A critical analysis of the misuse of the venture capital company regime

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Mini-dissertation accepted in partial fulfillment of the requirements for the degree Master of Commerce in Taxation at the North-West University

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Graduation: June 2023

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ABSTRACT

Title: A critical analysis of the misuse of the venture capital company regime

Key terms: Abuse, Design, Section 12J, Tax incentives, Venture capital

In the economy of South Africa there is room for the promotion of entrepreneurship, mechanisms that will decrease unemployment and inequality, and to increase access to finance. One mechanism that can be used to promote entrepreneurship, decrease unemployment, and increase the access to finance is to promote the growth of SMMEs. However, SMMEs often have a high risk attached to the investment due to the failure of new start-ups.

The VCC incentive was enacted to address the above-mentioned risks and promote the growth of SMMEs. The three objectives of the VCC regime were first, to increase access to equity financing and supportive managerial services; second, to create a pooling mechanism for investors to reduce the risk of investing in SMMEs; and third, to develop growth in SMMEs and use that as a mechanism to decrease unemployment and inequality. Thus, it should be considered why the incentive did not meet its objectives.

The primary objective of this research was to identify aspects in the design of the legislation of the VCC incentive which made it susceptible to misuse. First, an analysis was performed of the historical development of the VCC incentive to determine what the objectives of the VCC regime were. In the second place, a critical analysis was performed to identify which aspects of the design of the VCC incentive made it susceptible to misuse.

The VCC incentive was measured against the following three criteria: instrument choice, qualifying criteria of the tax incentive, and administration and monitoring requirements. According to the findings in this study it could be concluded that it was not clear what the outcomes of the investments were and therefore it fell short in its expected deliverables of creating employment and promoting growth of SMMEs. The qualifying criteria for the qualifying investee company could have been better targeted. The form, instrument choice, and targeting structure of the incentive drew the investments to capital intensive industries that would not have decreased unemployment. In the last place, the policy uncertainty and complex requirements and regulations were difficult to monitor and administer which made the incentive susceptible to misuse.

In this research there are several principles that could be considered when an incentive is designed by the National Treasury that will increase the access to finance for SMMEs and which can be used as a mechanism to decrease unemployment and inequality. The principles that must

be considered when designing an incentive could also be used to mitigate the risk of the incentive being misused and to bring the incentive closer to its intended deliverables.

ACKNOWLEDGEMENTS

I am thankful for the opportunity to complete my master's degree in taxation and being able to fulfil my dream. It has been a journey of self-growth and endurance and came one step closer to the woman I would like to be.

I want to thank prof. Pieter van der Zwan for his guidance and motivation during the period of my Masters. I would like to thank him for his mentorship and patience during this process and never giving up on encouraging his students. I would also like to thank him for the quick responses, insightful commentary, and knowledge on the subject and the role he played in finalizing the study.

I would like to thank Dr Philip Nolte for the language editing of this mini-dissertation.

I would like to thank my friends and family for supporting me during this period. The motivation and encouragement throughout the process kept me motivated in achieving the end goal. I would especially like to thank my parents for making this journey possible, for always listening and giving advice, and encouraging me through my nine-year process of studying. I would also like to thank my sister for standing by my side, helping me to keep my head up, and got me out of my head when things felt like it was going to fall apart. I would not have been able to accomplish this without everyone's support.

I would like to thank the Lord my Saviour for giving me the talents to achieve this goal and giving me the energy and strength, through His grace alone.

KEY TERMS

Abuse

Design

Section 12J

Tax incentives

Venture Capital

LIST OF ACRONYMS AND TERMS USED

BASA – The Banking Association of South Africa

BPR – Binding Private Ruling

CGT – Capital Gains Tax

FSCA - Financial Sector Conduct Authority

IMF – International Monetary Fund

OECD – The Organisation for Economic Cooperation and Development

SAIT – South African Institute for Tax Professionals

SARS – South African Revenue Service

SAVCA – Southern Africa Venture Capital Association

Section 8E - Section 8E of the South African Income Tax Act (58 of 1962)

Section 8EA - Section 8EA of the South African Income Tax Act (58 of 1962)

Section 12J - Section 12J of the South African Income Tax Act (58 of 1962)

Section 24M - Section 24M of the South African Income Tax Act (58 of 1962)

SMME/SMMEs – Small, Medium, and Micro-sized enterprises

The Act – The Income Tax Act (58 of 1962)

the Commissioner – The Commissioner of the South African Revenue Service (SARS)

TLAA – Taxation Laws Amendment Act

UN – The United Nations

VCC/VCCs – Venture Capital Company

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CHAPTER 1: INTRODUCTION

1.1 Background to the research area

In 2017 the organisation for economic cooperation and development (OECD) mentioned that the South African government has identified the need to promote entrepreneurship and increase the prominence of Small, Medium, and Micro-sized enterprises (SMMEs) two decades ago (OECD, 2017). In the report by the OECD it is mentioned that insufficient protection for creditors in South Africa is reducing the access to finance because lenders are not willing to take risks with companies. This is due to the reality that the exit rates of new start-up businesses are higher than emerging start-up businesses. The normal trend in South Africa is that new start-ups will use savings and funds from friends and family in the first phase and will have to use debt-financing when the entities expand. The aim of the venture capital company incentive (VCC incentive) was to increase funding to micro and small businesses.

