMEs.

### **3.4 Qualifying criteria of tax incentives**

As mentioned earlier, tax incentives are designed for a specific group of taxpayers with particular characteristics. As a consequence of this idea, tax incentives, regardless of their intended use, include targeting as an integral part of the design process. The targeting mechanisms of tax incentives is achieved via the application of qualifying criteria that explicitly limit who is eligible to receive the benefits in question. In order to be successful, tax incentives must be designed to satisfy a certain set of criteria. In order to get targeted marketing outcomes, qualifying requirements are employed. These criteria limit who is allowed to take part.

Prior to implementing particular incentive regulations, it may be necessary to get initial permission or make another affirmative choice in certain circumstances (Bergner *et al.*, 2017:5). Several variables influence the approval of a project, including whether the investment is in a specified business, if the investment size or timeframe is defined, and whether the investor complies with the pre-set criteria. Generally, tax authorities will require some kind of formal documentation showing that an investor or business is qualified before they would allow the incentive. This is an important consideration in the development of tax breaks and incentives. The criteria used for qualification when designing a tax incentive could include the size, age or sectors of the business. With respect to the investor, the criteria could generally include the type of investor, the size of the investment and the duration it is held.

Business age characteristics, according to the European Commission (2017:74), may be used to distinguish between companies at various phases of development. The government's goal of increasing small and medium-sized businesses' access to capital may be achieved by focusing on new businesses in particular. There are worries regarding administrative complexity, such as the requirement for anti-avoidance measures to ensure that companies do not keep moving their activities into new, incentive-eligible entities.

Business size parameter also has its drawbacks as governments tend to focus on smaller companies which are particularly vulnerable to market failures, particularly those at the lower end of the SME spectrum whereas sector specific incentives on the other hand prohibit companies in other sectors and narrows the effect of the incentive tremendously (European Commission, 2017:74). While this may be the case it is also conceivable that it will allow for better targeting of expenditures in areas where tax-incentivised investment is most required and where it will yield the best macroeconomic outcomes. The fairness of such an incentive is questionable as companies of the same size and age but in different sectors are treated differently.

When it comes to the investor the limitation could have the greatest effect as governments can inadvertently exclude investors that could have contributed substantially to the economic goal. Tax incentives for SMEs can generally be classified as those available at business level and those available at shareholder level. At investor level tax incentives for SMEs in countries worldwide generally affects three different types of investors namely entrepreneurs or business owners, business angels and venture capital funds. The distinction between these investors is important in assessing the tax incentives available to investors as the requirements for qualification can differ tremendously.

According to Mbhele (2012:95) venture capital funds are businesses that serve as principals in the management of money raised from individuals, institutions, and corporations. They make investments in unquoted business initiatives, which may include SMEs that satisfy specific requirements. To increase a company's prospects of success, a business angel uses his or her own personal assets to make direct investments in new and developing unquoted ventures. Business angels may be able to offer entrepreneurs with valuable company management skills in addition to financial support. The entrepreneur is usually the original owner of the business. The entrepreneur establishes a new business and takes on most of its risks and benefits.

When it comes to SMEs and start-ups, tax incentives for investors frequently differ in their treatment of natural persons and corporate investors, among other things. In addition, governments tend to focus on excluding related parties from such incentives as their inclusion

has shown to increase the abuse of such policies. This has been the case in South Africa with the VCC regime (De Klerk, 2020:29).

The most important distinction between the investment criteria for investors in SMEs is the tax treatment of debt and equity instruments. Historically, equity has played a limited part in the capital structure of SMEs and start-ups due to the high cost of financing. As a result, it might be claimed that incentivising debt financing via tax cuts would be more successful in assisting SMEs in gaining access to credit. Taking the duration of the investment into account, a minimum holding period may assist to maintain some stability in the financial structure of SMEs while also reducing the prevalence of short-term or speculative behaviour in investors.

### **3.5 Administration of tax incentives**

According to Babatunde (2012:2) one of the most significant disadvantages of tax incentives is the amount of time and money it takes to administer them. It is possible that creating loopholes because of tax incentives would raise the costs to the government by increasing possibilities for tax planning, cheating and corruption in the tax administration. It is important that countries with a bad tax administration do not give out generous incentives that promote tax avoidance and other unethical behaviour. Tax incentives need administrative resources to be diverted from revenue collection to compliance, since the rules and implementation of the tax incentive must be continuously checked to ensure that they are being followed.

According to Holland and Vann (1998:12) tax administrators have an extra challenge when auditing incentives since they must first verify that the incentive has been correctly administered before proceeding with the audit. When there are complex calculations involved, verification may be time-consuming and difficult to complete. When developing tax incentive schemes, governments should consider the administrative consequences.

When developing an effective tax system, it is necessary to consider a country's administrative capacity (G20 Development Working Group, 2011:11). Even the most comprehensive tax legislation may result in poor results if it is not effectively administered and maintained. It goes without saying that the introduction of special investment incentives would inevitably complicate tax administration and pave the way for the development of loopholes that will enable companies and wealthy people to avoid or evade their other tax obligations. A modest tax benefit may quickly develop into a huge loophole due to its specific features. Tax incentives have traditionally been especially susceptible to tax planning, with most of it proving to be very difficult for tax authorities to identify and prosecute when it occurs. Consequently, governments may experience substantial

revenue leakage. In the wake of these administrative problems, the cost-effectiveness of tax breaks is further reduced.

Good intentions in tax incentives may lead to abuses, even in a system with a competent tax administration. This can lead to significant revenue losses due to actions that have nothing to do with the policy's stated goal. Businesses and individuals may engage in 'active tax planning' by taking advantage of tax cuts and incentives. This means they are making an effort to minimise their tax burden. These techniques are used most often by profitable companies, who can afford the finest legal counsel and stand to benefit the most from reducing their tax liabilities.

Selective incentives require the application of a variety of rules to a diverse range of taxpayers, which by its very nature makes the system more complicated. It takes a large number of administrative resources, all of whom are highly qualified, to avoid and manage the exploitation of gaps. Zee *et al.* (2002:1501) mentions that the higher the percentage of limited resources devoted to managing tax incentives, the greater the proportion of other important administrative tasks that would be compromised, ultimately jeopardising overall revenue collection. Selective incentives need the use of screening processes, which may result in substantial administrative expenses and delays for the organisation. Unlike other kinds of incentives, tax incentives that are created using well-defined technical criteria are less likely to be abused.

For the business the cost of compliance could also increase substantially. Businesses with unsophisticated access to knowledge and resources may run into huge administrative costs just to try and comply with the intricacies of the tax incentive regime. According to Braunerhjelm *et al.* (2021:682) the administration burden of the scheme in itself can divert interested investors to other investment avenues. The regime may also require the business to have additional registration and compliance obligations outside the tax code. One such an example can be found in South Africa where the section 12J tax regime as discussed in this document requires that a venture capital company needs to be registered with the financial services regulator. These additional requirements need highly skilled people and dedicated resources to administer which in general could only be afforded by the wealthiest of investors.

According to Holland and Vann (1998:9) if an incentive is to be given, it must be given with the approval of the authorities, which is a basic design issue that impacts all kinds of incentives. This is called 'administrative discretion'. Using this strategy may have a number of advantages. Changes may be made more easily since fewer businesses are affected and the challenges of transition can be more easily handled, allowing the government to adapt its policy aims over time. To prevent tax evasion, the government might deny access to a taxpayer that appears to overstep

the boundaries. However, according to the European Commission (2017:90) this is not recommended as discretion can increase the risk of corruption and error.

### **3.6 Conclusion**

There can be no universal tax incentive scheme since the efficacy and impact of any tax incentive is dependent on country-specific judgements and circumstances. It has been shown in various studies that investment tax incentives have a disproportionately positive impact on the economy, while their negative impact is vastly underappreciated. Divergent viewpoints on tax incentives exist, and they reflect a difference in the perspectives of researchers, international organisations, and academics on the subject.

This bias towards tax incentives is generated in part by errors in the analysis of tax policy, and in part by political forces that are biased in favour of special interests by their very existence. When evaluating the advantages and disadvantages of each tax incentive instrument, it is critical to consider the specific local circumstances and goals, as well as the findings of systematic policy research, to make well-informed decisions about which tax incentive instruments to use. For a tax incentive to be effective it must be easy to understand, implement and monitor and ultimately deliver on its initial goal.

This chapter includes a study of the features of a good tax incentive's design and implementation. An important goal is to comprehend the considerations and judgments that governments must make in order to develop tax incentives that are utilised to accomplish specified goals. In the next chapter, the emphasis is on the various tax incentives available in South Africa, as well as the features of these incentives as they are designed. The focus is on tax incentives relating to equity investment for investors in SMEs in South Africa, based on the principles established in Chapter 2 when looking at the design criteria of scope, qualifying requirements and administration as discussed in Chapter 3. A short discussion of the scope, qualifying requirements, and administration of each incentive is provided, with particular emphasis on the historical context for its creation.

## **4 Tax incentives available to investors in South African SMEs**

### **4.1 Introduction**

The major purpose of this chapter, in terms of tax incentives for investment in small and medium-sized businesses, is to provide an overview of the existing South African law on the subject.

In this chapter, the historical context of tax incentives for SMEs in South Africa is addressed, and the numerous tax incentives imposed by the National Treasury are identified and studied further. The development and operation of sections 12E and 12J of the IT Act, as well as paragraph 57 of the Eighth Schedule to the IT Act, are briefly discussed. Additionally, with reference to the judgments made by the National Treasury for the numerous revisions made to the law, a history of the shortcomings of the section 12J legislation is reviewed to give context to the reasons for its eventual demise and to facilitate comparison to other similar incentives used by G20 countries.

Application of the ideas outlined in Chapter 2 and Chapter 3 is used to determine the scope, eligibility criteria, and administration of these tax breaks, which are then explored in detail. The application of the scope of equity-based tax incentives for investors and the eligibility criteria to include SMEs are kept in mind when discussing these incentives. The groundwork has been created for a comparison of these incentives with those offered by G20 nations, which will be discussed in further detail in the next chapter.

### **4.2 Tax incentives for SMEs in South Africa**

Historically, tax breaks for investors in SMEs in South Africa were restricted. After conducting in-depth research on the current incentives that drive investment in small and medium-sized companies, it was discovered that there is a severe lack of appropriate incentives to direct investment in SMEs (Smulders *et al.*, 2012:185). As discussed in Chapter 2, the challenges relating to SMEs and how they obtain finance is of concern to all governments including South Africa. The focus of the South African Government on SMEs in their development plan and the challenges relating to their finance structures led the South African Government to implement various tax relief measures specifically designed for these companies.

Section 12E of the IT Act was enacted in 2001 to address the deterrent impact of taxes on SMEs in an attempt to boost development in this sector. The introduction of paragraph 57 of the Eighth Schedule as a part of the Capital Gains Tax Bill in 2001 ran parallel to the establishment of section 12E. Both of these tax breaks were designed to emphasise the entrepreneurial aspect of SMEs and the shareholders who serve as the primary drivers of their growth.

Section 12J of the IT Act has been enacted for the aim of easing the equity financing limitation in the private equity financing market. This strategy is consistent with the method used by a number of G20 nations. The favourable impact that venture capital incentives may have on the development of SMEs has been shown in several studies.

The Davis Tax Committee (2014:15), in its report on tax considerations for SMEs, mentions only sections 12E and 12J when addressing tax benefits pertaining exclusively to SMEs. In addition to the provisions of sections 12E and 12J, there is also a special tax relief available in terms of paragraph 57 of the Eighth Schedule to the IT Act, when a capital gain is realised on the sale of 'small business assets' to an individual who meets certain criteria. Other incentives, which are not unique to SMEs, are available however, they will not be included in this study.

The return on investment in SMEs may be influenced by the incentives provided to individuals who are involved in the transaction at various levels of the transactional hierarchy. Section 12J of the IT Act and paragraph 57 of the Eighth Schedule to the IT Act examines the direct advantage to the investor from the standpoint of the shareholder. Section 12E on the other hand, is concerned with the indirect advantage to the investor that results from the availability of incentives to SMEs. It may be argued that if a small and medium-sized enterprise (SME) qualifies for certain tax advantages, the resultant decrease in taxes will be seen primarily by the investor. There are many reasons both in favour of and against this concept (OECD, 2007b:1).

### **4.3 Overview of section 12E**

According to the Budget Speech presented by Mr. Trevor Manuel in 2000, the development of SMEs is vital to the extension of the South African economy's growth and employment potential. The National Treasury proposed a graduated corporation tax rate structure for incorporated small and medium-sized businesses in order to complement a number of existing government programmes geared at small and medium-sized businesses. Moreover, they believed that these initiatives would help to the expansion of the labour-intensive SME sector in the future, resulting in increased income from active firm activities (Department of Finance, 2000:20).

Small and medium-sized enterprises were given favourable tax rates and income tax credits for the acquisition of plant and equipment of any sort when section 12E of the IT Act was originally adopted in 2001. Under this provision, tax relief is provided to companies that meet the definition of a 'small business corporation' in the form of reduced corporation tax rates and accelerated wear and tear allowances. It must be noted that the legislation regarding section 12E uses the term Small Business Corporations (SBC) to refer to SMEs. Although these terms are used interchangeably in practice, for this part of the discussion the terminology according to legislation



will be used. As section 12E is primarily two types of incentives available at firm level and not at investor level, only a basic background of the scope, qualifying criteria and administration will be discussed.

#### 4.3.1 Scope of section 12E

Specifically, the section 12E allowance scheme is intended to accomplish two things. Supporting the manufactured asset accelerated depreciation allowance which helps to promote and advance capital formation and subsidising the wear and tear allowance which helps to stimulate the fixed capitalization of other assets (Bizcommunity, 2013).

In the case of small businesses, a complete deduction for the acquisition of qualified manufacturing assets is permitted during the year in which the assets are put into service. They must have been bought with instalment credit, installed for the first time on or after 1 April 2001, and used to perform business other than mining and farming to be eligible for the tax allowance. The section 12E manufactured asset allowance is equal to the entire cost of the item in the year in which it is purchased. As a result, a SBC offers major tax advantages when it comes to the acquisition of industrial equipment and machinery.

Any assets, other than manufacturing assets, are eligible for wear and tear allowances under section 12E in the following manner:

- 50% of the asset's cost when the asset is utilised for the first time,
- 30% in the second year,
- and 20% in the third year.

The second kind of tax relief provided by section 12E is the provision of considerably reduced rates of tax due by organisations that fulfil the criteria of an SBC. The taxation of small business corporations for financial years ending between 1 April 2021 and 31 March 2022 can be calculated using the following table:

**Table 3 : Tax table for SBC - 1 April 2021 to 31 March 2022**

Taxable Income (R)	Rate of Tax (R)
1 – 87 300	0% of taxable income
87 301 – 365 000	7% of taxable income above 87 300
365 001 – 550 000	19 439 + 21% of taxable income above 365 000
550 001 and above	58 289 + 28% of the amount above 550 000

As can be seen from the table above the effective tax rate after distribution of profits for investors in SBCs will differ from those in other companies depending on the level of taxable income of the SBC. The SBC will be subject to normal tax based on the table as illustrated, after which the distribution of profit will be subject to dividend tax at a rate of 20%.

The effective tax rate for an investor in an SBC can be summarised as follows:

**Table 4 : Effective tax rate for an Investor in SBC**

Taxable Income of SBC (R)	The effective tax rate for the Investor
1 – 87 300	20%
87 301 – 365 000	Between 20% and 24.26%
365 001 – 550 000	Between 24.26% and 28.48%
550 001 and above	Between 28.48% and 36.42%

Several restrictions with respect to section 12E incentives were highlighted by the Davis Tax Committee (2014:16) in its report to the Government. It is claimed that small business corporations (SBCs) with no taxable income do not get the benefits of the tax break. A lower tax rate for SBCs has no impact in this situation, and the SBC does not get a tax advantage from the incentive. In particular, SMEs, who have a large taxable revenue, are favoured by the tax incentive.

#### **4.3.2 Qualifying criteria of section 12E**

Providing that the small business meets certain criteria, it will qualify for the relief measures contained in section 12E. Section 12E provides relief to SBCs, although only incorporated firms are eligible. For tax relief to be granted under section 12E, taxpayers must fulfil all of the conditions set out in the section. It basically implies that if there are taxpayers who fulfil all of the requirements for section 12E except for one of the criteria, they will be unable to apply for tax relief (Heiriss *et al.*, 2018:47).

A company with a gross annual income not exceeding R20 million will qualify as a small business corporation subject to the following criteria:

- Shareholders and members of a company or closed corporation must be natural persons to be eligible.
- For the company to be valid, none of its shareholders or members may have any interests in other companies.

- 'Investment revenue' and income from 'personal services' are allowed to account for no more than 20% of the entity's total income.

Killian *et al.* (2007:28) states that South Africa adheres rigidly to the parameters that govern small company tax breaks. All SBC concessions for that year will be lost if an entity's taxable income rises by even a single rand beyond the R20 million level. It was proposed by the Davis Tax Committee (2014:19) that the gross income cap be raised from its present level of R20 million to R50 million.

Company groups will also be rejected since a SBC's whole ownership must be held by natural person shareholders or members throughout the assessment year. Accordingly, any juristic person who wishes to own shares in a SBC is barred from doing so under this condition. According to Killian *et al.* (2007:28) the purpose for restricting the ownership of shares in a SBC to natural people is to include an anti-avoidance mechanism into section 12E. Entities in group structures will be prevented from segmenting their revenue into smaller pieces and then having these smaller portions of income taxed at a lower rate. There are no measures for winding down the programme. If any of the owners owned shares in another company for even a single day throughout the assessment year, no relief will be given. A revision to these criteria was proposed by the Davis Tax Committee (2014:19), which would enable for at least 33.3% of the ownership in a small business corporation to be owned by another corporation.