The deterioration in South Africa's financial conditions was led by the reduction of private investments in the manufacturing and mining industries (OECD, 2010) which led to a sharp decline in growth from five percent in 2007 to two percent in 2009. The National Treasury decided on an incentive to help the growth in this important sector of the South African economy. The VCC incentive in section 12J of the Income Tax Act of 58 of 1962 (the Act) was enacted from the first of July 2009 to realise this goal. The VCC incentive was enacted to increase the investments in SMMEs by increasing the access to equity financing. It is important to consider when the VCC incentive stopped meeting its planned objectives and how the wealthy started using the VCC incentive to increase their tax deductions because the design of the VCC incentive was not successful in stopping the misuse

In the 2011 budget speech by the Minister of Finance of South Africa a comment was made that the VCC incentive had poor response and that the approach of the VCC incentive would be adjusted to have greater success in getting access to finance for small and medium-sized entities (Manuel, 2011). The Explanatory Memorandum on the Taxation Laws Amendment Bill (2011) mentioned that the applications for VCCs were few and none of them was successful. It was also noted that the VCC incentive was too restrictive, that the VCCs could not operate in the private equity model as it was initially intended, and that the regulations were far too complex. The initial purpose of the VCC incentive was not meeting the expectation of the government to increase the finance for SMMEs and did not help South Africa's economy to grow as planned.

The government decided to amend the legislation regarding section 12J of the Act in 2011. A significant amendment was made to the legislation and the number of venture capital fund

managers grew with 41 percent from 2012 to 2015 (SAVCA, 2015). Thus, with the change in legislation in 2011 the VCC incentive started meeting its planned objective of providing finance to SMMEs and helping them grow. The increase was due to the general relaxation of requirements. Minimum anti-avoidance requirements were present in the general relaxation of the VCC incentive (National Treasury, 2011). After 2011 several other amendments were made.

In 2015 the first binding private ruling (BPR) was issued and determined the meaning of “equity shares” and “controlled group company” with reference to companies issuing different classes of shares (SARS, 2015). BPR 264 determined whether shares issued by a VCC were in fact equity shares and whether a target company is a controlled group company (SARS, 2017a). BPR 274 also determined the meaning of controlled group company and equity shares for the purpose of companies issuing more than one class of shares and included a ruling with regards to impermissible trade in respect of immovable property, whether rental income was investment income, and whether the qualifying investee company could claim capital allowances. BPR 314 and BPR 242 determine the tax consequence of an investment in a new hotel development by a VCC and the qualifying investee company trading as a hotel keeper.

By reviewing the BPRs issued by the Commissioner of the South African Revenue Service (the Commissioner) it is evident that the design of section 12J could have been interpreted in various ways, and because the design of the VCC incentive not being clear in some areas it led to the misuse of the VCC incentive. Three examples where the interpretation of the Act was interpreted in a way that was not in line with the objectives of the incentive is evident in BPR 264, BPR 274, and BPR 314. The conclusion on these rulings were mostly in favour of the taxpayers because of the design of the VCC incentive. One of the principles of a good tax incentive is that it should be uncomplicated and not subject to constant change (Mynhardt, 2020). The VCC incentive had policy uncertainty, underwent various amendments, and the anti-avoidance provisions complicated the legislation further.

As part of the government’s reconstruction and recovery plan of 2020 one of the enablers to the success of the plan is access to finance (National Treasury, 2020a). In the plan presented by the government it is mentioned that working capital loans will be made available to entities in the development phase at a rate of zero to two percent interest aiming to enhance the introduction of SMMEs in the value chain of the economy. The plan of the government to help SMMEs getting access to finance confirms that there is still a problem in South Africa, and that the initial purpose of the VCC incentive is still a high priority for the government in achieving growth in the economy at a rate of 5.4 percent.

In the 2021 budget review by Minister of Finance, Mr Tito Mboweni, it was stated that the sunset clause will not be extended beyond 30 June 2021 (National Treasury, 2021). The National Treasury determined that the VCC incentive did not meet its initial objectives of developing small businesses, generating economic activity, and creating jobs but provided a significant tax deduction to wealthy taxpayers instead. Most of the investments were in low-risk ventures and if not, the promised returns would have attracted funding without the VCC incentive (National Treasury, 2021). Taking the above information into account it is evident that there is still a problem in South Africa with providing finance to SMMEs. With the problem still present, there is an underlying question regarding the VCC incentive and where the design and implementation of the incentive failed in providing the help to SMMEs as was initially planned.