Companies that receive more than 20% of their total revenue in the form of investment income, such as dividends, interest, royalties, and annuities, will not be eligible for the tax savings provided to small businesses. A further restriction is that no more than 20% of the company's total revenues and accruals for the year may be derived by providing 'personal service'. Almost all services are included under the idea of 'personal service', which is quite wide in scope. The National Treasury (2010:65) indicated that this limitation exists due to the fact that professional services are often delivered by highly knowledgeable, high-income taxpayers who create profit margins that are much larger than the profit margins envisioned in the design of the turnover tax. Services such as accounting, actuarial sciences (including law), draughtsmanship, entertainment, commercial arts, performing arts, journalism, secretarial services, broking, and consultation are only a few examples of what is provided.

#### **4.3.3 Administration of section 12E**

The Davis Tax Committee (2014:18) stated that the SBC regime is also too costly to administrate. The committee noted that the accelerated allowances in sections 12E and 12B are simply temporal changes that have no significant effect on the financial position. Furthermore, whether

it comes to establishing a business or assisting an ailing company that is suffering from an assessed loss, the SBC tax incentive provides little or no benefit at all.

Because of its high degree of complexity, the SBC definition adds to these issues. As the Davis Tax Committee (2014:19) notes, the section 12E(4)(a) holder of shares requirement is at the core of the complication of the definition of SBCs' complexities. It is excessive, complex, and difficult to administer the requirements of this section. The relevant problems with respect to SBC tax incentives, according to some experts, may have arisen because of the way the tax incentives were established or managed (Ssenyonjo, 2019:73). In the IT Act, certain terms and phrases that are critical to the administration of tax incentives are not specified in sufficient depth, which is a major deficiency. Consequently, any of the confusing phrases may be easily misunderstood, resulting in a taxpayer claiming and deducting an allowance for which they are not entitled to claim a deduction. When it comes to allowances on the other hand, a taxpayer may not claim any at all, even if they are otherwise qualified to do so. According to Heiriss *et al.*, (2018:42) there is still no good reason to provide tax relief just to South African small enterprises that are legally formed. As a result, it is clear that section 12E's focus on a company's incorporation status may be overblown.

Taxpayers who were not expressly targeted by the incentive scheme are properly claiming a considerable share of the benefits of the incentive, according to the Davis Tax Committee (2016:17). This incentive is, however, generally reserved for well-established, profitable speciality SMEs that have a proven track record of success. Consequently, the SME sector in South Africa accounts for a modest share of the country's total economic output. When it comes to starting a business or helping a failing organisation that is suffering from an assessed loss, the SBC tax incentive provides little or no advantage, depending on the circumstances. Even though tax breaks for small firms are still available, the benefits are offset by exceedingly strict qualifying requirements. Small firms also have to deal with a slew of regulations, including hefty anti-avoidance rules that do not only target tax cheats but may sometimes catch innocent taxpayers unaware (Killian *et al.*, 2007:33).

It was suggested by the Davis Tax Committee (2014:20) that a new incentive be created that would promote tax-compliant SBCs while also paying them for some of the extra expenses involved with achieving tax compliance. As a result, the SBC incentive would be tapered down over time, and the resource would be transferred in the form of another incentive. This incentive may be in the form of a refundable compliance rebate (RCR), among other things. The Treasury did not consider this advice yet, and the section 12E system continues to operate as a result.

It was stated by the Davis Tax Committee (2016:5) that the SBC tax system is basically inefficient since almost a third of the tax benefit is distributed to SBCs that are unrelated to the initial objective of the SBC endeavour. In its recommendations the committee suggested that the resource be redirected within the Department of Small Business Development (DSBD) or Department of Trade and Industry (DTI) through targeted actions to eliminate the SBC incentive entirely, that the RCR system is used to expand the SBC resource to include all tax-compliant SBCs, or that the existing SBC regime is used while accepting the additional risk of fraud and enforcement issues that may arise because of doing so. The Treasury chose the second option, and the system is still in place as of 2021.

#### **4.4 Overview of paragraph 57 of the Eighth Schedule to the Income Tax Act**

Kewley (2013:268) states that entrepreneurs who own and operate their own firms may have difficulties in saving for retirement in the conventional sense. Small business owners have particular challenges over the course of their business life and the company itself effectively functions as a retirement finance instrument. Providing a small business with preferential treatment for its profits upon retirement may thus be acceptable to the extent that it is fair and economically beneficial.

In most cases capital gains tax is assessed when assets are sold or considered sold. The Eighth Schedule to the Income Tax Act 58 of 1962 ('the Eighth Schedule') on the other hand, provides for exceptions to this general rule. With the introduction of capital gains tax in 2001 the National Treasury proposed and implemented relief for small business owners with the focus on retirement.

##### **4.4.1 Scope of paragraph 57 of the Eighth Schedule**

The small business asset capital gains tax exemption allows relief for small business owners when they dispose of assets under certain conditions. An exemption of R1.8 million is allowed for capital gains tax purposes. The exemption has several significant limitations, one of which is that the R1.8 million exemption is a life-time restriction.

##### **4.4.2 Qualifying criteria of paragraph 57 of the Eighth Schedule**

For the exclusion to apply, several criteria must first be satisfied. According to paragraph 57(2) of the Eighth Schedule, a natural person is required to ignore any capital gain decided in respect of the disposition of any of the following:

- a) A natural person's interest in an active business asset of a small business owned by that natural person as a sole proprietor or,

- b) An interest in each of the active business assets of a business, which qualifies as a small business, owned by a partnership, upon that natural person's withdrawal from that partnership to the extent of his or her interest in that partnership or,
- c) Any direct interest (shareholding) in a company (which consists of at least 10% of the equity in that company), to the degree that such interest relates to active business assets of the business, that qualifies as a small business of the firm.

In situations where the asset in issue is a membership interest, such as a share, the exemption will be applicable if the membership interest is linked to an underlying qualifying asset via the use of the 'see through' method where the exclusion will apply if underlying company assets falls within the qualifying criteria.

This exemption is only available to small business owners who are natural persons, and it is only applicable in respect of retiring people over the age of 55, or in situations where retirement is due to ill-health or infirmity, and the assets have been held for a minimum of 5 years before the individual retires. The exemption is not accessible to individuals under the age of 55. Ssennyonjo (2019:85) mentions that the age limitation on individuals of 55 years is particularly limiting as few small business owners in South Africa are older than 55 years.

An individual who has died may be eligible for exemption from capital gains tax (CGT) on capital gains of up to R1.8 million in respect of the considered sale of small company assets at the time of his or her death. This is a once-in-a-lifetime concession, and if the deceased has previously made use of the concession, it will not be accessible to him or her upon his or her death (SARS, 2021c).

Sole proprietors, partners, and owners of 10% or more of a small business company or close corporation who dispose of an asset or interest with a market worth of less than R10 million are eligible for a capital gains tax benefit. If the individual owns more than one business, all the assets of all the businesses are added together to determine the R10 million threshold requirement, and the exemption applies to the total of the capital gain from the sale of all the businesses' assets.

The term 'active business asset' refers to an asset that is immovable property to the extent that it is used for business purposes, or an asset other than immovable property that is used or held wholly or exclusively for business purposes. Financial instruments and an asset held while carrying on a business primarily to derive any income in the form of an annuity, rental income, foreign exchange gain, royalty, or any other income of a similar nature are not included in this definition.

Although assets other than immovable property must usually be utilised fully and exclusively for business purposes to qualify as active business assets, the section explicitly includes immovable property but to the degree that it is employed for business purposes. The implication of this is that even if a piece of immovable property is utilised partially for business purposes, it may qualify as an active business asset even if the property is not used fully and exclusively for business reasons. A disposition of a section of real estate that is currently in use would be considered a disposition of an active business asset. Additional requirements include having to realise the whole amount of the qualifying capital gains in 24 months starting on the day the first qualifying disposal was made.

#### **4.4.3 Administration of paragraph 57 of the Eighth Schedule**

The restriction of the small business asset exemption to retiring natural persons owning assets in SBCs together with the qualifying assets limitations and exemption threshold, greatly reduces the tax monitoring and compliance of the section to a small group of taxpayers. This limitation was highlighted by Ssenyonjo (2019:85) as only allowing 16.6% of small business owners to qualify for the exemption.

Although this may lead to reduced administration, the effectiveness of the incentive comes into question. According to the Davis Tax Committee (2016:25) the SBC incentives have increased in number, and they currently amount to a sizable discount available to SBC owners. They mention that there is however no proof that the SBC incentives are having the desired effect on job creation. What is concerning is the fact that SBC numbers are really decreasing, indicating that very few SBC owners reach the age criteria for the paragraph 57 relief.

#### **4.5 Overview of section 12J**

Section 12J of the IT Act was specifically designed to increase the number of investors to enhance access to equity funding for SMEs. Equity financing has been highlighted as a possible obstacle or limitation for SMMEs (Olawale & Garwe, 2010:731). The VCC would serve as a pooling vehicle, bringing together investors and these businesses. Individual investors would be better protected against overexposure because of this. The VCC will act as an 'angel investor', providing equity and management services to the business in exchange for a share of the company's profits. The VCC retains a substantial stake in the selected business until it reaches a particular level of maturity and growth, at which point it sells the investment for a profit to the public.

The Treasury introduced section 12J as a tax incentive in 2008 to encourage venture capital investments in SMEs. This was done in recognition of the fact that development requires SMMEs and that equity investments in SMMEs have the potential to contribute to economic growth. The

National Treasury (2008:54) said in its Explanatory Memorandum on the Revenue Laws Amendment Bill that the Government's goal is to increase access to equity financing for small and medium-sized companies by providing an investment tax incentive. The VCC was intended to be a vehicle to attract retail investors. Small investors have the benefit of pooling their investment knowledge, while many small investors may pool their investment experience to assist small companies in need of assistance. Two of the most significant advantages of regulating the VCC environment are the provision of liquidity and the management of risks in small business portfolios.

Section 12J was enacted into law on 8 January 2009 and became effective immediately. This section contains all the essential laws related to VCCs, including legislation pertaining to VCCs as an investment holding company. It explains how investors may subscribe for shares in such a business and claim a complete income tax deduction for the amount paid for the shares purchased.

According to the National Treasury (2014:52), the program's uptake had been severely limited since its inception in 2008. This has remained the case even after 2011 revisions. According to the Government, after consultation with relevant organisations, the following amendments were proposed:

- Permanent deductions may be allowed in the event of investments that are held for a certain period.
- If at all feasible, investors should be able to transfer their tax benefits when they sell their assets.
- Specifically, the total asset limit for eligible investee companies has been enhanced from R20 million to R50 million, and the total asset limit for junior mining companies has been raised by one-fifth from R300 million to R500 million.

Other suggestions were to broaden the range of permissible business structures and to exclude capital gains from taxation on the disposal of shares. Even though these proposals were beneficial, the development was still slow. The National Treasury (2016:162) highlighted in the 2016 budget review the challenges it was experiencing with the progress achieved via the VCC regime, noting the difficulties encountered with the development of this sector. Small companies continue to face several difficult challenges, according to the National Treasury. It was reported that a total of 31 venture capital firms were established in 2016. Specifically, the Treasury was concerned that potential investors might abandon their intentions to take advantage of this incentive if certain provisions of the IT Act were applied to these companies. Since the



Government was aware of this, it was decided that the ramifications of this unexpected outcome would be investigated and recorded.

The National Treasury (2017:142) said that, as part of its efforts to encourage investment in small and medium-sized companies, the Government had implemented modest changes to the regulatory framework governing venture capital firms as part of the 2017 budget review. It was recommended that further changes be made to the system to remove obstacles to investment, such as rules relating to investment returns and the need for a company to fulfil specific requirements. This was supported by the participants.

Prior to the latest amendments to section 12J of the IT Act, the National Treasury acknowledged that the VCC system had fallen short of its main objective of encouraging equity investors to invest in SMEs. A significant number of investors believe that the benefits provided to investors under section 12J are insufficient, which serves to restrict the section's efficacy. This has caused the system to become unsustainable since the Government has imposed limitations on investee companies that do not conform to the private equity model on which the regime was founded. It should be noted that the VCC tax incentive rules have, at various times in the past, been applied in a way that differed from the way the National Treasury had intended them to be implemented. Specifically, tax evasion and investment structures that were not in accordance with the original legislative purpose have resulted in this kind of behaviour. While certain aspects of the VCC tax incentive scheme have been modified over time to better address these concerns, the National Treasury continued to express reservations about the system.

According to the National Treasury (2019:133) the causes for the collapse were attributed to abusive behaviour participants. The results of the National Treasury's research and assessment indicate the possibility of abusive behaviour on the part of taxpayers because of the mismatch between the increase in venture capital investment and the increase in section 12J tax deductions claimed by investors. To further limit these abusive arrangements, the National Treasury amended section 12J, which took effect on 1 January 2019.

The National Treasury's 2021 budget review (2021:49) mentioned that during the previous year, the National Treasury requested information on the effectiveness of the VCC incentive from 100 VCCs and 360 qualifying companies. According to the information collected, a total of R11.5 billion had been invested at the level of VCC. A total of R4.2 billion has been invested at the qualifying company level. The total amount of tax paid by qualifying companies in 2019/20 was R207 million, with VAT accounting for half of this amount. Qualification companies employed a total of 8 239 people, with 4 035 of those people being indirect employment, according to the data. In all, just 37% of qualified companies that received VCC funding were able to expand their

operations and generate new jobs. According to the information provided, it seemed that more than half of the investments were in low-risk moveable asset rental structures, low-risk income-producing enterprises, and guaranteed-return real estate investments. Because of the incentive, a total of R1.8 billion in tax revenue has been lost since 2015/16, with R1.7 billion of that going to individuals who have taxable income and make a VCC investment of more than R1.5 million each year receiving the advantage. Approximately R745 million in income was lost in 2018/19 due to the introduction of the deduction limit of R2.5 million, which was implemented in 2019. This evidence suggests that the incentive offers a significant tax benefit to high-net-worth people.

#### **4.5.1 Scope of section 12J**

Section 12J of the IT Act makes it possible to claim a specific tax deduction for qualified venture capital investments. A company that has been approved by the Commissioner provides investors with access to a diverse range of businesses that have the potential to grow. Because risk-targeted businesses have made substantial investments, providing them with a tax credit upfront would encourage investors to evaluate and accept the risk they are taking (SARS, 2020:1).

In line with section 12J, a taxpayer may deduct 100% of the expenditures incurred in connection with an investment in a VCC that has been really made. Previously, an individual may deduct from his gross income up to R750 000 in a single year of assessment, subject to a lifetime maximum of R2 250 000, which might be refilled by any sums of investment recouped under the general recoupment provision. These ceiling amounts were abolished and replaced with no limit to the amount of money that may be deducted. To protect against misuse, anti-avoidance measures have been established in lieu of the previous limitations.

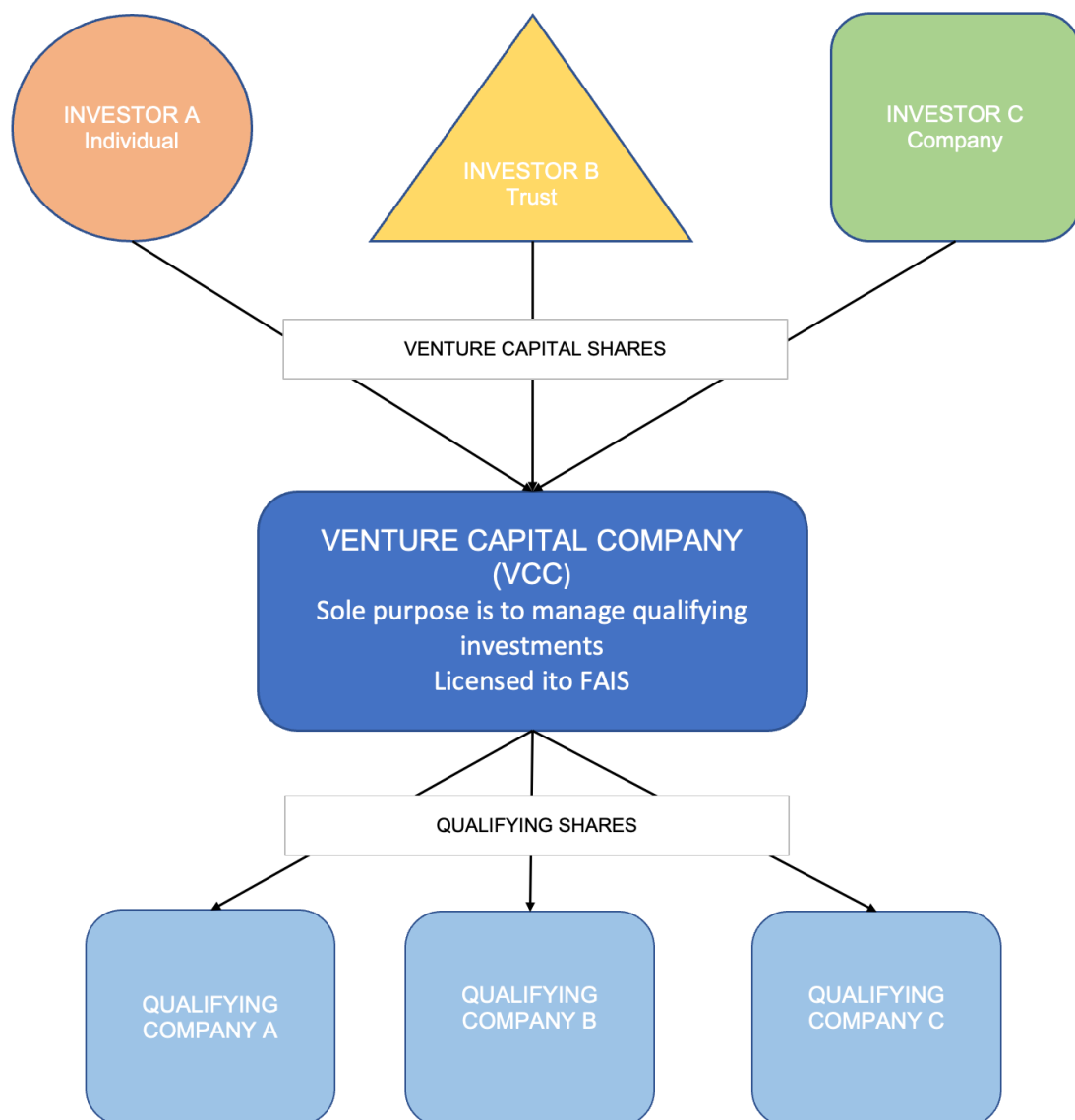
An authorised VCC is a company created to offer investment vehicles to individuals and corporate investors that can increase in value. The VCC gains capital by offering shares of stock to investors, and the money is then distributed to organisations that meet certain eligibility requirements. The VCC would serve as a money-pooling vehicle, channelling funds from a variety of sources to assist these businesses in their growth.