1.2 Literature review

The literature review conducted was to gain an understanding of the VCC incentive evident in previous studies. In most of the literature reviewed and studies performed it was evident that the sunset clause of the VCC incentive should not have been invoked but rather extended (De Klerk, 2020). The failure of the regime is mostly because the design of the legislation of the VCC incentive failed. However, the objectives and initial purpose of the VCC incentive were in line with helping SMMEs grow and receive external finance by way of investments. The reason behind the extension of the sunset clause was due to the regime not yet meeting its full potential because the uptake of the VCC incentive was only effective from 2015 onwards.

Ngwenya (2014) stated in a study that it is important not only to analyse the VCC incentive with the objective of making it more desirable for investors, but also to consider the effectiveness of the VCC incentive and make it less susceptible to distortion in the tax system. Important issues to take into account are whether (1) the benefit of increased support for SMMEs outweighs the foregone tax revenue, (2) consideration should be given to the question if the quality is higher than alternative sources, (3) young firms benefit, and (4) the scheme is used for tax avoidance (OECD, 2017). The amendments made were first, to increase the uptake of the VCC incentive and second, to stop the misuse of the regime. The changes made the VCC incentive more desirable for investors to invest, but the VCC incentive became more susceptible to the misuse of the legislation by wealthy taxpayers

Mynhardt (2020) stated in a study that there was a significant increase in the uptake of the VCC incentive, however it was estimated that a total of R8.3 billion was raised by the VCC incentive but only R3.7 billion were invested into qualifying investee companies. It was, however, noted that the investors focus more on the tax relief than on the investment opportunity which potentially led to low quality investments. To decrease unemployment and increase the growth of SMMEs in

South Africa, more focus should be given to improving the quality of investments (Mynhardt, 2020).

De Klerk (2020) argued that the regime only started to meet its objectives in the last five years and was still in its growth phase. Various gaps in legislation were identified in the study (De Klerk, 2020) with regard to a critical analysis that was performed where the VCC incentive of South Africa was compared to the United Kingdom's enterprise investment scheme/venture capital trust regime. Recommendations were also made for the possible improvement of the VCC incentive but none of these considered the abusive structures invented by investors or where legislation failed in stopping the misuse of the VCC incentive (De Klerk, 2020). Due to the sunset clause South Africa will never see the benefit of the regime materialise. The sunset clause was initiated by the National Treasury and the benefit of the VCC incentive in the economy was minimal. There is still a gap in knowledge as to why the VCC incentive failed and what was wrong with the design.

These studies do not consider the abusive structures or transactions that were evident from the VCC incentive. The objective of the VCC incentive is in line with the National Development Plan, and the National Treasury should indeed consider a tax incentive helping SMMEs to get finance and in return achieve growth and decrease unemployment. If a new incentive is designed consideration should be given to the abusive structures evident in this study and how the design of legislation should be different to the VCC incentive.

1.3 Motivation of topic actuality

In the 2009 budget review a statement was made that access to finance in small and medium-sized entities was one of the biggest problems in achieving growth in that important part of the economy (SARS, 2008). The South African Economic Reconstruction and Recovery Plan, that was presented in 2020, stated that the challenges in the South African economy worsened over time by low investment levels and thus less growth in the economy (National Treasury, 2020a). The Banking Association of South Africa stated that SMEs are the drivers of the economic growth and development in South Africa (BASA, 2019).

In a survey performed by the OECD on the economics of South Africa in 2020 a comment was made that a critical improvement in investor confidence is needed to reverse the weak investment and employment growth that could be due to policy uncertainty (OECD, 2020).

The high cost of crime is impacting businesses in South Africa which ranks 131st out of 140 countries in terms of the business cost of crime (World Economic Forum, 2019). Thus, clearer implementation of reforms would reduce the uncertainty and in return it would facilitate long term planning and increase the growth impact (OECD, 2020).

The National Treasury assessed the VCC incentive in 2021 and used the information from 100 VCC's and 360 qualifying entities to measure the performance of the regime (National Treasury, 2021). The results that became evident was that R11.5 billion were invested at a VCC level and that a 100 percent deduction were available for investors, with only R4.2 billion invested at qualifying company level. The total contribution from qualifying company level were merely R207 million for 2019/2020 half of which was for VAT purposes. Employment for qualifying companies were 8,239 employees with only 4,035 directly employed. Only 37 percent of the qualifying companies added new jobs after receiving the funding. The National Treasury's findings on the VCC incentive corresponds mostly to South Africa's Venture Capital Association (SAVCA) survey but differ about predictions of job creation and tax estimates. As per the National Treasury, SAVCA's survey is more optimistic than the actual response. Since 2015/2016 when the uptake of the VCC incentive increased significantly, the total tax revenue forgone was R1.8 billion of which R1.7 billion went to individuals who had taxable income and VCC investments above R1.5 million per year (National Treasury, 2021). In 2018/2019 the total revenue forgone was R745 million before the deduction cap of R2.5 million was brought into legislation. The National Treasury's conclusion was that the VCC incentive gave a tax deduction to high net-worth individuals that cannot be justified given the limited economic impact (National Treasury, 2021).

As can be seen from the results that was obtained by the National Treasury's survey it was evident that the VCC incentive did not meet its initial objective in terms of job creation and getting finance for SMMEs. The remark that was made by the National Treasury that the VCC incentive gave a tax deduction for high net-worth individuals shows that the National Treasury was aware of the flaws in the design of the tax incentive. But due to the National Development plan to increase the access to finance in SMMEs there is a possibility of a new incentive being enacted to help getting finance for SMMEs. In this study (1) areas are identified where the design of the VCC incentive failed in preventing its misuse and (2) examples are given in the form of BPRs where the misuse of the VCC regime was identified.

1.4 Problem statement and research question

1.4.1 Problem statement

A problem exists where section 12J was amended in various ways by the National Treasury since inception of the VCC incentive in the Act. The design of the VCC incentive was, however, inefficient in stopping various abusive structures. The National Treasury also decided not to extend the VCC incentive after the activation of the sunset clause because it was determined that the VCC incentive did not meet its initial objectives. The objective was to increase finance for

SMMEs, economic growth, and decrease unemployment. Instead, it created loopholes that led to significant tax deductions for wealthy taxpayers.

1.4.2 Research question

This study will endeavour to answer the following question: Which design aspects of the VCC incentive made it susceptible to misuse?

1.5 Objectives

In order to answer the research question as stated above, the objectives as set out below have been identified.

1.5.1 Main objective

The main objective of this study is to identify aspects in the design of the legislation of the VCC incentive which made it susceptible to misuse.

1.5.2 Secondary objectives

- The first secondary objective is to determine what the initial objectives of the VCC incentive were by reviewing the historical development of the regime. This theoretical research objective is addressed in chapter 2.
- The second secondary objective is to critically analyse the characteristics of the VCC incentive against important design principles of a tax incentive to identify which aspects of the design made it susceptible to misuse. This empirical research objective is addressed in chapter 3.

1.6 Research design

1.6.1 Research method

The Oxford Dictionary of English defines research as the systematic inquiry of the root of information to establish facts and reach new conclusions (Stevenson, 2010: s.p.) The research process consists of three elements namely, the researcher's ontology, epistemology, and methodology. The methodology of research is a set of discussions, decisions, and choices a researcher must make to construct and conduct the research. The researcher must first determine the ontology and epistemology— these two aspects are critical for the research methodology because they determine the research paradigm within which the research is conducted (McKerchar, 2008).

There are two core research paradigms commonly known as positivism and interpretivism. Every paradigm is based on its own ontological and epistemological assumptions. Different paradigms have different assumptions of reality and knowledge that underpin the research approach (Scotland, 2012). The ontological position of positivism is one of realism. Realism could be described as the view that objects exist independent of the researcher and that reality does not intervene with a researcher's senses. Positivist epistemology is one of objectivism which means that knowledge about realities in the world is discovered impartially. In other words, the researcher and researched are independent entities. The statements made by positivists are factual and descriptive and their explanations are based on empirical evidence and tested theories. Positivism is adopted by researchers who want objectivity in their description of reality (McKerchar, 2008).

The ontological position of interpretivism is relativism. Relativists argue that people's view of reality is subjective and differs from one person to another (Guba and Lincoln, 1994:110). They believe that reality does intervene with their senses. The interpretive epistemology is one of subjectivism which is based on the conviction that phenomena in the world do not exist independently of our knowledge (Grix, 2004:83). The assumption of interpretivism is that the researcher cannot be detached from the subject being studied (McKerchar, 2008). Interpretivism does not provide hard and fast explanations where causal relationships can be identified and predictions made but is rather based on the subjective interpretation and understanding of the social reality of the researcher (McKerchar, 2008). If the researcher chooses the interpretivism paradigm it would most likely mean that the researcher would perform qualitative research.

To reach a conclusion on this specific study, and to address the objectives, factual knowledge obtained in the research was interpreted to provide insights into the design of the VCC incentive and where the design failed in stopping the misuse. Therefor this will incorporate human interest in the study and thus the interpretivist approach is the most suitable for the proposed study (Dudovskiy, 2016).

1.6.2 Paradigmatic assumptions and perspectives

Paradigm choice indicates the way the researcher sees the world (ontology) and also how knowledge is created (epistemology) (McKerchar, 2008).

1.6.2.1 Ontological assumptions

The Oxford Dictionary of English defines ontology as "the study or nature of being" (Stevenson, 2010: s.p.). Ontology focuses on the nature and structure of things independent of other considerations and of their own existence. This reflects how the researcher sees the world

(McKerchar, 2008). Ontology is also an individual's belief of what comprises reality (Dubovskiy, 2016).

1.6.2.2 Epistemological assumptions

Epistemology is concerned with the nature and forms of knowledge, in other words how knowledge can be created, acquired, and communicated in a field of study (Scotland, 2012). Epistemology is also concerned with the possible results, characteristics, sources, and limits of knowledge.