The VCC enters and exits an investment by selling it when the desired business has achieved a certain level of maturity and development. The VCC itself would serve as an 'angel investor', providing funding and services to qualifying companies. Investment holding companies are defined under section 12J(2) and 12J(5) of the IT Act. A taxpayer must make an investment in a VCC authorised by SARS under section 12J of the IT Act to be eligible for the tax benefit (Parker, 2014).

An example of a typical fundraising event would be one in which all the investment money from VCC investors is channelled into a fund created by the VCC itself. This money, which is also referred to as capital or venture capital, is typically comprised of savings or other kinds of collateral. After the money has been received from the investors, it is invested in companies that meet the required requirements (SARS, 2020:3).

The working of the VCC in terms of section 12J can be depicted by the following diagram.

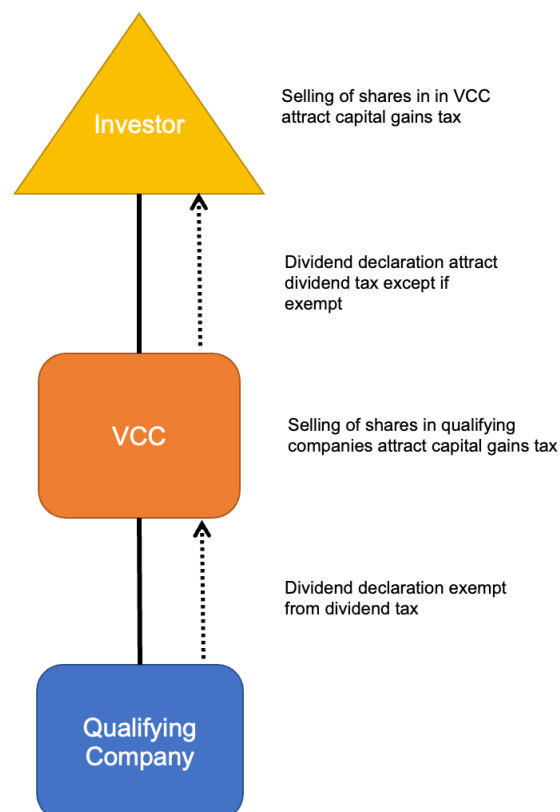
**Figure 2 : The structure of a VCC**



The trading of VCC shares between investors does not have a ready market. Several funds aggressively promoted 'second hand' VCC shares to help bridge the gap. The final exit from a VCC investment can trigger tax on various levels. There is a high likelihood that the VCC will realise the investment of existing investors by either selling their shares in the qualifying companies and then distributing the profits to the investor or by re-purchasing the VCC shares from investors. When the VCC sells its investment in the qualifying companies, the VCC will be liable for capital gains tax at a rate of 22.4% (28% x 80% inclusion rate). Following the payment of CGT on the transaction, the VCC may distribute the cash profits to the VCC investors. A dividend, a return of capital, or a mix of the two may be included in these distributions. Generally speaking, dividends given by a VCC to its investors are subject to dividend tax at a rate of 20% except if the investor is a SA resident company, in which case the dividend tax is zero.

The types of taxes can be seen in this diagram.

**Figure 3 : The different levels of tax in VCCs**



With respect to the buyback of their VCC shares, the investors will be liable to either dividends tax, capital gains tax, or a combination of the two. The tax exemption on dividends will be

available to companies that are residents of SA. As a result, the dividends tax will apply solely to private investors.

When the investor sells the VCC shares or realises the investment, he or she does not qualify for any CGT exemptions that are unique to VCCs. Initially, on the sale of the investment, the amounts deducted were recouped, and any capital gains were subject to tax in terms of the Eighth Schedule of the Income Tax Act. Treasury made certain amendments to this regulation in 2015 to reduce the negative effect of the disposal of the VCC shares after five years.

In the 2014 Draft Explanatory Memorandum on the Taxation Laws Amendment Bill the National Treasury (2014:51) noted that to encourage the VCC regime to gain further ground, it suggested that if investments be kept in a VCC for at least five years, tax deductions would not be recouped. Guiding investors to invest for the proper reasons, rather than just for a tax benefit, is done by including this timeline into the investment strategy. With effect from 1 April 2015 and applicable to assessment years beginning on or after that date, section 12J(9) provides that, notwithstanding section 8(4), no amount shall be recovered or recouped in respect of the disposal of a venture capital share or a return of capital if the taxpayer held the share for a period of more than five years.

This requirement is certainly one of the most limiting as the extension by the Treasury of the required retention time for the investment did not fully exclude the investment from taxation. The reason for this is that although no recoupment of the deduction applies, the base cost of the asset is reduced to zero with the effect that all the proceeds are taxed as a capital gain. Depending on the investor, between 40% and 80% of the investment would be taxable at the applicable tax rate of the investor. The National Treasury (2019:118) alluded to this fact by stating that when the taxpayer sells the investment, he or she is liable for capital gains tax since the asset's base cost is considered to be zero for tax purposes.

Capital gains tax is computed at two different levels: first on the venture capital company and then on the qualifying company. Consequently, the effective capital gains tax rate is greater than it would be if the money were invested directly. It is possible that the taxpayer will be in the 45% marginal tax band, in which case the capital gains tax rate will be higher than 36%. With the 'sunset' clause enacted, there is no way for any investor to reduce this effect except for keeping their shares indefinitely.

#### **4.5.2 Qualifying criteria of section 12J**

All companies categorised as start-ups, small and medium-sized enterprises, and medium-sized enterprises were included in the enterprise sector addressed by section 12J. High-growth and

high-tech businesses, as well as junior mining and exploration companies, were among those targeted. The incentive was created to ensure that a VCC would purchase a specific percentage of interest in a qualifying company to diversify its investment portfolio.

Even though the term 'qualifying investee companies' is used in section 12J of the IT Act, reference is also made to SMMEs in an earlier statement by former South African Minister of Finance, Mr Trevor Manuel, who called for Government support for SMMEs when he proposed the VCC regime in his 2008 budget speech (National Treasury, 2008).

Most industries are permissible for section 12J VCC investments; nevertheless, the legislation specifies certain industries are not permitted by the regulation. Therefore, a section 12J VCC would need to determine whether any of the following elements exist, and if they do, the section 12J VCC would be barred from participating in that particular venture.

It is impermissible to invest in a target company if its gross asset value is greater than R50 million (in the case of a junior mining company if it is greater than R500 million) or if the target company earns more than 20% of its income from investments. The target company must also conduct the majority of its trade or business operations in South Africa.

Section 12J VCCs can invest in a wide range of enterprises with a gross asset worth less than R50 million (R500 million in the case of mining firms) with examples of qualified businesses including (but not limited to) construction companies, manufacturing companies, service companies, mines and contract mining firms; agribusiness enterprises; franchises; hotels, lodges, student dormitories, and bed and breakfast establishments; manufacturers; renewable energy businesses; and general SMEs.

One of the main concerns of the National Treasury had been the focus on investments in enterprises with a high asset base. The argument was that the main objective of section 12J is to set up a mechanism whereby VCCs could have access to funding which they would not normally be able to procure. It is generally accepted that companies with a high asset base find it easier to procure finance and is therefore not in need of venture capital. This was the reason that commercial property as an investment was specifically excluded.

Many 12J businesses received generous contributions from rich donors and venture capital firms (VCCs). As property VCCs have the economies of scale and bigger investment pools that property usually demands, most of the money went to real estate VCCs. As a result, investors neglected to put any money in the investment vehicle save for the tax advantage (Balfour, 2021).

Venture capital firms and the companies they invest in were permitted to have just one class of shares. Due to the change to the tax incentive, the industry has been paralysed. SAVCA and other accountants who participated in public hearings held by parliament's finance committee, as well as those who made submissions on the proposed amendments, agreed that the incentive was being misused, like purchasing second homes during holidays, but they said the Treasury's approach to fixing this problem was far-reaching and not narrowly targeted. In their opinion, the Treasury's suggested solution would put the sector out of business (Ensor, 2018).

Other comments raised included that the majority of VCCs put their money into investment opportunities that are relatively secure, like real estate or assets like equipment. They also invest in the ageing enterprises in traditional areas of the economy. Not the sort of investments one thinks would generate the employment or creativity the nation desperately needs. Some funds have been invested in hotels, equipment rental businesses, alternative energy suppliers, infrastructure, and fibre-optic networks. These are investments that could have been financed by banks. Only a small number of VCCs have shown a clear commitment to growing or establishing high-growth or creative companies or to building and supporting businesses.

The primary purpose of the VCC is to handle investments in qualified businesses. That is to say, a VCC cannot operate another business or manage a trading or long-term investment portfolio in non-VCC assets in addition to managing investments in qualified businesses. According to the relevant Explanatory Memorandum published by SARS (2020:2), with respect to the only purpose of the business, a VCC may not have any objective, even if it is subsidiary in nature, other than the administration of investments in qualifying companies. The memorandum states that if the VCC has extra office space, such excess space may be rented to tenants. It is difficult to discern if a VCC is renting additional space or has purchased more space to increase their available capacity unless the evaluation is done on a case-by-case basis.

The memorandum also alludes to the fact that while a VCC is prohibited from maintaining a trading or long-term investment portfolio in non-VCC assets, it is permitted to make short-term investments using money it obtains via the issuance of equity shares in non-VCC investments. During this interim time, the IT Act does not stipulate what the money may be invested in. To best manage qualifying investments, the kind of investment and the method in which the investment is made must be properly aligned.

Another restriction placed on companies by the National Treasury was that a company might be disqualified if, after 36 months from the date on which the VCC subscribed for its shares, it derives more than 50% of its total receipts or accruals of any trade from investors in the VCC or their connected persons.

It must be noted that section 12J imposes restrictions on both the VCC and the 'qualifying company' whose shares are owned by the VCC. Despite its VCC status, a VCC is taxed in the same manner as a company and does not qualify for any special tax breaks. Both the VCC and the qualifying companies will, however, enjoy the general incentives available to taxpayers. Because VCC dividends typically go from the underlying companies to the VCC, investors will want to get some of their money back either in the form of dividends or as proceeds from the disposal of the VCC's interests in the underlying companies. When a VCC shareholder receives dividends, a 20% dividends tax applies, save to corporate investors who will be exempt from dividend tax.

Section 12J(1) defines a '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 (3A), (3B), (6) or (6A)”.

Section 12(5) states that “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;
- (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;
- (g) the company is licensed in terms of section 8 (5) of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002).”

Companies that are incorporated in South Africa, as well as those whose place of effective management is in South Africa, are included in the definition of resident, but any person who is deemed to be exclusively a resident of another country due to the application of a double taxation treaty entered into by SA and that country, is excluded from the definition. It stands to reason that a VCC may be formed in another country if its seat of effective management is in South Africa, and it is not considered to be exclusively resident in that other country because of the implementation of a double tax treaty between the two countries (SARS, 2020).

It can take an extended time for a prospective VCC to be established. Once the VCC has determined the most appropriate structure, it must prepare and submit an application for registration with the Financial Services Conduct Authority (FSCA) and the Financial Intelligent Centre (FIC) to be recognised as a Financial Service Provider (FSP). The procedure of forming



a company is rather quick, but it is the registration as a licenced FSP with the FSCA that takes the most time and effort to complete (Van Zuydam, 2017).

A VCC must abide by several standards to get authorisation to operate as a financial service provider and to maintain their licence. Gaining authorisation to conduct business as a financial service provider can take several weeks (Van Zuydam, 2017). Thereafter the approval with SARS must be obtained, which could add to the already lengthy process. According to the SARS website, an application as a VCC can be lodged to SARS by using a VCC001 form available from the website. As part of its evaluation, SARS will evaluate whether the business fulfils the criteria. A venture capital firm reference number will be assigned to the applicant if the application is successful, and an acceptance letter will be sent to the applicant. An application rejection letter will be sent to the applicant if its application is not successful. The rejection letter will include the reason or reasons for the rejection (SARS, 2021b).

From inception, one of the main criticisms against section 12J was the initial qualification limitation of the investment to include only individuals, listed companies and their group companies. Previously, only natural persons could claim the deduction, but companies or trusts were not allowed to take advantage of it unless they were a listed company or formed part of a listed company's 'controlled group'. This requirement made it extremely difficult for the VCC to procure investors. The restriction on eligibility has since been lifted and all taxpayers, including legal entities and non-residents, could take advantage of it (National Treasury, 2011).

The initial investment restriction did not apply to a listed company or its controlled subsidiaries; nevertheless, the listed company and its controlled subsidiaries could not own more than 10% of the shares of the venture capital company when combined with their controlled subsidiaries. The threshold percentage was later lifted to 40%. These limitations have eventually been lifted since 2012 (National Treasury, 2011).

Other comments from the industry regarding the shortcoming of section 12J was that bigger investors might snap up all the available shares. Previously disadvantaged individuals and the rising economic class were all unable to engage in the programme. It could never develop without having both size and inclusiveness (Balfour, 2021).

Balfour (2021) added that for private investors the investment required for a VCC might have been set excessively high. One had to invest R100 000 or more and maybe even as much as R500 000 to qualify for an investment in a VCC, with this conferring tax advantages for high-net-worth people. As a result, wealthy individuals resorted to section 12J VCCs. One might claim

that exorbitant minimum investments played a major role in the scheme failing to provide the anticipated outcomes for its mission after almost a decade.

The amount of the investment was also limited for individuals. The previous deduction limit was R750 000 per year of assessment, with a lifetime limit of R2 250 000. The lifetime limit would be replenished if any amounts previously deducted were recouped due to the sale of the investment. The lifetime ceiling amount initially imposed has since been lifted. The yearly deduction limit has however been retained although substantially increased. The retention of the limit was seen by many fund managers as a limiting factor for growth in investment. Many experts have expressed worry over the ceiling for deductions that investors may claim from 21 July 2019, claiming that it would limit the amount of money that venture capital firms (VCCs) can raise (The 12J Association of South Africa, 2020:34).

If a taxpayer incurred expenditure on or after 21 July 2019 in relation to an investment in a registered VCC, the deduction allowed under section 12J(2) in that year of assessment by a taxpayer who is a company was limited to R5 million. For taxpayers other than companies, the deduction was limited to R2,5 million. No mechanism was introduced into the IT Act to enable taxpayers to claim amounts in excess of the limits in subsequent tax years. The deductions could however create or increase an assessed loss for the taxpayer. Unless the investments in the VCC are pure equity investments, the deduction will not be permitted under these circumstances. Investments with debt-like features are completely disallowed (SARS, 2020).

In addition to all these requirements, section 12J(3)(a) sets forth the conditions under which the amount eligible for a deduction under section 12J(2) may be claimed. To determine whether the limitation test has been met a taxpayer, who utilised credit in a year of assessment to fund a previously incurred expenditure and still owes an amount on the final day of the year of assessment, must do the test.

There is no s12J(3)(a) restriction on the deduction for a shareholder who obtains their shares from their own funds. However, section 12J(3) would apply when a taxpayer obtains or finances their portion in the VCC by using some kind of credit. An investor must shoulder the risk of the loan or credit facility if the investment is made using borrowed money or credit. A loan or credit facility that is directly or indirectly granted by the VCC does not meet the 'at-risk' criterion (SARS, 2020).

The amount eligible is set according to section 12J(3)(b), which determines whether the taxpayer is at risk at the end of the year of assessment. To the extent that the investment exceeds the amount to which the taxpayer is exposed, the excess is lost and cannot be deducted.

Sections 12J(3A) was initially introduced in 2012 to prevent investors from making investments in a VCC through various 'connected persons', thereby exceeding the thresholds set. Initially, it was required that a VCC not be controlled by another company. This clause was repealed. This was done in conjunction with the adoption of anti-avoidance measures, one of which would prohibit the deduction provided to an investor if that investor became a 'connected person' to the VCC.

#### **4.5.3 Administration of section 12J**

The administrative cost associated with a tax incentive is directly proportional to the scope and conditions of the incentive. The administrator, SARS in this case, is responsible for monitoring compliance not just throughout the registration process but also during the duration of the incentive programme (Ssenyonjo 2019:60). Many conditions are often linked to rewards that are tied to continuing performance, such as those listed in the section 12J qualifying criteria. This is especially true for performance-based incentives. Such incentives must be monitored on a continuous basis. The fact that it adds an extra administrative load on authorities is offset by the fact that it provides the host government with a realistic picture of how an investment is faring in terms of performance.

SARS's ongoing surveillance of section 12J is essential, not just to ensure that the qualifying criteria are met on a continuous basis, but also to identify tax avoidance or evasion. Tax avoidance creates further problems since various nations have differing views on what constitutes avoidance and what should be done to combat it (Zolt, 2014: 19).

All the tax responsibilities required by the Commissioner's administration must be met. If the VCC has, during a year of evaluation, failed to comply with the criteria, their VCC designation may be revoked. Complying with all registration requirements, submitting all tax returns on time, and paying any tax obligation, interest, or fines are all examples of this requirement.

Comments from the market indicated that VCCs had difficulties because of this stringent regulation since there are only a limited number of investors that are willing to offer initial financing at the beginning of a venture. From a practical perspective, a VCC had to procure a minimum of 6 investors each holding less than 20% at start-up to be able to qualify for the deduction. The National Treasury (2016) again made changes to the IT Act. They noted that there had been a need for reconsideration of the scheduling of the connected person test to provide a more enabling atmosphere for VCCs to operate. It was suggested that the linked person test be conducted for the first time 36 months after the first shares are issued by the VCC and then at the conclusion of each year of assessment afterwards.