1.6.2.3 Methodological assumptions

The research consisted mainly of doctrinal research where a systematic process was followed to analyse why the law was written in a particular way and how it has developed and applied. In order to achieve the research objective a literature review was performed on previous studies and other available literature to gain an understanding of knowledge that has already been collected. Doctrinal research is described by Pearce (cited by McKerchar, 2008) as the traditional approach and is explained as the process of identifying, analysing, and organising legislation, decisions, and commentary. The first step to doctrinal research is to verify if the doctrine is complied with so that the researcher can verify if any defects are a result of poor legislation or lack of compliance to legislation (Hutchinson, 2013). An analysis was done on the abusive structures that happened with the use of the VCC incentives legislation. An analysis was also performed on the lack of compliance to the legislation and how the structures were used to misuse the defects in the legislation. The purpose is to make specific enquiries in order to identify specific pieces of information (Ali, 2017). Doctrinal can be described as an instruction, knowledge, or learning (Hutchinson, 2013). It also means that legal rules take on the quality of being doctrinal because they are not casual rules for convenience but rules that are consistently applied and which evolve slowly over time (Hutchinson, 2013). An analysis was performed on the evolution of the VCC incentive, how the rules of the legislation changed and were adjusted over time, and how these changes affected the design of the legislation and caused misinterpretation of the rules. Doctrinal research involves rigorous analysis, making connections between doctrinal strands, and extracting general principles from an incoherent mass of primary sources (Hutchinson, 2013).

Irrespective of what paradigm the researcher chooses the research must have a clear purpose at the outset (McKerchar, 2008). This can only come from a literature review where a gap of knowledge has been identified. A detailed literature review was performed to identify previous literature on the specific topic and to gain a clear understanding of the relevant topic. Literature that was used was (1) information readily available on the importance of SMMEs in South Africa

and how important they are to the growth of South Africa's economy, (2) available literature on the effectiveness of the VCC incentive, (3) and information available regarding the abusive structures that were used to create loopholes in the legislation of the VCC incentive. Previous studies on the VCC incentive were reviewed and consideration was given to the information that was included in the specific study.

The norm of normative law research provides a prescription as to how one should behave in accordance with the norms (Christiani, 2016). Normative research involves the process to find legal rules and principles to address the legal issue at hand. The aim of normative research is to consider existing theories or the application in practice to describe what should happen. The aim of normative research in analysing legislation is to find the legal principles that apply and those that should not apply based on their specific values (Christiani, 2016). The rationale behind normative research that examines the law as an object of study is that the characteristics of the law as a science are prescriptive, and to study the law is a prescription of what should be in accordance with the law so that the object of the research is the norm of the law (Christiani, 2016). The normative research approach was followed when the principles published by previous scholars were compared to the characteristics that were evident in the VCC incentive. This was to verify if the characteristic of the VCC incentive is adhering to the principles published by previous scholars.

The BPRs are used to perform the critical analysis. The structures and transactions as described in the BPRs are used to describe how the structures were used to undermine the VCC incentive. The structures were also described by the South African Institute of Chartered Accountants (SAICA) and the information available by SAICA will also be used to describe the transactions regarding the structures that were invented by investors for the abuse of the VCC incentive. The information published by both the South African Revenue Service (SARS) and SAICA was used to gather enough information to describe the abusive structures for a better understanding of the abuse that happened. It was also used to make a prediction on how such structures can be prevented in the future.

Factual knowledge was gained through doctrinal research, normative research, and a full literature review. To reach a conclusion on this study and to answer the research objectives and the research questions, the factual knowledge is interpreted and compared to the design principles of an effective tax incentive. This incorporates human knowledge and interest. The interpretivist approach was followed to conduct the research in this study.

1.7 Structure and overview of study

1.7.1 Chapter 1: Introduction

Chapter 1 describes the background of the study. It gives insight into the topic and why the research needs to be performed. It provides a summary of core principles for a better understanding of the VCC incentive. Included in this chapter is also a literature review regarding previous studies that were performed and why this study is different. It formulates the problem statement and outlines the main and secondary objectives. It further describes the research method, outlines the various chapters, and gives an overview of what is included in each chapter.

1.7.2 Chapter 2: A review of the historical development of the VCC incentive

This chapter reviews the historical development of the VCC incentive and how the VCC incentive changed since enactment in 2009. This chapter explores how the initial VCC incentive was written in 2009 and what the requirements and specifications were. The changes of the VCC incentive are described in more detail and how the requirements and specifications of the VCC incentive changed in the following years leading to the sunset clause being activated in 2021. It gives an overview of the initial objectives as described by the National Treasury in 2009 and how changes in the legislation since enactment changed the objectives of the VCC incentive. Chapter 2 addresses the first secondary research objective as identified in paragraph 1.5.2.

1.7.3 Chapter 3: Critical analysis of the characteristics of the VCC incentive against the most important design principles of a tax incentive.

In this chapter a critical analysis is performed regarding the characteristics of the VCC incentive and where the design failed in stopping the misuse of the VCC regime. First, a motivation is provided on the use of tax incentives by governments. Also, that an incentive is effective when the social benefit exceeds the social cost. Second, the design of tax incentives will be further analysed using reports published by several scholars. An analysis of the most common abusive structures evident in tax incentives is done. In the third place, the characteristics of the VCC incentive is critically analysed against the design principles of an effective tax incentive. Lastly, the changes as explored in chapter 2 are further analysed and when the amendments in the VCC incentive increased the uptake of the regime but made the incentive open to misuse. Chapter 3 addresses the second secondary objective as mentioned in chapter 1.5.2 and uses the changes identified in chapter 2 to meet the specific objective.

1.7.4 Chapter 4: Summary and conclusion

Chapter 4 addresses the research question by presenting a summary of the research findings and a clear conclusion on the research question. Important findings are summarised, and aspects of the design are stated that made the VCC incentive susceptible to misuse.

CHAPTER 2: A REVIEW OF THE HISTORICAL DEVELOPMENT OF THE VCC INCENTIVE

2.1 Introduction

The VCC incentive was enacted in 2009. During this period there was a problem for small and medium-sized firms to get access to finance for new start-up companies. The National Treasury developed the VCC incentive to get access to finance for the small and medium sized firms and to decrease the unemployment rate in South Africa. The National Treasury stated in the budget tax proposals for 2009 that the private equity industry in South Africa was well developed but the appetite to invest in start-ups, early stage and seed capital transactions were low (SARS, 2008). The enactment of such a regime is of great importance for developing countries as the high unemployment rates and the struggle to get finance often hinders the growth in an important sector of the economy.

This chapter will address the importance of SMMEs in the national economy. In the second place this chapter will identify how the VCC incentive was changed over the years until the sunset clause were activated in 2021. The purpose of the study is to identify the concerns in the design of the VCC incentive and what aspects in the design of the VCC incentive made it susceptible to misuse. To identify the design issues the historical development of the VCC incentive had to be considered and how it changed over the years. This is necessary because with the initial enactment of the VCC incentive the requirements were too strict and there was minimal uptake in the VCC incentive. However, upon the amendments of the requirements of the VCC incentive it made it susceptible to misuse and the VCC regime did not meet its objectives as originally planned.

First, the chapter will include a summary of the objectives and where the objectives originated from and why it is important for such an incentive in a growing economy related to the above-mentioned objectives. Second, a review of the historical development of the VCC incentive and how it changed over the years is included.

2.2 Objectives of the VCC regime

Upon enactment of the VCC incentive the main reason for its promulgation was to increase investments in SMMEs by increasing the access to equity financing (National Treasury, 2009). This was also noted in the 2016 Explanatory memorandum (National Treasury, 2016). The sole object of a VCC is to be a manager of qualifying investments (National Treasury, 2009). National Treasury further explained that one of the reasons for the VCC itself is to offer supportive

management services and that the qualifying investee companies should reach a certain level of growth in the organisation (National Treasury, 2011). It was also noted that the purpose of the VCC is to create a structure where investors could pool their funds together to channel the funds into small business and junior mining operations (National Treasury, 2011). The risk relating to the investment in SMMEs is quite high. The investment must put the investor genuinely at risk as the tax deduction should reduce the risk relating to the investment in qualifying investee companies (National Treasury, 2011). The VCC regime was one of many measures to encourage growth for SMMEs and use that growth as a mechanism to decrease unemployment and inequality (National Treasury, 2017).

The objectives of the VCC regime can be summarised as follows:

- Increasing the access to equity financing as mentioned by National Treasury in 2009 and 2016 and to increase supportive managerial services to SMMEs as mentioned by National Treasury in 2009 and 2011.
- Creating a pooling mechanism for investors to pool their funds together to invest in qualifying investee companies and reducing the risk relating in investing in the equity of SMMEs by giving an upfront tax deduction as mentioned by National Treasury in 2011.
- The development of growth and to use the growth as a mechanism to decrease unemployment and inequality as mentioned by National Treasury in 2017.

These three objectives will now be discussed in more detail in the following three sections.

2.2.1 Importance of equity investments to get access to finance and the importance of the increase in managerial support services

The 2022 report by the OECD mentions that access to finance in South Africa is constrained by two factors namely, the supply side of the finance and the demand side (OECD, 2022b). The demand side has a constraint due to the high costs of financing and the high collateral requirements. Also, most SMMEs do not have the cash flow to pay for the finance cost and do not have high-value assets to put up as collateral for loans to be approved. One of the disadvantages of debt financing is that when a company has a constraint on its cash flow it may not be able to make regular loan repayments which, in return, will make the company more vulnerable to interest rate spikes (Blake, 2022). The supply side experiences problems due to the demand side not applying for finance. The SMMEs are usually not able to put up the collateral or they do not have the cash flow to pay the high cost of financing from their normal operating activities. With an equity investment there is no set obligation to repay the money invested (Blake, 2022). A new start-up company often does not have sufficient collateral to obtain the necessary

credit score when seeking external financing, and if the internal equity of the start-up is high the credit score is deemed sufficient based on the investment of the investor (Blake, 2022).