As most of the restrictions were lifted the Treasury implemented certain anti-avoidance measures. These measures have also been criticised due to their difficulty to administer. Section 12J(3), section 12J(3A), and section 12J(3B) all apply when deductions for expenditure incurred in acquiring venture capital shares are claimed. Since the first connected person test will only be performed 36 months after the first shares are issued, it should be easier for VCCs to attract additional start-up/angel investors and allow them more flexibility in terms of when they issue the shares during the VCC's start-up period. From 1 January 2017, the connected person test is done after 36 months after the first issue of shares by the VCC. If, after the prescribed time, the connected person test is failed, the VCC's approval will be terminated by the Commissioner.

At the conclusion of every year of assessment, which is more than 36 months from the initial issuance of venture capital shares of that class, the VCC conducts a test on all venture capital shares of that class. The 20% threshold is mentioned, but not how the shares were obtained. Thus, how a taxpayer obtained it is immaterial and the shares bought from other parties will therefore be taken into consideration as well.

In terms of section 12J(3B) the consequences for the VCC are severe in such a case.

- According to paragraph (2), no deduction must be granted in respect of that year of assessment in respect of any expenditure made by the taxpayer in connection with the acquisition of any venture capital share of that class issued to that taxpayer by that venture capital company;
- In accordance with paragraph (5), the Commissioner must, after giving the venture capital firm reasonable notice, revoke any permission given in accordance with that subsection with effect from the beginning of the assessment year in question; and
- A sum equivalent to 125% of the expenditure spent by any individual to purchase shares issued by the VCC shall be included in the revenue of the VCC in the year of assessment in which the permission is withdrawn by the Commissioner.

The penalties relating to non-compliance in the managing of investment as initiated by the National Treasury in 2018 were quite severe. Many fund managers found it difficult to keep up with the changes and found themselves risking the disqualification of the VCC due to these strict requirements. Section 12J outlines the conditions for deregistration and it states that the Commissioner may choose to deregister an entity under certain circumstances. If so, the VCC is in a disadvantaged position as the Commissioner is responsible for making the final decisions on compliance with VCC rules. There is no need under the IT Act for the review of the Commissioner's decision to deregister a company under the VCC system.

Because of policy uncertainty, South African SMMEs and start-ups hesitated to collaborate with section 12J VCCs because they do not trust the viability of the incentive in the long term. The 12J Association of South Africa (2019:6) expressed the sentiment that the uncertainties surrounding the VCC regulation have impeded the South African industry's ability to access capital from investors, as well as hindered the industry's ability to invest that capital in small and medium-sized businesses. In addition, the association expressed the opinion that fund managers' ability to sustainably run their businesses has also been compromised by the regulation. As a consequence of constant changes in the legislation there is a great deal of uncertainty for investors. Therefore, many people prefer to put their money in assets that are deemed safer (i.e., offshore investments) instead of section 12J companies. It is evident from the facts that the section 12J regime was challenging to administer and manage. The abusive behaviours identified by the National Treasury and the subsequent changes to try and prevent these set the regime on its final path.

Constant changing and tweaking of a tax incentive should also be avoided. The OECD (2007a:18) states that the deletion and/or modification of existing tax incentive programmes is likewise seen as a difficult task for policymakers to undertake. Even after their ineffectiveness has been proved, business leaders will continue to exert pressure on the Government to retain, restore, and even enhance tax breaks and incentives as is the case in South Africa.

Section 12J was really an extraordinary addition to the IT Act, although it was impeded by strict eligibility requirements and incorporates many punitive restrictions that were extremely difficult to carry out and which, if broken, resulted in negative tax consequences. Within the past few years the amendments passed have also created consternation for administrators. While administrators and investors both attempt to keep up with the constant stream of new amendments, they must work with several grey areas and legislative changes that are particularly challenging (The 12J Association of South Africa, 2020:40).

Although the section 12J allowance has been discontinued, company and individual investors in VCCs will retain their positions even though they will no longer benefit from tax breaks. They will be seeking a reasonable return on their capital. An important aspect of the actual value of these investments for the local economy is that investors are locked into their positions for at least five years, allowing for the prudent and sustainable creation and expansion of the underlying investee business.

## 4.6 Conclusion

To achieve its policy objectives, the South African Government has established several tax breaks for small companies in the country. These tax breaks vary from progressive tax rates and accelerated capital allowances for small companies to tax deductions and capital gains exemptions for individual investors and other types of businesses. The efficacy of these incentives, on the other hand, has been questioned. Particularly the section 12J allowances have been the subject of significant design modifications resulting in widespread criticism not just from the business community but also from the Government.

As of 29 February 2020, the section 12J industry has raised about R9.3 billion, according to the study done by The 12J Association of South Africa (2020:4). Respondents also said that businesses believe about 82% of the money produced is incremental, which means that further investments of this magnitude and scope would not have happened if section 12J legislation had not been enticing them to do so. Because of the weakening of the South African rand and the weakening of the local economy, high-net-worth individuals, trusts, and businesses in the country are increasing their outside investment flows.

In contrast, when capital investment exits a country the positive impacts that it has on the economy are also lost because of the departure of capital investment. Given that the COVID-19 pandemic is expected to have a negative impact on an already fundamentally weak economy, it is especially critical to encourage South Africans to make long-term investments in their own country for at least the next five years.

With South Africa's economic fundamentals deteriorating and investors continuing their hunt for return the important question will be how the National Treasury can incentivise investors to retain their money onshore where it can continue to support job creation and inclusive economic development. What South Africa needs the most is a more significant number of creative businesses that seek to find solutions to the main issues that the country faces.

A review of present small and medium-sized enterprise capital arrangements and the obstacles they confront in accessing financing was given in Chapter 2. The definition of SMEs was discussed as well as their capital structures in order to identify the criteria for inclusion of these entities in the scope and qualifying requirements of tax incentives. Chapter 3 looked at the design of tax incentives as a tool to aid governments in attracting investors and fostering development in small and medium-sized enterprises and how the scope and qualifying requirements of tax incentives play a role in targeting SMEs. The present chapter concentrated on the various incentives created by the South African Government to aid in the development of SMEs. In order

to provide a better understanding when comparing these incentives to those in other nations, the drawbacks of these incentives have been emphasised. The following chapter seeks to discover similar tax breaks for SMEs in other G20 nations, with the purpose of comparing them to the tax breaks applied in South Africa.

## **5 The design characteristics of tax incentives identified in selected G20 countries and how they are distinguished from those in South Africa.**

### **5.1 Introduction**

The tax incentives granted to investors in numerous G20 countries are examined in this chapter using the design ideas of scope, qualifying criteria, and administration discussed in Chapter 3 and their application to SMEs as discussed in Chapter 2. In Chapter 4 the tax benefits accessible to qualified investors in SMEs in South Africa as well as the shortcomings in their design were examined. Applying the principles from Chapters 2 and 3, Chapter 4 concentrated on all of the design elements associated with these incentives in South Africa.

An important goal of this chapter is to provide a critical comparison between the SME tax relief schemes available in South Africa and those available in other G20 nations. With this chapter the secondary research purpose of describing and comparing the features of tax incentives discovered in selected G20 countries and how they compare to those in South Africa is addressed.

Tax incentives for venture capital and business angel investment have been found by the European Commission (2017:9) to be an important factor in spurring investment. The study was initiated as part of the Capital Markets Union initiative which aims to enhance the European Union's single market by promoting deeper integration of investment throughout the continent.

One of the most often mentioned points was that a growing number of member states are already promoting venture capital and business angel investment via tax breaks and other incentives. They advocated for the sharing of successful projects' knowledge and expertise. The study was done as part of its efforts to promote best practices among EU member states. The study's objectives were to identify potential design characteristics of tax incentive schemes as well as the types of current tax incentive schemes used by member countries of the European Union, and that policy recommendations on tax incentives for investors in general be made. The study analysed the various tax incentives in member countries by ranking them based on certain design criteria.

### **5.2 Tax incentives for SMEs in G20 countries**

A 2015 study by the Organization for Economic Co-operation and Development (OECD, 2015b:3) said that taxation systems frequently offer incentives for SMEs to incorporate and distribute



revenue as equity, especially capital gains. Small and medium-sized enterprises are more susceptible to taxes than big companies. These companies also have higher compliance expenses because certain tax systems handle earnings and losses asymmetrically. These systems also favour corporate debt over equity.

As a way of boosting the availability of early-stage venture capital a growing number of nations are promoting business angel and venture capital investment via explicitly targeted tax benefits. According to Bergner *et al.* (2017:29) tax incentives that are competitive among nations within a region are often the rule rather than the exception. Although a significant amount of theoretical and empirical study has been conducted in industrialised countries to evaluate the effect of tax incentives on economic growth, the issue of whether tax incentives have an impact on economic development continues to be a source of dispute.

In recent years tax incentives intended to promote investment in new, growing, and creative businesses have become a more common component of the overall innovation policy mix, particularly in the United States. According to the European Commission (2017:10) the venture capital ecosystem in the United States is very strong. The United States received investments totalling \$79.3 billion in 2015 with investments in the European Union totalling just €5.3 billion. G20 nations are now offering a broader variety of tax incentives to SMEs. Fourteen G20 countries offer some kind of assistance with unique measures for incentives totalling more than 25.

Incentive programs in G20 countries cover a wide range of various initiatives. Some of these include:

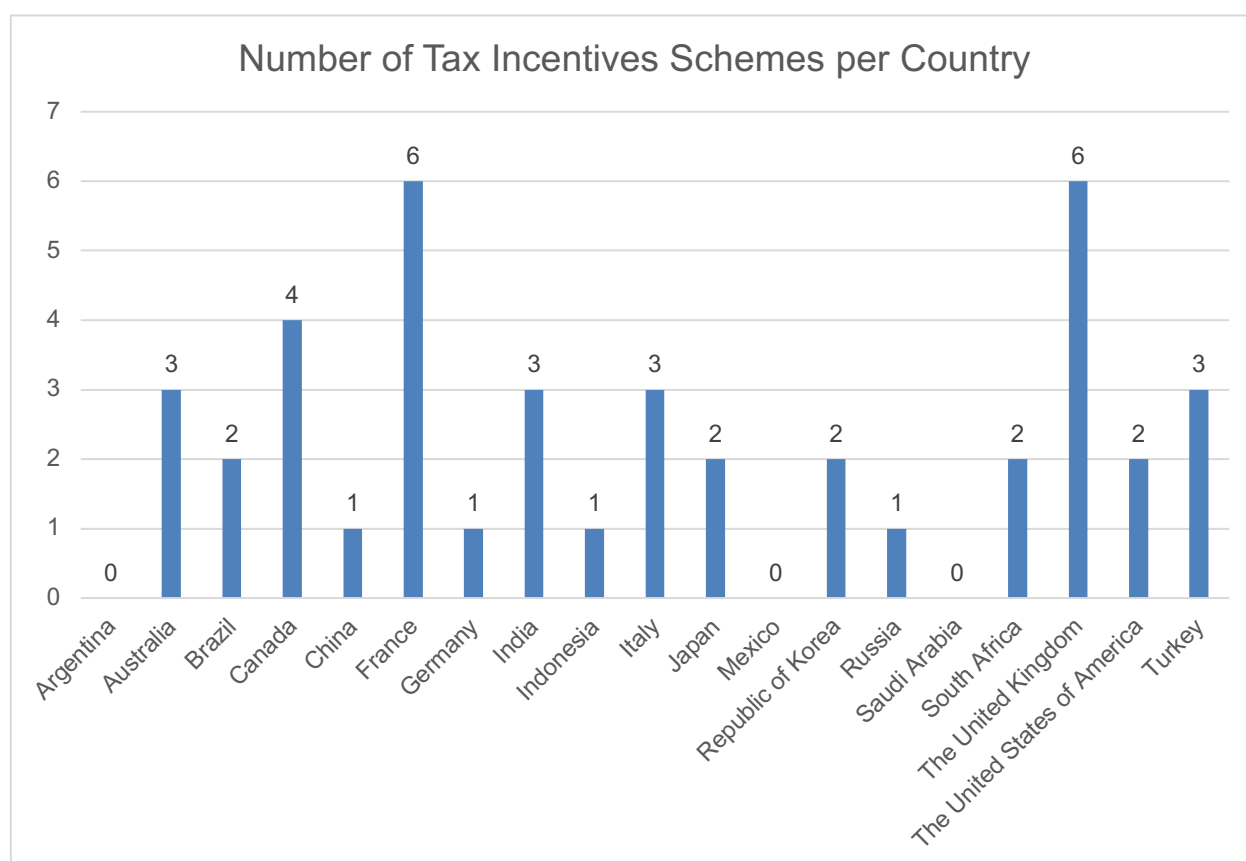
- Early-stage investor programs
- Seed capital tax incentives
- Angel investor tax incentives
- Venture capital incentives
- Development zone tax initiatives
- Social investment tax relief

These types of arrangements include both input-based incentives in the form of full and partial allowances and tax credits as well as output-based incentives in the form of reduced tax rate, exemption of income and other flow-through structures enabling taxpayers to set-off losses against the income from investments they receive. The criteria to define a small and medium-sized enterprise (SME) is mainly consistent with those discussed in Chapter 2 (i.e., the number of employees, sales and total assets). On the other hand, the specific criteria are subject to change on a regular basis.

Small and medium-sized businesses benefit from a variety of tax advantages provided by governments across the G20. Sixteen of the nineteen G20 member nations implemented tax incentives specifically for investment in small and medium-sized businesses with 12 of them allowing for more than one scheme.

The following figure shows a summary of the number of tax incentive schemes available in each country. The table is summarised from the data contained in table 5.

**Figure 4 : Number of Tax Incentives Schemes per Country**



From figure 4 it can be seen that there are currently more than 42 distinct regimes operating in those countries containing 80 different types of incentives. Thirteen of the schemes allow for a combination of input- and output-based incentives. Argentina, Mexico, and Saudi Arabia are among the nations that do not provide assistance in the form of tax relief where France, Canada, and the United Kingdom are contributing the most by way of tax incentive schemes. The United Kingdom (UK) has put in place a plethora of tax exemptions and other incentives to encourage the growth of micro, small, and medium-sized enterprises.

The following table gives a summary of the tax incentives available to investors in G20 countries.

**Table 5 : Tax incentives for investors in SMEs in G20 countries**

Term	Definition
<b>Tax Incentive</b>	The formal or informal name used to identify the tax incentive.
<b>Qualifying Criteria</b>	The criteria used to limit eligibility to certain types of investors and investments.
<b>Input-based</b>	The tax incentive allows for relief when the investment is made. Generally, this is allowed at the start of the investment phase and is based on the amount invested.
<b>Output-based</b>	The tax incentive allows for relief on the amounts received by the investor during and at the end of the investment phase. The relief can apply to income received on the investment as well as capital gains on disposal.
<b>Holding Period</b>	The minimum term in years the investment must be held to qualify for the tax relief.
<b>Size Requirement</b>	The size of the business is restricted by way of specified criteria such as turnover, number of employees or assets.
<b>Corporate</b>	The tax incentive is applicable to corporate investors.
<b>Individual</b>	The tax incentive is applicable to natural persons.
<b>Tax Deduction</b>	The taxable income is reduced by allowing a specified deduction.
<b>Tax Credit</b>	The tax amount payable is reduced by allowing a specified credit amount.
<b>Income Tax Reduction</b>	The taxable income is reduced by way of a partial or full exemption.
<b>Capital Gain Tax Reduction</b>	The taxable capital gain is reduced by way of a partial or full exemption.
<b>Tax Deferral</b>	The tax payment on income or capital gain is deferred to a future date.
<b>Loss Relief</b>	Losses on disposal are allowed to be offset against specified taxable income or capital gains.
	The use of green shading indicates that the incentive is in use.
	The use of red shading indicates that the incentive is not in use.

Country	Tax Incentive	Qualifying Criteria				Input-based		Output-based			
		Holding Period	Size Requirement	Corporate	Individual	Tax Deduction	Tax Credit	Income Tax Reduction	Capital Gain Tax Reduction	Tax Deferral	Loss Relief
Argentina	No special tax incentives schemes	N/A									
Australia	Early-stage Innovation Companies	≥ 1 year									

Country	Tax Incentive	Qualifying Criteria				Input-based		Output-based			
		Holding Period	Size Requirement	Corporate	Individual	Tax Deduction	Tax Credit	Income Tax Reduction	Capital Gain Tax Reduction	Tax Deferral	Loss Relief
	Venture Capital Limited Partnerships	≥1 year									
	Early-stage Venture Capital Limited Partnerships	≥1 year									
Brazil	Angel Investor Incentive Scheme	5 – 10 years									
	Non-resident Investor Scheme for Investments in Unlisted Entities	5 – 10 years									
Canada	Small business Venture Capital Tax Credit	≥4 years									
	Provincial Labour-sponsored Venture Capital Corporations	≥8 years									
	Canadian Controlled Private Corporations	≥2 years									
	Enhanced Capital Gain Exemption	≥2 years									
China	Venture Capital Investment Offset	≥2 years									

Country	Tax Incentive	Qualifying Criteria				Input-based		Output-based			
		Holding Period	Size Requirement	Corporate	Individual	Tax Deduction	Tax Credit	Income Tax Reduction	Capital Gain Tax Reduction	Tax Deferral	Loss Relief
France	Income Tax Deduction on Start-up Investments (Madelin Reduction)	≥5 years									
	Young SME Investment	≥1 year									
	Wealth Tax Reductions	≥5 years									
	Venture Capital Companies	≥5 years									
	Venture Capital Funds	≥5 years									
	PEA-PME	≥5 years									
Germany	INVEST – Venture Capital Grant	≥3 years									
India	Domestic Funds Tax Passthrough	None									
	Transfer of Unlisted Company Shares	≥2 years									

Country	Tax Incentive	Qualifying Criteria				Input-based		Output-based			
		Holding Period	Size Requirement	Corporate	Individual	Tax Deduction	Tax Credit	Income Tax Reduction	Capital Gain Tax Reduction	Tax Deferral	Loss Relief
	Tax Exemption on Share Premium	None									
Indonesia	Venture Capital Investment Incentive	≥10 years									
Italy	Funds for Venture Capital	≥5 years									
	Innovative Start-up Investments	≥3 years									
	PIR (Piani Individuali di Risparmio)	≥5 years									
Japan	Angel Tax system for Individual Investors	≥5 years									
	Tax Incentives to Promote Open Innovation scheme	≥5 years									
Republic of Korea	Venture Capital Funds	None									
	Investors in Venture Capital Funds	None									

Country	Tax Incentive	Qualifying Criteria				Input-based		Output-based			
		Holding Period	Size Requirement	Corporate	Individual	Tax Deduction	Tax Credit	Income Tax Reduction	Capital Gain Tax Reduction	Tax Deferral	Loss Relief
Mexico	No special tax incentive schemes	N/A									
Russia	0% Tax on Sale of Shares	≥5 years									
Saudi Arabia	No special tax incentive schemes	N/A									
Turkey	Venture Capital Investment Companies (VCIC)	None									
	Venture Capital Investment Funds (VCIF)	None									
	Business Angel Scheme	≥2 years									
South Africa	Venture Capital Companies (Discontinued)	≥5 years									
	Small Business Asset Capital Gains Tax Relief	≥5 years									
The United Kingdom	Venture Capital Trusts (VCTs)	≥5 years									

Country	Tax Incentive	Qualifying Criteria				Input-based		Output-based			
		Holding Period	Size Requirement	Corporate	Individual	Tax Deduction	Tax Credit	Income Tax Reduction	Capital Gain Tax Reduction	Tax Deferral	Loss Relief
	Enterprise Investment Scheme (EIS)	≥3 years									
	Seed Enterprise Investment Scheme (SEIS)	≥3 years									
	Social Investment Tax Relief	≥3 years									
	Private Placement Withholding Tax Exemption	≥3 years									
	Business Asset Disposal Relief (BADR)	≥2 years									
The United States of America	Angel Investment Tax Credit Schemes	≥1 year									
	Qualified Small Business Stock	≥5 years									

Table 5 was compiled by the author using information obtained from the report by the European Commission (2017) and from Thompson Reuters (2019).