An equity investment in SMMEs is an important factor and is better than just financing the cash flow problem of an SMME. When an equity investment is made into a company it gets access to much more. For instance, the SMME gets help to clear up inefficiencies in management and operations and the investor will identify market opportunities to grow their investment and unlock the value of the business (Van Lil, 2019:25). An equity investment will give the management of the entity guidance on how to better the operation of the company and how to grow the company. Management of SMMEs tend to lack management skills received through formal training which will empower management to improve the strategic development and core processes of SMMEs and help SMMEs not fail within the first year (Cass, 2012). Private equity practitioners will not only provide capital for the investment but also financing, management, strategy, human resources, and industry knowledge (Weidig *et al*., 2004).

South Africa has one of the lowest success rates of new start-ups of SMMEs. As per the OECD 2022 report, 70 percent - 80 percent of SMMEs fail within the first year of operation and only 50 percent of the SMMEs that survive will last for the following five years (OECD, 2022a). This could be due to many constraints and difficulties in South Africa which will not be discussed in this study. This, however, increases the importance of equity investments. It increases the risk of the investment, but it will provide SMMEs with some of the other tools they will not receive from lending money from a bank. A new start-up company may have an increase in investments if there are high-profile investors who invest in the start-up and would add credibility to the SMME (Blake, 2022)

2.2.2 Importance of reducing the risk in high-risk investment by creating a pooling mechanism for investors and giving an upfront tax deduction

When reducing the risk of an investment you need to consider that the reward of the investment might also be lower. Due to the upfront tax deduction the reward of the investment is still high as the investment is still high risk. Another risk that needs to be addressed is that the shares will not be easily resalable after the five-year holding period has passed as the buyer of the “second-hand” shares cannot take advantage of the upfront tax deduction (SAICA, 2014). The high risk associated with SMMEs is increased by the low success rate and high failure rate of new start-ups (OECD, 2022a). It is not an easy task to get equity investors to invest in an entity that might not be successful and fail within the first year of operating.

Equity investments usually have a minimum amount that can be invested. This will increase the possible losses when investing equity into a company. One of the major concerns is the liquidity risk the investor takes (Horton, 2022). This is due to the fact that the growth of the entity might take longer than expected and the investment funds cannot be taken out of the company at any moment. The funds also need to be held in the investment for several years before they can be extracted to make a profit. By regulating the VCC environment the liquidity and portfolio management risk is addressed in small businesses (Blake, 2022). An important consideration is the risk appetite of the investor (Blake, 2022). If the entity operates in a high-risk industry it needs to be considered that there are various investors that would not invest due to them having a low-risk appetite. As VCCs are allowed to invest in several qualifying investee companies the risk is decreased due to diversification in the investment. If the risk is spread among various stake holders the risk is decreased due to the pooling mechanism offered by the VCC regime and the risk being spread into various qualifying investee companies.

Due to the fact that debt takes precedence over equity in the event of liquidation or a creditor claim, the risk of equity investments is also higher (Blake, 2022). The value of debt is less than that of equity because the profitability of an entity does not have an effect on whether the loan is repaid but is does have an effect on the value of the distributions of dividends and how much value is added to the investment due to the retention of earnings (Blake, 2022). The initial tax deduction and saving that the investor received from the investment in a VCC lowers the liquidity risk. The waiting period for the growth in the investment before any funds are received is shortened due to the immediate cash saving on the investment. This will decrease the risk in the investment and more investors might invest in such schemes as the reward will still be high but the risk is reduced.

2.2.3 Development of growth and the decrease of unemployment in South Africa

Entrepreneurs seek out equity investments as they want added value on their investment; they can also add business skills, social capital, and access to networks to increase the growth in the SMME (Wieczorek-Kosmala *et al.*, 2020:1546). In a study performed in 2002 by the Task Group of the Policy Board for Financial Services and Regulation it is mentioned that depending on the growth stage of the SMME the most appropriate form of finance is often venture capital rather than debt due to the added services the SMME receives (Falkena, *et al.*, 2002). They also mentioned that SMMEs in developing countries play a big role due to their contribution to the social-political stability of the country and if there is successful promotion of SMMEs the level of unemployment can be reduced dramatically (Falkena, *et al.*, 2002).

Upon the enactment of the VCC regime South Africa had an unemployment rate in Q4 of 2009 of 24.3 percent. Most of the jobs created between Q4 of 2008 and Q4 of 2009 was in the finance, construction, and trade industry (StatsSa, 2009). The unemployment rate in South Africa was 34.5 percent in the first quarter of 2022 (Trading economics, 2022). This was also the first decline in the employment rate in seven quarters (Trading economics, 2022). The increase in the jobs created were in the community and social services sectors, manufacturing, and trade sectors.