The table assists in obtaining a better idea of how various nations are approaching this problem. In part, this is due to incentive designs which are tailored to the specific challenges faced by each country and the governments' corresponding tax policies. On the other hand, the data in the table may allow for certain deductions to be made. Preferential tax treatments of equity investments or loans to specific firms may be provided to individuals who make their first investment in small and medium-sized businesses. Countries like Germany, Japan, China and the United States



have opted for the exclusive use of this approach by giving either a tax deduction or tax credit incentive for initial start-up investments.

SME ownership stakes may provide shareholders with tax advantages for their income earned from investments, allowing them to pay less in federal and state income taxes on the money they earn by investing in certain SME ventures. This allows for either a reduction in the taxable income rate or full or partial exemption from tax altogether. In the case of output-based tax incentives, the provision of a relief is related to the output generated by an investment rather than the investment itself, as is the case with tax allowances and credits (Bergner, 2017:31).

The possibility to transfer residual tax deductions or tax credits earned on qualifying expenses to investors via flow-through tax incentives also give much needed relief. In this case countries like Brazil and Indonesia have opted for this method with Italy having a majority of its tax incentives using this approach exclusively. Some tax regimes may provide incentives for the sale or disposal of assets belonging to small and medium-sized enterprises such as exemptions from capital gains, inheritance, and gift taxes. Most of the countries use this method or combined with tax credits to improve investor interest with only Russia applying this approach exclusively to their tax incentive.

Investor tax incentives are standard practice in the G20 nations as shown by an examination of the various regimes available. The incentives on the other hand, vary significantly in terms of their design as well as the extent of their application. As a result, the ability to measure and compare the real effect of existing incentives on the majority of micro, small, and medium-sized businesses may be restricted (OECD, 2015b:62). The European Commission has conducted a comprehensive investigation of tax breaks for SMEs. By evaluating incentive regimes using benchmarking the European Commission came to the conclusion that some tax breaks were more valuable than others.

The tax incentive schemes seen by the research were compared to the standards of good practice established in the study, which served as a baseline for comparison. The scheme rankings were determined by a combination of ratings obtained across three categories: scope, qualifying requirements, and administration. Despite the fact that certain G20 countries were not included in the research it is worth noting that the top 5 most highly rated incentives were from the United Kingdom, France, and Germany, all of which are G20 member countries themselves.

The rankings table taken from the study showed the following rankings:

**Table 6 : Top 5 Tax Incentives as ranked by the European Commission**

Top 5 Tax Incentives for Venture Capital Investors and Business Angels as ranked by the European Commission (2017:17)		
Rank	Country	Scheme
1	United Kingdom	Seed Enterprise Investment Scheme
2	United Kingdom	Enterprise Investment Scheme
3	France	'Madelin' Tax Reductions
4	United Kingdom	Social Investment Tax Relief
Tied 5	Germany	'INVEST' - Venture Capital Grant
	United Kingdom	Venture Capital Trust

By using the design criteria set for tax incentives the characteristics of the incentives can be explored.

**Table 7 : Scope, Qualifying criteria and Administration of Top 5 incentives**

Scheme	Scope	Criteria	Administration
<b>Seed Enterprise Investment Scheme (SEIS) - UK</b>	<ul style="list-style-type: none"> <li>Aimed to promote investment in 'seed stage' companies to assist with start-up capital.</li> <li>Income tax credit equal to 50% of the amount invested by the person, up to a maximum of GBP 100,000 per tax year.</li> <li>Tax relief cannot create a tax loss.</li> </ul>	<ul style="list-style-type: none"> <li>Investors can only be natural persons.</li> <li>SEIS qualifying company must have UK permanent establishment.</li> <li>Must not be listed on stock exchange.</li> <li>Must not be controlled by another company.</li> <li>Gross asset limitation of GBP 200,000 before investment.</li> </ul>	<ul style="list-style-type: none"> <li>Application must be lodged to HMRC.</li> <li>Fund managers must be authorised by Financial Conduct Authority.</li> <li>Tax reliefs applicable if company has spent at least 70% of money raised.</li> <li>Company must report annually to tax and financial authorities.</li> </ul>

Scheme	Scope	Criteria	Administration
	<ul style="list-style-type: none"> <li>Capital gains tax exemption for shares held for at least three years.</li> <li>Partial exemption (50%) from capital gains tax or disposal of profits from other capital assets 'matched' with investments in SEIS businesses within the same tax year.</li> </ul>	<ul style="list-style-type: none"> <li>Less than 25 full-time employees.</li> <li>No prior investments under VC schemes.</li> <li>Sole purpose of 'Qualifying Trade'.</li> <li>Have not actively traded for longer than 2 years before investment.</li> <li>Can only raise maximum of GBP 150,000.</li> <li>Only new fully paid-up ordinary shares.</li> <li>Shares must be held at least 3 years.</li> <li>Tax reliefs applicable if company has spent at least 70% of money raised.</li> </ul>	<ul style="list-style-type: none"> <li>Tax relief can be excluded if not compliant with criteria.</li> </ul>
<b>Enterprise Investment Scheme (EIS) - UK</b>	<ul style="list-style-type: none"> <li>Aimed to promote investment in qualifying companies to assist with growth and expansion.</li> <li>Income tax credit equal to 30% of the amount invested by the person, up to a maximum of GBP 1,000,000 per tax year. GBP 2,000,000 for knowledge intensive companies.</li> <li>Tax relief cannot create a tax loss.</li> <li>Capital gains tax exemption for shares held for at least three years.</li> <li>Capital gains tax on disposal of profits from other capital assets can be deferred if money is invested in EIS.</li> <li>Loss relief against other income tax liability if shares sold at loss.</li> </ul>	<ul style="list-style-type: none"> <li>Investors can only be natural persons.</li> <li>EIS qualifying company must have UK permanent establishment.</li> <li>Must not be listed on stock exchange.</li> <li>Must not be more than 50% controlled by another company.</li> <li>Gross asset limitation of GBP 15m before investment and not more than GBP 16m after investment.</li> <li>Less than 250 full-time employees.</li> <li>Less than 500 full-time employees for knowledge intensive companies.</li> <li>No 'connected' investors allowed.</li> <li>Sole purpose of 'Qualifying Trade'.</li> <li>Have not actively traded for longer than 7 years before investment. 10 years for knowledge intensive companies.</li> <li>Can only raise maximum of GBP 5m, GBP 10m for</li> </ul>	<ul style="list-style-type: none"> <li>Application must be lodged to HMRC.</li> <li>Fund managers must be authorised by Financial Conduct Authority.</li> <li>Company must report annually to tax and financial authorities.</li> <li>Tax relief can be excluded if not compliant with criteria.</li> </ul>

Scheme	Scope	Criteria	Administration
		<p>knowledge intensive companies on rolling basis with lifetime limit of GBP 12m.</p> <ul style="list-style-type: none"> <li>Only new fully paid-up ordinary shares.</li> <li>Certain 'risk to capital' conditions apply.</li> <li>Shares must be held at least 3 years.</li> </ul>	
'Madelin' Tax Reductions - France	<ul style="list-style-type: none"> <li>For cash contributions to the initial capital or capital increases of certain small and medium-sized businesses, as well as for cash subscriptions to mutual funds investing in innovation or local investment funds.</li> <li>French individual investors may be eligible for a personal income tax reduction if they meet certain criteria.</li> <li>For single, widowed, or divorced taxpayers, investments are taken into account up to a maximum annual limit of EUR 50,000.</li> <li>For taxpayers subject to joint taxation, the maximum annual limit is EUR 100,000.</li> <li>According to the percentage of the investments that exceed the yearly limit, the taxpayer will be eligible to receive a tax reduction under the same terms and circumstances for the following four years.</li> <li>The amount of the tax credit is equivalent to 18% of the value of the investment that was completed.</li> <li>The 18% tax credit rate has been temporarily raised in 2020 to up to 25%.</li> <li>When calculating wealth tax, a reduction of 50% is possible up to a maximum of EUR</li> </ul>	<ul style="list-style-type: none"> <li>Must be a French natural person.</li> <li>Shares must be held for 5 years.</li> <li>Business must have less than 50 full-time employees.</li> <li>Business turnover less than EUR 10 million.</li> <li>Business with assets less than EUR 10 million.</li> <li>Must be an unlisted entity.</li> <li>Must carry out commercial, industrial or agricultural activities.</li> <li>Financial or real estate businesses are excluded.</li> <li>Company must be located in France or European Union Area.</li> </ul>	<ul style="list-style-type: none"> <li>No specific registration requirements.</li> <li>Monitoring done based on self-declaration of criteria by investors and companies.</li> </ul>

Scheme	Scope	Criteria	Administration
	45,000 in assets. A combination of the above-mentioned wealth tax reduction and the income tax decrease cannot be applied to a single investment.		
<b>Social Investment Tax Relief (SITR) - UK</b>	<ul style="list-style-type: none"> <li>SITR is intended to assist in raising of funds to support trade activities of a community interest business, community benefit society, or a charity.</li> <li>Income tax credit equal to 30% of the amount invested by the person, up to a maximum of GBP 1,000,000 per tax year.</li> <li>Tax relief cannot create a tax loss.</li> <li>The investment can be in equity or a loan. This is to enable investment in non-corporate charitable entities.</li> </ul>	<ul style="list-style-type: none"> <li>Investors can only be natural persons.</li> <li>Entity must have a social purpose as opposed to commercial.</li> <li>For 3 years the company cannot be controlled by another company, be listed, be in a partnership or control another unqualified company.</li> <li>Gross asset limitation of GBP 15m before investment and not more than GBP 16m after investment.</li> <li>Less than 250 full-time employees.</li> <li>No 'connected' investors allowed.</li> <li>Sole purpose of social benefit.</li> <li>Can only raise maximum of GBP 1,5m.</li> <li>Only fully paid-up new ordinary or unsecured new debt.</li> <li>Debt or shares may not be redeemed within 3 years and carry interest rates not higher than reasonable commercial rates.</li> </ul>	<ul style="list-style-type: none"> <li>Application must be lodged to HMRC.</li> <li>Fund managers must be authorised by Financial Conduct Authority.</li> <li>Company must report annually to tax and financial authorities.</li> <li>Tax relief can be excluded if not compliant with criteria.</li> <li>Reporting of funding and costs is done publicly.</li> </ul>
<b>'INVEST'- Venture Capital Grant - Germany</b>	<ul style="list-style-type: none"> <li>The INVEST financing programme provides assistance to private investors, particularly business angels, in order to allow them to engage with early-stage, creative businesses and provide venture money to these companies.</li> <li>Program includes non-refundable tax-free</li> </ul>	<ul style="list-style-type: none"> <li>Investors can only be natural persons.</li> <li>Must be resident in European Economic area.</li> <li>Investments amount minimum of EUR 10,000.</li> <li>Annual investment limit of EUR 500,000 per investor.</li> <li>Company must be 7 years old.</li> <li>Less than 50 full-time employees.</li> <li>Business turnover less than EUR 10 million.</li> </ul>	<ul style="list-style-type: none"> <li>Company needs to register and be certified.</li> <li>Full business plan submitted.</li> <li>Managed by Federal Office of Economics and Export Control.</li> <li>Registered companies are listed on INVEST website.</li> <li>Annual compliance declarations and submissions.</li> </ul>

Scheme	Scope	Criteria	Administration
	<p>investment grant of 20% of investment.</p> <ul style="list-style-type: none"> <li>• Tax relief on exit.</li> <li>• A lump-sum refund of 25% of capital gains tax on the sale of stock is available.</li> <li>• The amount of capital gains must be at least EUR 2,000.</li> <li>• The exit grant is limited to 80% of the original investment.</li> </ul>	<ul style="list-style-type: none"> <li>• Business with assets less than EUR 10 million.</li> <li>• Company must be a corporation with headquarters in the European Economic Area.</li> <li>• Must have least one branch office in Germany that is registered in the trade register, or a permanent establishment that is registered in the commercial register as innovation company.</li> <li>• Company must show inventive capability.</li> <li>• Must have ongoing trade or commencing trading within 1 year of investment.</li> <li>• Shares must be held at least 3 years.</li> <li>• Only new fully paid-up ordinary shares.</li> </ul>	
Venture Capital Trust (VCT) - UK	<ul style="list-style-type: none"> <li>• VCTs are publicly traded businesses that make investments in a portfolio of higher-risk trading companies.</li> <li>• Income tax credit equal to 30% of the amount invested by the person, up to a maximum of GBP 200,000 per tax year.</li> <li>• Tax relief cannot create a tax loss.</li> <li>• Capital gains tax exemption on disposal of shares in VCT held for at least five years.</li> <li>• Income tax exemption on dividends received from VCT.</li> </ul>	<ul style="list-style-type: none"> <li>• Investors can only be natural persons.</li> <li>• Shares must be held for 5 years.</li> <li>• The VCT must be listed on the London Stock Exchange or admitted to trade on a regulated EU market.</li> <li>• Investments in 'qualified holdings' must account for at least 80% of the total value of the VCT's assets.</li> <li>• A single business cannot account for more than 15% of the VCT's total investment value.</li> <li>• Investment companies (qualified holdings) requirements similar to those of EIS.</li> <li>• Gross asset limitation of GBP 15m.</li> <li>• Less than 250 full-time employees.</li> </ul>	<ul style="list-style-type: none"> <li>• Application must be lodged to HMRC.</li> <li>• Fund managers must be authorised by Financial Conduct Authority.</li> <li>• Company must report annually to tax and financial authorities.</li> <li>• Tax relief can be excluded if not compliant with criteria.</li> <li>• Reporting of funding and costs is done publicly.</li> </ul>

Table 7 was compiled by the author using information obtained from the report by the European Commission (2017) and from Thompson Reuters (2019).

The brief comparison of the top-rated tax incentives identified shows similar design features. The offer of upfront tax savings and loss compensation, among other design features, are found in all of the incentives. All the incentives restrict the investor types to natural persons. Certain design features of tax incentive programmes target certain types of entrepreneurial companies enhancing the efficacy of such initiatives. Combining targeting by business age and size while excluding particular sectors or not using sector targeting may assist to avoid the challenges of picking winners in competitive circumstances.

When looking at the top 5 ranked incentives according to the European Commission report it is noteworthy that both the French and German tax incentives are input-based tax credit incentives whereas the UK incentives are a combination of both tax exemptions (output-based) and tax credits (input-based).

The relatively low administrative burden may also help reduce compliance risks and abuse. Some of the design features covered include restrictions on related parties, new investment targeting, investment levels, and minimum investment holding periods. These design features may not be adequate on their own to enhance investment quality, but together they may assist to restrict the extent of tax avoidance strategies being used. It must also be noted that exit relief in the form of capital gains exemption is also found in a majority of the incentives. A more comprehensive comparison follows in the next section.

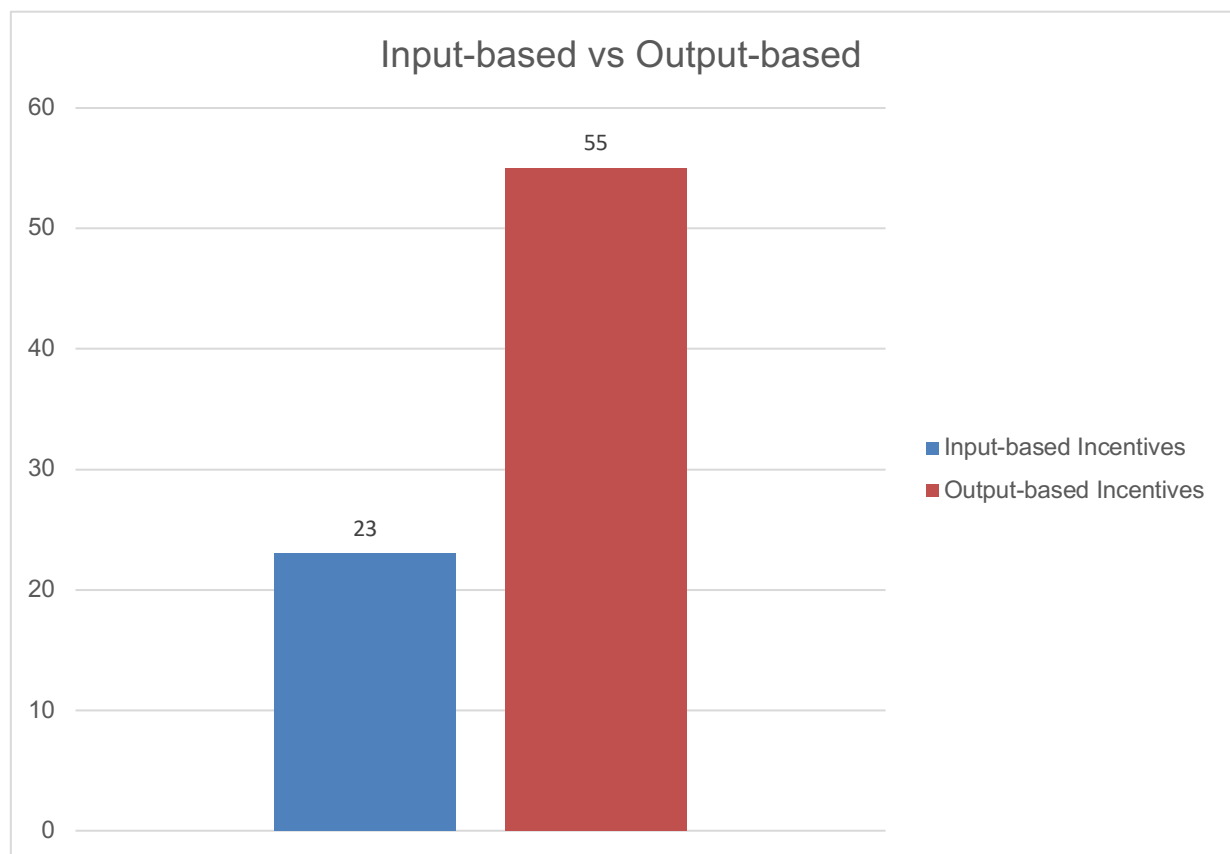
### **5.3 What distinguishes the G20 tax incentives from those in South Africa?**

The results of the research given in this chapter indicate that investors who make investments into SMEs in G20 countries are eligible for substantial tax benefits on their investment, regardless of how the investments are made. The design of the tax incentives is similar in various aspects with certain exceptional differences in some cases.

#### **5.3.1 Comparison of the scope of tax incentives**

When comparing the scope of investments of the G20 countries to those of South Africa the following conclusions can be reached. In general, output-based incentives are preferred above input-based incentives. Twelve of the G20's 19 member countries prefer output-based incentives over input-based incentives. Tax reductions are the most often utilised tool to assist SMEs. Input-based incentives are also being frequently employed, but the emphasis is on providing tax credits rather than tax deductions or allowances. When compared to output-based incentives, the input-based regimes often come with rigorous qualification criteria.

**Figure 5 : Number of Input-based vs Output-based Incentives**

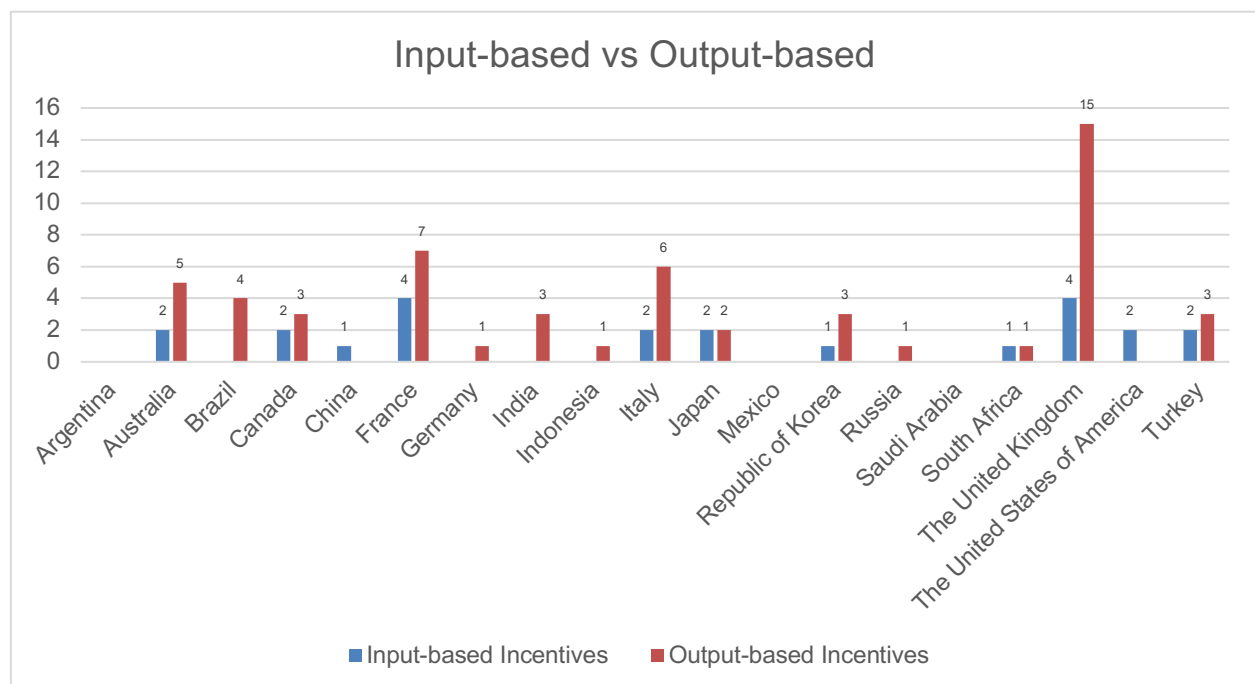


From Figure 5 an examination of the currently available small and medium-sized enterprise incentives reveals that the countries generally prefer output-based incentives with only Germany, China, and the United States shying away from the use of output-based incentives in their respective jurisdictions. Because input-based incentives need more time to administer, it is conceivable that the widespread adoption of output-based measures reflects a deliberate effort to reduce the time required to administer rewards. It is also conceivable that countries with more efficient tax administration systems could opt for more complicated tax incentives.

The European Commission (2017:55) noted that it is safe to assume that any tax system put in place at the start of a venture capital or private equity investment will be designed to address the riskiness of these types of investments, which is a distinguishing feature of these types of investments, and which may result in a financing gap. This could also be the reason why the South African regime struggled at its inception.



**Figure 6: Input-based vs Output-based Incentives by Country**



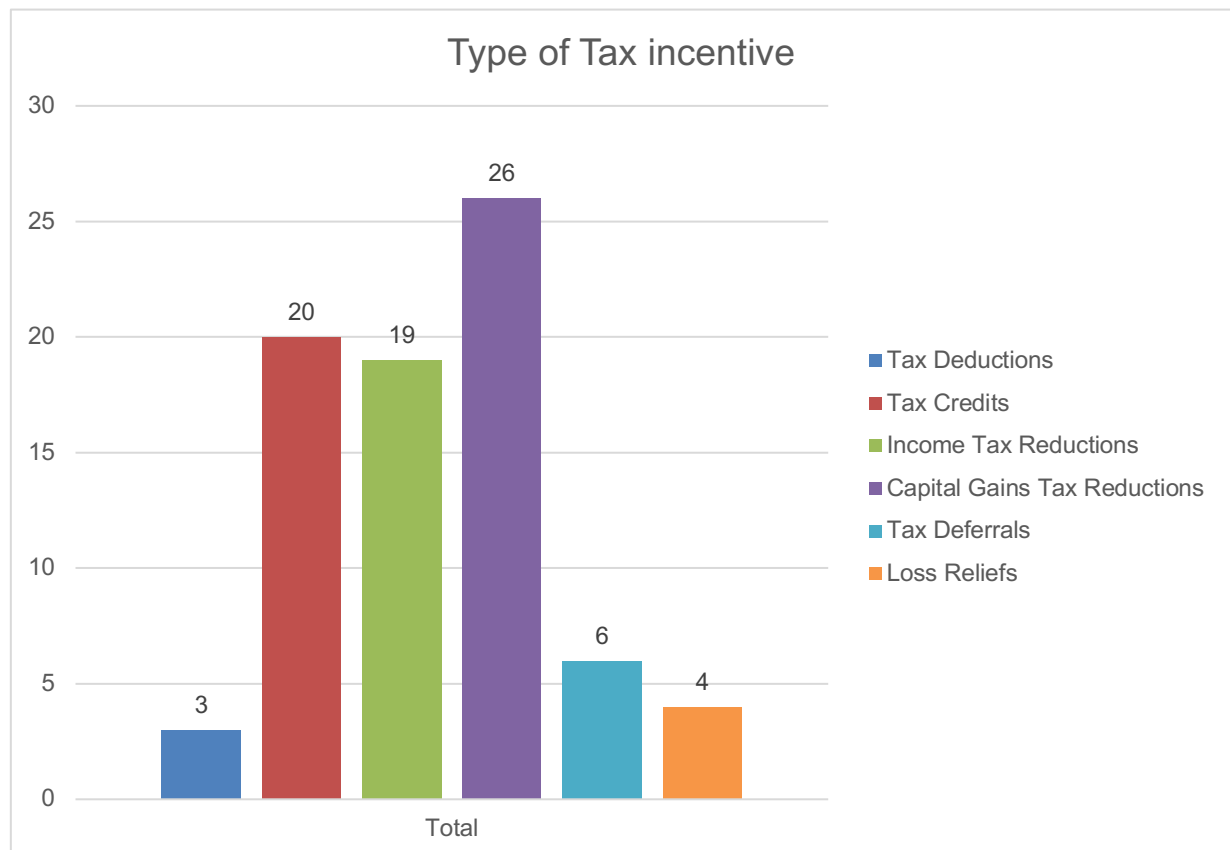
In certain nations small and medium-sized enterprises may take advantage of a variety of tax breaks. When several incentives are given at the same time, they may have an influence on one another's efficacy. The presence of several input- and output-based taxing systems adds a significant degree of complexity to the overall tax system (Abeler & Jäger, 2015:3). Small and medium-sized enterprises are heavily burdened with compliance costs therefore legislators would be smart to provide relief via a restricted number of regimes.

A significant difference between the top 5 tax incentives and the VCC regime of South Africa is the fact that in the relief provided by the UK (4 incentives) and France (1 incentive) is in the form of a tax credit as opposed to the tax deduction as granted in South Africa.

From Figure 7 below and in line with Zee *et al.* (2002:1504) it can be deduced that in general, investment tax credits (ITCs) are one of the most preferred kind of input-based tax incentives. A further argument made by the authors is that, in the case of similar tax rates such as those of companies, ITCs are equivalent to tax allowances in the effective relief it provides. They further maintain that it is more equitable to use the investment tax credits rather than the tax allowances when there are differential or progressive tax rates. As a result, investors subject to a higher tax rate are more likely to benefit from the tax allowances than are other businesses. This was one of the commentaries by the National Treasury (2021:49) in motivating the discontinuance of section 12J. Bergner (2017:30) holds that tax credits in aggregate seem to be the most effective kind of input-based tax incentives. Their traits of openness and impartiality, among others, are

among their greatest assets. It must be noted that although the German 'Invest' scheme does not allow for a tax allowance for credit in initial investment, a cash grant is supplied in its stead.

**Figure 7: Number of Tax Incentives by type**



Another difference is the additional relief given in the form of capital gains exemption at the disposal stage if the investment. In South Africa the tax allowance for section 12J was in essence a timing difference with the initial deduction being allowed but a recoupment enacted if the investment was sold within the minimum holding period or being subject to capital gains tax if sold after the minimum holding period. In his article Poterba (1989:3) claims that increasing capital gains tax (CGT) rates may have a detrimental influence on the amount and quality of investments.

Poterba (1989:3) goes on to say that a higher CGT would result in a poorer after-tax return on equity investments when compared to other types of investments, such as corporate debt. As a result, a decrease in the availability of venture capital would be expected. This contrasts with the schemes in Germany and the UK where capital gains are either fully or partially exempt from tax on the disposal of the investment. In certain circumstances this exemption is given in the UK together with the tax credit on initial investment which makes these incentive schemes very favourable to investors from a tax perspective. It is just the French 'Madelin' incentives which

only gives relief by way of a tax reduction on investment although some relief can be obtained on wealth taxes when the initial allowance was not claimed. Again, the German 'Invest' schemes do things a bit differently by allowing a tax lumpsum refunds on exit.

When it comes to income tax exemption on income received from the investment only the VCT incentive scheme in the UK allows for relief of income tax from dividends received although this principle applied to dividends received from VCCs in South Africa as well, albeit that a dividend tax is withheld on payment.

According to the OECD (2015b:65) small and medium-sized companies, particularly newly formed SMEs, may be more vulnerable to being in a loss scenario than larger organisations, and they may have less accessible cash flow or asset reserves from which to draw upon than larger enterprises. In certain countries this may result in a more flexible approach to the management of losses on investments in SMEs.

Japanese and the UK loss provisions for investments in SMEs are more flexible than those in the majority of other countries. The amount of an investor's investment in specified SMEs is deductible from the amount of taxable capital gains on stock in Japan. Losses on the sale of shares are deducted from taxable capital gains on the sale of shares, and any remaining losses after deduction may be carried forward to future sales of shares. South Africa has no allowances for loss relief which could deter investors from taking the decision to invest as the risk of failure is substantial. Loss mitigation is related with increased risk-taking among investors, according to the European Commission (2017:71), which has an influence on the initial investment decision.

In general, the trend in G20 countries tend to be towards output-based tax incentives as seen from Figure 6. The reduction of either income tax on returns or capital gains tax through exemption seems to be the preferred route. This contrasts with the South African approach of allowing for a tax deduction in the initial investment.

To stimulate investment in venture capital funds the Australian Government has put in place two different programmes. Limited partnership venture capital funds that invest under the Venture Capital Limited Partnership (VCLP) and Early-Stage Venture Capital Limited Partnership (ESVCLP) programmes may be eligible for flow-through tax treatment and other tax concessions for gains or refunds from investments made by the fund under the VCLP and ESVCLP programmes, respectively. These are output-based and incentivise the investor during and at the end of the investment period.

A tax credit or exemption for up-front investment, for example, may lose much of its attractiveness if the investor is taxed at a lower rate (International Monetary Fund, 2009:15). As was the case

in South Africa this may result in incentives systems that are biased in favour of affluent people thus decreasing the efficacy of the incentive. On the other hand, although output-based incentives have potential to increase transparency it could reduce efficiency by encouraging early disinvestment. Investments in newly organised SMEs by venture capital firms in South Korea result in no corporation tax on the profits realised from the sale of their equity shares in the SMEs that they have invested in.

Only a few countries provide a tax refund on tax allowances and tax credits that are more than the tax base (or responsibility, respectively). The most common choices are to carry forward or backward. In most other countries on the other hand, even carry forwards are disallowed or severely limited causing taxpayers who make a loss or have a low profit margin to lose out on the benefits to which they are legally entitled.

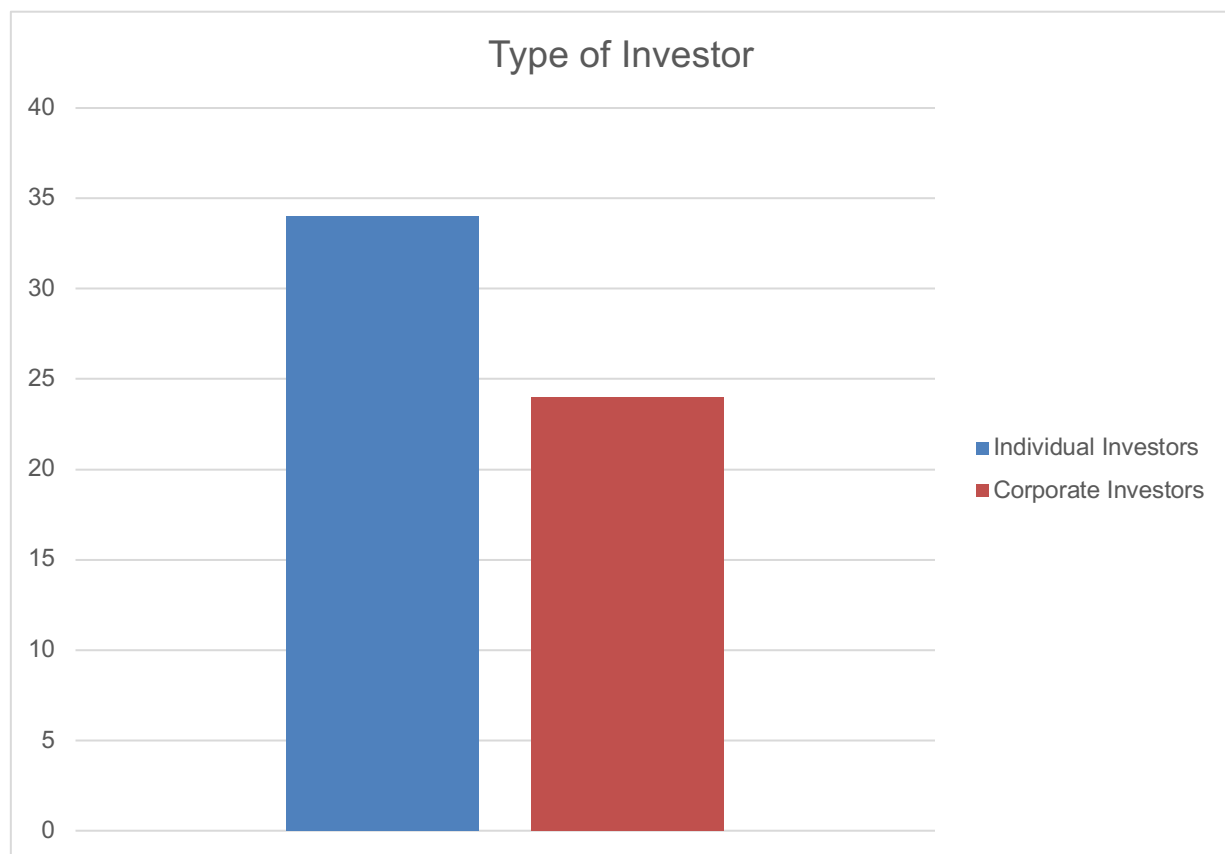
Some input-based incentives may only be utilised under certain conditions, such as deduction limitations or carry-forward requirements which must be fulfilled in order for the incentive to be used. As a consequence, it is possible that the number of small and medium-sized businesses affected, as well as the amount of average effective reliefs, will be much lower for tax allowances, tax credits, and other output-based measures than for non-output-based measures.

### **5.3.2 Comparison of the qualifying criteria of tax incentives**

According to the European Commission (2017:4) the design of tax incentives should include qualifying factors that enhance investment quality, such as performance-related tax relief, in conjunction with elements that encourage adoption of the incentives. When comparing the investor criteria, it has to be noted that all of the top 5 incentives are targeted at natural persons as investors as opposed to companies or institutional investors. This is different to the South African VCC regime which included corporate investors.

The general trend from Figure 8 below also shows that G20 countries have a preference for giving incentives to natural person although not exclusively. However, all of the schemes, including South Africa, exclude 'connected persons' from investment. In South Africa specific changes were made to the regime to curtail the high level of abuse when allowing connected persons as investors. The involvement of investors in the businesses they invest in is however a subject for debate.

**Figure 8 : Type of Investor**



It was revealed that all of the schemes in the G20 countries were administered on a non-discretionary basis due to the application of qualifying criteria. Every scheme uses combinations of qualifying criteria of varying complexity to target certain organisations, investors, investments, and holding term lengths in order to maximise their chances of succeeding.

In all of the instances business size criteria is used to target businesses at certain stages in their life cycle. To target early-stage investment the UK SEIS incentive, the Germany 'Invest' incentive as well as the France 'Madelin' incentive targets smaller business with a maximum number of employees in double figures. The turnover criteria for these firms are also lower than for the EIS and VCT investment schemes. As mentioned earlier the consideration in this regard is whether more established companies have the same need for equity funding as those in a start-up phase.

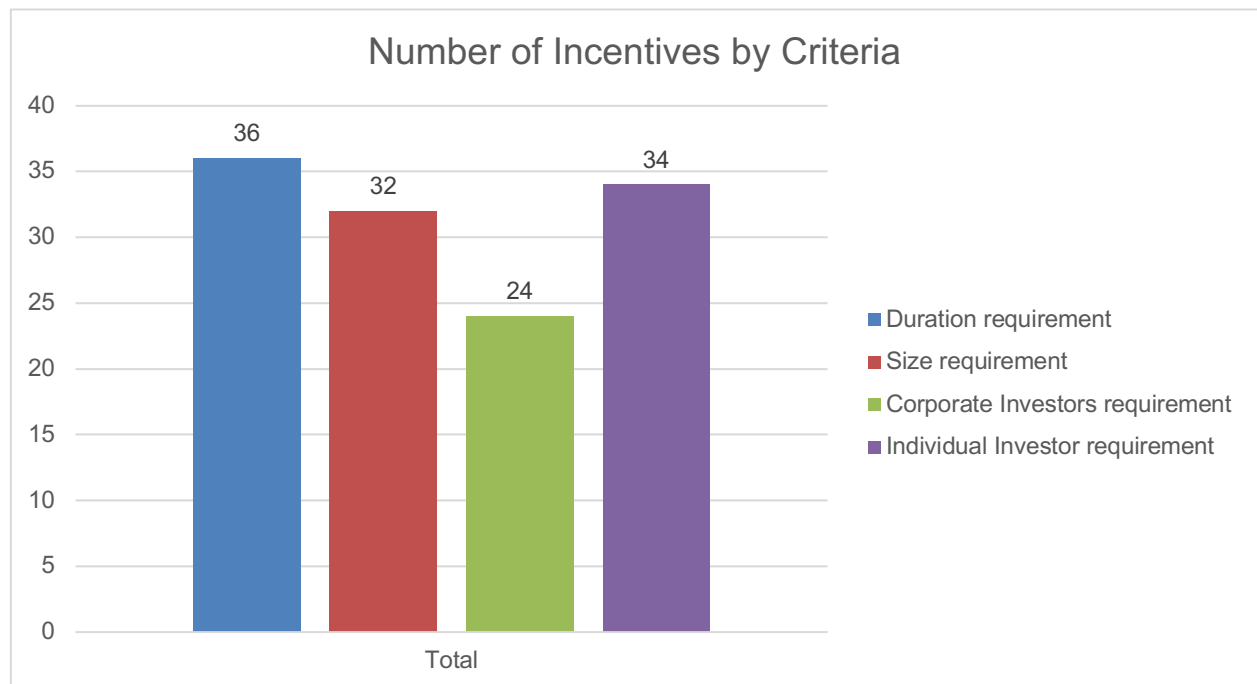
The Seed Enterprise Investment Scheme (SEIS) in the United Kingdom targets entrepreneurial firms based on a combination of variables such as age, size, and sectors that are not permitted to participate. It imposes constraints on the participation of linked parties, but it also offers possibilities for the participation of business angels.

When looking at sector targeting it is clear that the focus is in line with the argument held by Palazzi (2011:15) that sectors with a high concentration of innovation, a high potential to create

knowledge spill overs, or that make a substantial contribution to overall economic growth and development are targets for policymakers. The UK EIS gives additional support for knowledge intensive companies thereby specifically targeting these types of investments. Most of the other incentives use exclusion to narrow down the target group by excluding certain sectors or industries from the incentive.

According to the United Nations (2018:20) the qualification criteria used to target investors serve two purposes: (a) it specifies the types of investment that host governments wish to attract; and (b) it reduces the cost of incentives by limiting the number of investors who benefit from the incentives. Making investments more attractive by focusing on certain criteria raises issues such as whether the government should prioritise some industries, sectors or investors over others or leave investment choices entirely to the market.

**Figure 9: Number of Incentives by Criteria**

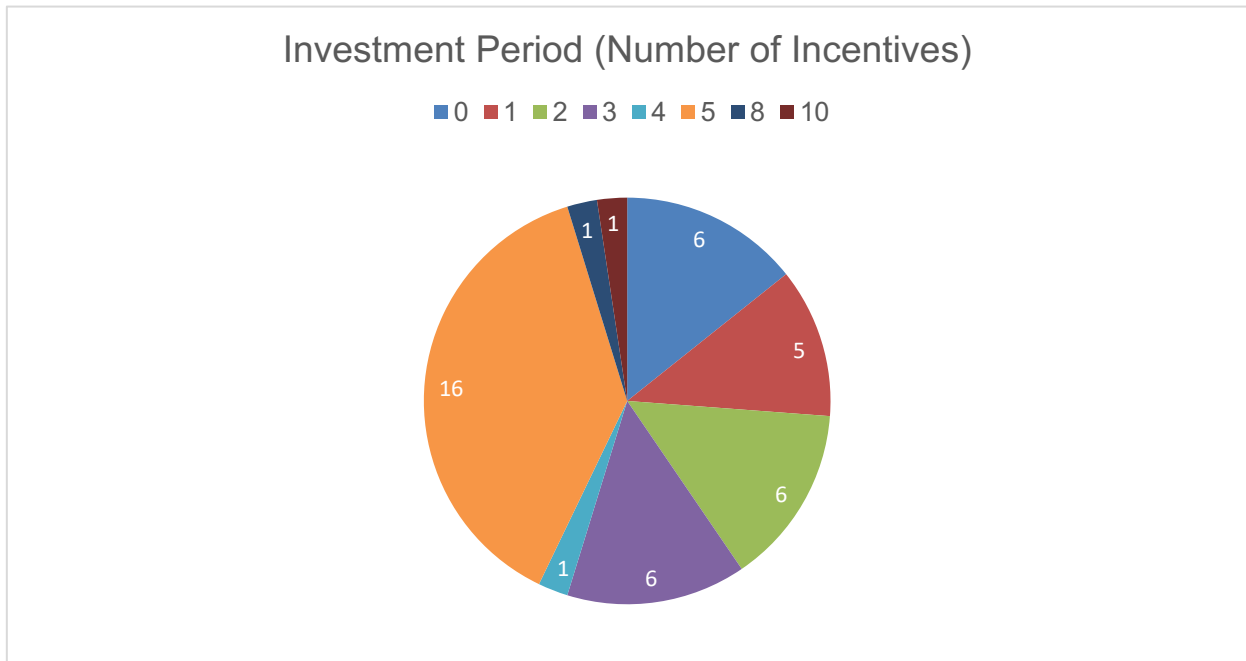


From the information in Figure 9 it can be deduced that although a wide range of criteria exist most of the incentives contain a minimum duration, size and investor type restriction.

The last qualifying criteria is the investment holding term. The inclusion of a minimum holding period is essential to create a sustainable business as this may facilitate knowledge spill over and stability in the business (European Commission, 2017:80). Four of the top 5 tax incentives have a minimum holding period of 3 years whereas both the UK VCT and the France 'Madelin' scheme opt for 5 years.

The general trend among G20 countries is a minimum holding period of 5 years with 16 schemes using this approach including South Africa. It must be noted that very few schemes require a holding periods of longer than 5 years.

**Figure 10: Number of Incentives by Investment Period**



### 5.3.3 Comparison of the administration of tax incentives

As mentioned earlier one of the essential requirements of tax incentive administration is the constant monitoring of tax incentives. Tax administration requires three things according to Bird and Zolt (2008:82) which are the political will to manage the system effectively, a clearly defined strategy for getting there, and the resources required to do the task. If the tax system is well-designed, appropriate for the country, and understandable and simple, the effect could be positive. But even the best-designed tax system will not work unless these three conditions are fulfilled.

The complexity of all the qualifying criteria used in the tax incentives identified makes monitoring difficult. The European Commission (2017:5) found there was a general lack of open monitoring of fiscal expenses and economic effects across the board as few countries monitor and report these on a continuance basis. In general, it is difficult to measure the effectiveness of administration due to the lack of information. For purposes of this study a brief comparison of the administration of the top 5 incentives is made to that of South Africa.

All of the tax incentives require some form of pre-approval with the France 'Madelin' deduction administrative process probably being the least onerous. The requirement to register for financial

services is seen as the biggest administrative burden for businesses but also creates a level of trust for investors as the compliance requirements are continually monitored as in the case of the South African and UK investment schemes. The German 'Invest' incentive is not managed by the revenue authority but by the Federal Office of Economics and Export Control. All of the incentives require annual compliance and reporting with various schemes requiring public reporting as in the case of the UK Social Investment Tax Relief scheme (SITR).

According to the European Commission (2017:180) keeping the maximum monetary value of tax incentives under control makes it feasible for tax incentive programmes to be properly managed and effective. Capping investment levels are beneficial for both fiscal and tax reasons, since they help to restrict the extent to which incentives may be exploited for tax planning purposes. Maximum investment thresholds guarantee that these programmes do not have an excessively distorting impact on the market by taking into account the fact that administrative costs associated with a specific investment are limited.

The fact that the administrative burden increases with the complexity of the tax incentive is one of the key factors to consider when designing a tax incentive. The monitoring by way of public reporting assists in the transparency of these tax incentives as can be found in the UK Social Investment Tax Relief scheme. Registration requirements for VCC are generally one of the major administrative burdens in VCC tax incentive regimes (Holland & Vann, 1998:12).

From Chapter 4 the comments made by the industry relating to the heavy burden of administration on both the taxpayer and the regulators could possibly not be worth the while. The VCC regimes found in the top 5 incentives require that the VCC be registered and administered by fund managers. This may reduce the risk but increases not only operational but also administrative costs. According to Bergner (2017:140) administrative simplifications should be the first line of defence against excessive compliance requirements, among the several types of relief that may be implemented. It is expected that requiring streamlined tax accounts, fewer tax reports, and fewer tax payments reduces the compliance costs of businesses.

## **5.4 Conclusion**

This chapter achieved the secondary research objective as mentioned at the outset of this chapter by evaluating the differences between the various types of tax breaks offered by South Africa and selected G20 countries. No matter how similar tax incentives seem it is critical to keep in mind that they all address different policy issues, and no two countries have the same set of issues. UK tax incentives have historically performed well, with four of them being rated as being in the top five in the European Commission's evaluation system.



It is a proven truth that tax breaks have both positive and negative features, and governments continue to provide new tax advantages while eliminating those that are deemed unnecessary and costly. When it comes to the design and implementation of tax incentives extreme vigilance should be used to guarantee that no loopholes exist that may allow the tax system to be abused. Chapter 6 of this study presents the findings of the research on the design characteristics of various incentive regimes in selected G20 countries and how these are distinguished from those in South Africa. Certain recommendations are made in this regard.

## **6 Summary and Conclusion**

### **6.1 Introduction**

Chapter 1 of this research gave the background of the challenges faced by the South African Government in the growth and development of SMEs. This problem is exasperated by the struggles of SMEs to obtain funding throughout their life cycle. The initiative by the Government includes the implementation of tax incentive programs of which one of these were the introduction of section 12J which gave investors in Venture Capital Companies some much needed relief. The section was however fraught with problems and eventually was discontinued in June 2021. With this in mind the problem statement and research objectives were defined as well as the research methodology that addressed them.

Chapter 2 discussed the challenges SMEs face in obtaining finance and how that relates to their capital structures. The ambiguity around the term 'small and medium-sized companies' makes a comprehensive assessment of tax-related and other issues such as management and finance problematic. The chapter looked at the definition of SMEs and how it relates to the South African economic climate. The capital structures of SMEs were then discussed and the various finance methods were explored. Small and medium-sized enterprises need funding at every step of their life cycle, from seed funding through development and on to the latter phases of their existence. A lot of these organisations struggle to get funding and therefore cannot grow beyond the SME category, which in turn hinders them from progressing economically.

To address the lack of finance available to SMEs governments across the globe utilize tax incentives in an effort to attract investment in this sector. Chapter 3 discussed the characteristic and design qualities of tax incentives specific to those relating to investors in SMEs. Tax law incentives provide favourable treatment for certain activities, investments, or contributions. They therefore need to be designed properly to achieve their purpose. Effectiveness, simplicity and transparency, neutrality and efficiency were identified as key qualities in the design of tax incentives. The core design areas of scope, qualifying criteria and administration were discussed and the effect they may have on the effectiveness of the tax incentive.

In Chapter 4 a summary of the different tax incentives available to SMEs in South Africa were given. This chapter examined the development of tax incentives for SMEs in South Africa. The working of the tax incentives was discussed. Sections 12E, 12J and the small business asset capital gains tax exemption allowed in the IT Act were examined in detail, with particular attention paid to the design requirements for scope, qualification, and management. The difficulties that the Treasury and investors have had with the law were addressed and the many modifications

that have been made to deal with them were examined. Regulation uncertainty made dealing with section 12J VCCs unsettling for SMEs and start-ups in South Africa. The conclusion was reached that South Africa needs better alternatives.

Using the design concepts of scope, qualifying criteria, and administration introduced in Chapter 3, the tax incentives offered to investors in several G20 nations were analysed in Chapter 5. Tax incentives for venture capital and business angel investment have been found to be an important factor in spurring investment. The tax incentives for investors in SMEs in G20 countries were firstly summarised and analysed. The top 5 incentives identified were then described considering the scope, qualifying criteria and administration.

The purpose of Chapter 6 is to consider and evaluate the findings and recommendations presented in the preceding chapters. This chapter uncovers various South African VCC regime alternatives implemented in selected G20 countries. It summarises the most important findings of the research, makes recommendations for correcting the weaknesses that were discovered, and suggests future research directions for the South African VCC regime.

## **6.2 Research objectives**

The main objective of this study was to compare the tax advantages available to small company investors in South Africa to those available in other G20 countries. This study aimed to shed further light on tax incentives in South Africa and other countries to identify possible tax benefits for SME investors in those countries.

By addressing the secondary objectives, it was feasible to achieve the primary objective. The following secondary objectives guided this study:

To provide an overview of and consideration for the definition of SMEs and the operation of their capital structures. This objective was addressed in Chapter 2.

To define and evaluate the design features of tax incentives for investors in small and medium-sized enterprises (SMEs). This objective was addressed in Chapter 3.

To provide an overview of the present South African law pertaining to tax breaks for investment in small and medium-sized enterprises. This objective was addressed in Chapter 4.

To describe and consider the design characteristics of tax incentives identified in selected G20 countries and how they are distinguished from those in South Africa. This objective was addressed in Chapter 5.

### **6.3 Summary of research results**

The findings of the research, as summarised in the preceding part, are addressed in detail in the next section. This summary focuses primarily on the accomplishment of the study's secondary goals. It is not intended to be comprehensive.

#### **6.3.1 Definition of SMEs and their capital structures**

This research investigated the many meanings of the word SME, both inside and outside of South Africa, in order to better understand what it means. In chapter 2 various meanings of the word were discovered which presented some difficulties when attempting to compare them. It was discovered that in order to offer tax and regulatory clarity for taxpayers and tax administrations, the design of SME tax incentives should be specified using particular, clear-cut criteria for businesses with a specific emphasis rather than general requirements for all companies.

In the realm of SMEs there are many variables that influence their definition. Small and medium-sized enterprises are difficult to define for a variety of reasons, one of which is that their size varies depending on the size of an economy. SME definitions have been developed by the European Commission with the most popular and often used term being small and medium-sized enterprise (SME). Depending on the number of workers, yearly income, and the size of their balance sheets, it was discovered that enterprises are categorised as micro, small, medium-sized, or big based on their size.

It was also discovered that the criteria used by the Organization for Economic Co-operation and Development (OECD) and the International Finance Corporation were remarkably similar to those used in South Africa. In order to offer tax and regulatory clarity for taxpayers and tax administrations, the design of SME tax incentives should be set using precise, clear-cut criteria for enterprises with a specific emphasis in order to provide tax and regulatory clarity for taxpayers and tax administrations. Qualitative and quantitative measurements may be used to differentiate small businesses from their larger rivals.

Small and medium-sized enterprises have a nebulous definition owing to the fact that the size of a company fluctuates with the size of the economy. The Organization for Economic Co-operation and Development (OECD) defines SMEs as companies with less than 249 workers, which may be categorised as micro, small, and medium. This is a condition that is analogous to that which exists in the country of South Africa.

When describing a firm's capital structure, it was discovered that the mix of debt and equity that the company employs to fund its operations must be considered. There are many factors that

affect how SMEs use external financing. In chapter 2 of this study it was discovered that SMEs have difficulties getting the funding they need, which restricts their ability to grow beyond the SME category and, as a result, hinders their economic growth. Small and medium-sized enterprises were particularly hard hit by the financial crisis's reduction in bank lending, a major source of SME financing.

As a starting point for discussing the many kinds of financing accessible, the choices may be divided into two categories: direct finance and indirect finance, as well as a mix of both. Whereas direct finance is concerned with equity investment, indirect finance is concerned with debt. It was determined that the success of SMEs over the long term is critical for long-term business investment, maintaining innovation, value creation, and economic development in general. Equity funding is essential for businesses with a high risk/return profile, such as start-ups and creative industries, as well as for corporations in the early stages of development. As many SMEs have challenges in securing enough capital, equity financing for SMEs offers a compelling economic basis.

Debt and equity are fundamentally different in terms of their commercial characteristics. There is a distinction between debt and equity in that debt takes priority over equity as a creditor claim in a firm and often generates a return in the form of interest payments. While debt is less risky than equity, it provides a more predictable but lower-yielding return in the form of periodic interest payments. Equity is often regarded to be a higher-risk investment vehicle (as opposed to debt) with more unpredictable returns and the potential for greater rewards in the form of capital appreciation and/or increased dividends.

### **6.3.2 Tax incentives and their design**

In Chapter 3 the design features of tax incentives and their application was discussed. It has been determined that the phrase 'tax incentives' refers to particular laws that allow a person or organisation to reduce their tax obligation in certain circumstances. The efficacy of tax breaks has been investigated and preliminary findings indicate that there is no general agreement on the issue. A broad variety of investment incentives have been created by governments in an effort to attract investors to make investments in their countries.

It was found that investment neutrality may be threatened by, for example, incentives that have a considerable influence on eligible firms, since more generous reliefs are typically accompanied by increased discrimination against non-eligible investments. In addition, as the standards get more sophisticated, the precision with which eligible businesses are targeted also increases. Diverse government initiatives over the last several years have focused on a broad range of

programmes, including those aimed towards supporting new entrepreneurial start-up companies in their formative phases.

Thereafter, the design features of tax incentives were investigated, and it was discovered that tax incentives must be successful and efficient while also being neutral and simple to apply and comprehend. The extent of the tax incentive, the qualifying conditions, and the administrative procedures were the three primary considerations in its creation. The conclusion was reached that the effect of tax incentives varies depending on the aim and conditions of their establishment and that there is no one solution that applies to all situations.

It is possible that a well-designed tax system will contribute to the accomplishment of both social welfare and financial stability at the same time. The capacity of a government to attract investment that might otherwise depart for a different region or country is dependent on the extent to which it gives tax breaks to investors. When it comes to economic decision-making, tax incentives play a major role. While these incentives may be very generous, they can also result in a more complicated tax system.

The design elements of tax incentives focused on three areas. Those of scope, qualifying criteria and administration. The definitions of these elements were discussed and how they fit in the design of tax incentives. The purpose of this approach was to facilitate the evaluation of tax incentives in South Africa and the G20 countries in the chapters to follow. It was found that the scope, qualifying criteria and administration plays a major role in effective working of a tax incentive.

An incentive's scope may be summarised by describing its nature as well as how it is applied. A criterion for qualification is a factor in the targeting process used to provide tax incentives, and it is used to guarantee that some taxpayers are included while others are excluded. It was further discovered that the administration of a tax credit is focused on the ongoing monitoring and reporting of the credit, as well as its compliance component. Complexity is created by a variety of qualifying requirements for tax incentives, regardless of the kind of relief. Because of this, the SME sector's overall usefulness is under question because of the increased compliance and administrative expenditures they will impose.

It was found that the scope of tax incentives can be divided into input-based and output-based incentives. At the beginning of an investment, input-based incentives are often offered, while output-based incentives concentrate on the return on investment throughout and at the conclusion of the term of the investment.

The difference between input-based tax incentives such as an investment tax credit and output-based tax incentives such as a capital gains tax exemption, is that the latter is only available if the investment results in a capital gain, whereas the former is not dependent on whether the investment was successful or not.

The qualifying criteria of tax incentives were discussed next, and it was found that they are used to target specific investors and companies when designing tax incentives. Various criteria could be used including business size, age, and investor profile among others. Each criterion has its own challenges and should be considered carefully as to not inadvertently exclude certain companies or investors which would normally qualify.

Finally, the administration aspect of tax incentives was discussed. It was found that the cost of tax incentives could outweigh their benefits as tax incentives need the redirection of administrative resources from revenue collection to compliance, since the rules and execution of the tax incentive must be verified on a constant basis.

The specific local circumstances and goals, as well as the findings of systematic policy research, must all be taken into consideration when evaluating the advantages and disadvantages of each tax incentive instrument to ensure that well-informed decisions about which tax incentive instruments to use are made. In order for a tax incentive to be successful, it must be simple to comprehend, execute, and monitor, and it must ultimately achieve its original objective.

### **6.3.3 Tax incentives available to investors in South African SMEs**

Chapter 4 examined the historical context of tax incentives for SMEs in South Africa, as well as the development and operation of sections 12E and 12J of the Income Tax Act and paragraph 57 of the Eighth Schedule to the Income Tax Act.

It was found that investors in small and medium-sized businesses in South Africa have enjoyed limited benefits from tax advantages in the past. Capital gains exemptions on company assets sold upon retirement were the primary sources of available relief, with one incentive scheme at the corporation level (section 12E) and one at the investor level (section 12J) providing some relief to investors. According to the findings, both section 12E and section 12J were harshly criticised for their intricacies and difficulties in administering the laws. According to the findings, a more in-depth examination of the workings of and difficulties associated with implementing section 12J was required in order to fully comprehend the issues encountered.

Chapter 4 also looked at the design elements of the incentives available in South Africa, with particular emphasis on the design criterion for scope of application, qualification requirements, and administration discussed in Chapters 2 and 3.

The introduction of section 12E of the Income Tax Act in 2001 provided SMEs with favourable tax rates and income tax credits for the acquisition of plant and equipment, regardless of the kind of equipment purchased. Companies that fulfil the description of a 'small business company' are eligible for tax relief under this provision, which includes lower corporation tax rates as well as expedited wear and tear allowances. Section 12E additionally allows for significantly lower tax rates to be paid by organisations that meet the conditions for being designated as SBCs.

Small company owners with a focus on retirement were offered relief from the introduction of capital gains tax in 2001 by the National Treasury. Under certain situations, small company owners who sell assets qualify for a capital gain tax exemption under the small business asset capital gains tax exemption. Owner-operators of their own businesses may find it difficult to save for retirement in the traditional sense. Small business entrepreneurs face unique obstacles during the course of their careers, and the firm itself serves as a retirement savings vehicle.

Finally, the VCC regime in South Africa were discussed. The difficulties that the Treasury and investors have had as a result of the design of section 12J were discussed, and the many later modifications which have been made to solve these difficulties were examined.

Specifically, it was determined that section 12J of the IT Act was created to expand the number of investors to provide access to equity financing for SMEs. According to section 12J of the IT Act, qualifying venture capital investments are eligible for a particular tax deduction that may be claimed. As a result of numerous restrictions in the section, it was discovered that the initial adoption was not as high as expected. When examining the extent of section 12J, it was determined that the relief was only transitory since the initial deduction would be offset by a recoupment of the relief upon the sale of the investment.

Upon closer examination of the design and execution of the qualifying requirements of section 12J, it was discovered that even larger difficulties had been encountered. This resulted in a significant rise in the administrative load without any improvement in efficiency. Although section 12J of the Income Tax Act recognised that there was tremendous potential for change in the South African investment climate, it was ultimately concluded that the IT Act, unfortunately did not follow through on its promise to transform the investment climate.



#### **6.4 The distinguishing characteristics in the design of tax incentives for investors in SMEs in G20 countries compared to those in South Africa.**

The scope, qualifying criteria, and administration of tax incentives accessible to investors in selected G20 nations were examined in Chapter 5 using the design principles of scope, qualification criteria, and administration.

It was found that in order to increase the availability of early-stage venture capital, a rising number of countries are encouraging business angel and venture capital investment via specifically targeted tax advantages. Rather than being the exception, tax incentives that are competitive among G20 countries are often the norm. As described in Chapter 3 above, each tax incentive has benefits and drawbacks in terms of efficacy and impact, with the advantages outweighing the negatives in certain cases. Because G20 nations are varied in terms of economic circumstances, fiscal needs, administrative capacities, and political preferences, no one tax incentive for investment is appropriate for all of them.

Tables were drawn up to provide an overview of tax incentives in the G20 nations and some remarks were made. The results showed that there are now more than 42 separate incentive systems in operation in those nations, each of which has 80 different types of incentives. For a total of thirteen schemes, it is possible to use a mix of input- and output-based incentives. A slew of tax breaks and other incentives have been put in place to support the expansion of micro, small, and medium-sized businesses in the United Kingdom.

It was discovered that there was an overall preponderance of tax credits and tax exemptions over tax deductions in the system. To avoid some of the issues associated with tax allowances, tax credits (also known as investment tax credits) serve as an alternate kind of input-based incentive. Moreover, it was shown that, although there are many distinct qualifying requirements for tax incentives, the top-ranked incentives all have some characteristics in common.

A majority of them are targeted at individual investors, with the size of the company being determined by the number of workers, turnover, and asset base. This showed that the qualifying requirements were restricted and, as a result, were less difficult to administrate. It was also discovered that exit relief in the form of capital gains exemption was included in the majority of the incentives.

The scope of tax incentives in G20 countries were analysed. It was found that output-based incentives are preferred by 12 of the G20's 19 member nations. Many countries however use input-based incentives as well although the focus is on tax credits rather than tax deductions or allowances. A tax credit or exemption for up-front investment, however, may lose much of its

attractiveness if the investor is taxed at a lower rate. As was the case in South Africa, this may result in incentives systems that are biased in favour of affluent people, thus decreasing the efficacy of the incentive as was discussed in Chapter 4. There are however times when it is better to employ investment tax credits than tax allowances when the tax rates are progressive or differential.

The main differences identified between the general scope of incentives in G20 countries and the VCC regime of South Africa is that South Africa only gave relief in the form of a tax allowance as opposed to the general trend of giving a tax credit. In addition, many countries allow for full or partial capital gains tax exemptions whereas South Africa does not include this in their scope except for the CGT relief allowed by the small business asset relief. This is however only applicable under specific circumstances and are generally allowed for individual owners of companies at their retirement stage. It was discovered that CGT rates may have a negative impact on the volume and quality of investment if they are increased.

Certain nations also provide for loss relief, in which losses on investments may be offset against other income or carried forward, according to the findings. This is the case in the top incentives found in the UK as well as some other countries.

It was also found that the complexity of the entire tax system is exacerbated by the existence of many input- and output-based taxation schemes. Many scholars maintain that a limited number of regimes would be the wise approach for lawmakers to ease the burden of compliance expenses on SMEs.

When it comes to qualifying criteria extra eligibility conditions are imposed by all the countries, such as minimum holding periods or company characteristics, such as the presence of innovative activities. Some regimes, in addition, limit the size of the investment to certain maximum absolute sums or to a certain number of maximum equity shares in the relevant enterprises.

It was found that all of the schemes in the G20 countries are administered on a non-discretionary basis. There are automated and objective techniques as well as discretionary and interpretable ways for policymakers to target specific investors. If the authorities have substantial discretion in determining which investors or projects get preferential treatment, corrupt practices are far more likely to occur than under other incentive systems. There is a greater risk of abuse when there are no defined norms for qualification.

The first observation on qualifying criteria made was that the G20 nations have a predisposition for providing incentives to natural persons although many schemes do include companies as well. The tax incentive can be designed to either lower the tax rate for all investors in general or to allow investors with a specific profile to benefit. The considerations in this regard is whether VCCs and business angels which generally have more access to capital should be the main focus area of a tax incentive. VCC and business angel investors are substitutes for each other. This means that certain types of investors could be beneficial at different stages of the development of a company. The tax policy and goal of the tax incentive need to be considered carefully in this regard. It was found in Chapter 4 that the South African VCC regime failed in part due to the fact that it benefited only high-net-worth individuals.

The second observation made was that business size criteria is essential in targeting SMEs as their definition in general are formed around various size criteria such as number of employees, turnover, and asset base. The UK SEIS incentive, Germany's 'Invest' incentive, and France's 'Madelin' incentive all target small businesses with a limit range of 25 to 50 workers. EIS and VCT investment programmes, on the other hand, have higher thresholds. As previously indicated, a factor to examine is if more established businesses need equity capital at the same rate as start-ups do. Size criteria generally targets companies at various stages of their existence. The scale of a company alone may not be sufficient grounds for government action in the form of unique rules and regulations to be implemented. Special tax regulations may be targeted with care to limit their costs and any distortions while still achieving the objectives that were set forth in the legislation.

The third observation made was that sector criteria was also used by many governments to target specific companies, especially those with highly innovative products. From Chapter 4 it was discovered that this is also an area where the South African regime was prone to abuse as the uncertainty of the qualifying business criteria left the door open for innovative tax planning. It is evident that the focus of sector targeting is in accordance with the argument that sectors with a high concentration of innovation, a high potential to create knowledge spill overs, or that contribute significantly to overall economic growth and development are targets for policymakers. Extra financial assistance for investments is provided by the EIS in the United Kingdom, which expressly targets these kinds of investments.

The final observation on qualifying criteria was that the holding period of most of the regimes were around 5 years. This is in line with the VCC regime in South Africa. It was concluded that short-termism among investors might be curbed by requiring investors to retain their assets for at least a certain amount of time. It also reduces the risk of the abuse of tax incentives as the investors are in it for the long term.

When the final criterion of administration was explored it was noted that the complexities in qualifying criteria in various tax incentives create challenges in monitoring and administration. Best practice would be to reduce complex criteria. The risk on the other hand is that this could lead to increased abuse. A number of important characteristics distinguish general tax incentives from one another, including the types of companies and activities that are likely to benefit from them, the time profile of the revenue impact on the government for any given level of incentive, the difficulty of administration, and the possibility of tax avoidance. The latter could especially be very costly to any administration if not properly designed. The fact is that all tax incentives need to be administered properly.

France's 'Madelin' deduction, which requires pre-approval for all tax benefits, is among the most straightforward. On the other hand, investors in both South African and UK investment schemes may have trust in a company's capacity to satisfy its financial reporting standards owing to continual monitoring of compliance. The German 'Invest' incentive is administered by the Federal Office of Economics and Export Control, not the tax department. Monitored by public reporting, these tax incentives similar to the UK Social Investment Tax Relief scheme are more transparent.

The overall conclusion reached is that although the tax incentives found in the G20 countries may comply to generally accepted principles of good design, their effectiveness is not only measured in their theoretical design characteristics but mainly in their practical results. As the measuring of the effectiveness of tax incentives used in the G20 countries did not form part of this study this could be an area for further research as indicated in the following section.

## **6.5 Recommendations**

In recent years, the VCC sector has grown to be more conservative, investing in asset-backed businesses and generally giving more growth capital. Consequently, the amount of money accessible to start-ups and other industries that benefit from VCC financing has decreased. This is very noteworthy. The Government's stated goal of providing equity financing to start-ups and high-growth sectors seems to have gone unmet.

From this study result the following recommendations can be made. The struggle to enable SME growth in South Africa is a problem which will not be addressed by any tax incentive. It must be taken into consideration that tax incentives do not necessarily drive investment decisions of investors but rather the economic environment in which they operate.

Small and medium-sized enterprises need finance and therefore the South African policy makers should extensively explore the options available in other G20 countries. Alternative methods and platforms for financing SMEs should be investigated together with their interaction with tax policy.

Tax and non-tax incentives such as those in Germany should be considered. The G20 countries' current venture capital options, as well as other possible relief measures that could be implemented to stimulate growth in the South African small and medium-sized enterprise market, could serve as the basis for further research, which researchers could use to make recommendations to the National Treasury.

Using tax incentives as a method of deflecting attention away from other policies and projects that may be able to do far more to improve investor returns and decrease their risk is not a good idea. Given that the investment environment is so bad that the vast majority of companies fail, it seems doubtful that even a tax-free system would be adequate to attract substantial investment.

The use of special tax incentives to attract foreign direct investment is discouraged by international best practices, which advocate instead for tax rates that benefit both existing and newly acquired capital while avoiding the pitfalls of other forms of relief and relieving the domestic base of tax planning burdens, rather than the use of special tax incentives.

From Chapter 4 it could be seen that one of the challenges faced by the industry was the numerous changes made by the National Treasury to the VCC regime in South Africa. Constant changing and tweaking of a tax incentive should also be avoided. It is also recommended that tax incentives not be changed or tweaked on a regular basis. Removal and/or modification of current tax incentive programmes is also considered to be a tough issue for politicians to accomplish.

It is suggested that the complexity of tax incentives for investors be considered throughout the design process, as this fact alone may have a significant impact on the success or failure of an incentive. Consideration needs to be given to the fact that any tax incentive targets specific taxpayers to the exclusion of others. Further research is needed on the impact of these exclusion criteria on the success rate of tax incentives.

The natural bias of our tax legislation towards debt financing raises the logical question whether more can be done on this front to enable a better result through the tax system. It is recommended that the Treasury explore the mechanisms relating to equity and debt finance for investors and their inter-relationship with entity level taxation.

Finally, explicit assumptions and techniques should be utilised to estimate the economic impact and revenue costs. The reasons for giving tax advantages should be made clear via the use of well-reasoned economic justifications. Simple objective criteria should be used to prevent or limit the use of arbitrary criteria by authorities and to simplify enforcement and monitoring. This should be made clear in the budgeting process, so that the public may judge how accurate it is. It is

essential that tax incentives be understood in all aspects including their legal foundations, economic consequences, and administrative procedures.

## **6.6 Limitations of the study**

A comparison was made between the South African law and the venture capital regimes of other G20 nations in this research. Notably, it was not the goal of this research to offer a thorough examination of how each regime has affected the various economies. The efficacy of these tax breaks was also not one of this study's objectives. This study also did not include the objective of a detailed analysis of the G20 countries' tax incentives for investors and their working.

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