Unemployment in South Africa is one of the biggest challenges the country is struggling with. This also has an effect on the crime rate in South Africa. South Africa has to create three million jobs by the end of 2020 and 11 million jobs by 2030 (OECD, 2018) of which most have to come from SMMEs. The OECD (2022a) report for South Africa mentions that 90 percent of the country's workforce in 2030 will be employed by SMMEs. This illustrates the increased importance of making an incentive work that has the objective of creating jobs. SMMEs that survive past the five-year mark of new start-ups before failing should be able to absorb a significant part of the unemployed labour force and also reduce crime and government expenditure (Falkena, *et al.*, 2002).

2.3 Historical development of the three elements of the VCC regime

In 2009 the initial Section 12J was promulgated into the Act on 8 January 2009 in terms of section 27 of the Revenue Laws Amendment Act (60 of 2009). This included the deduction of the value of the VCC shares from the taxable income of the qualifying investor. National Treasury had to specifically write this into the Act because the general rule regarding shares in companies is that it would be of a capital nature and that the investment in shares is not part of the normal course of trading (Deloitte, 2009). The costs of acquiring shares on a capital account is in general not deductible from income (SARS, 2020). The deduction was the main reason that the risk in the investment should have been lowered and that the uptake of the investment in VCC companies should have been higher. The section 12J provision allowed the deduction for the expenditure incurred for the period commencing on 1 July 2009 and the deduction will not be allowed for expenditure incurred after 30 June 2021 (Deloitte, 2009). Hundred per cent of the cost of the shares was deductible from the investor's total taxable income (SARS, 2020).

To understand the principles as stated below it is important to understand how the process of venture capital works and where the different tax consequences come into consideration. An investor invests funds into a VCC and in return the qualifying investor will qualify for a tax deduction for the expenditure incurred, subject to certain limitations. The VCC will use the investment capital to invest in qualifying companies' shares subject to certain criteria to which the VCC must adhere in terms of how much and in what type of companies may be invested in. The

qualifying company will in return use the share capital of the investment to fund its operations (Deloitte, 2009). The flow of funds is depicted in the illustration by SARS (Figure 1) and also illustrates the tax consequences at the different levels.

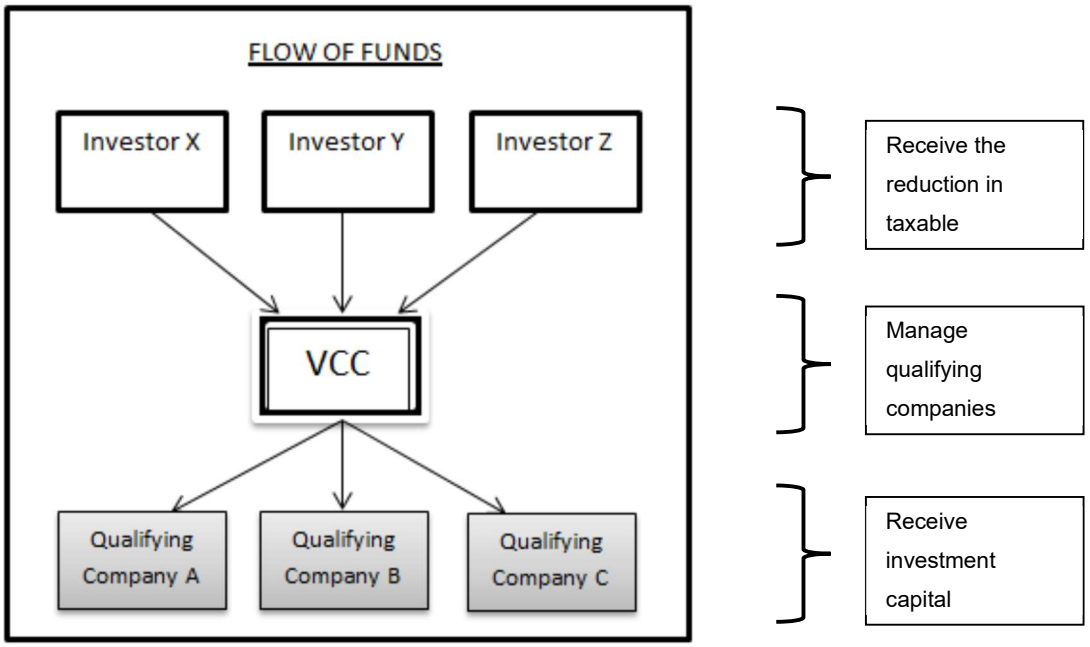

Figure 1: Flow of funds in the VCC environment *(SARS, 2020)*

Figure 1 has tax consequences on different levels of the structure as discussed below.

At the investor level:

- An initial tax deduction in terms of section 12J from the investor's taxable income.
- When the shares are sold it would attract capital gains tax (CGT) and before 2014 there would have been a recoupment of the deduction previously received.
- Dividends tax at 20 percent on the dividends received except if the investor is a resident company.

At the VCC level:

- Normal income tax rules apply and has no special tax concessions (SARS, 2020).
- When the shares are sold in the qualifying investee company it attracts CGT.
- Exempt from dividends tax on dividends received from the qualifying company as the VCC should be a resident company.

At the qualifying company level:

- Normal income tax rules apply and has no special tax concessions.

The different levels of taxation should be considered when the amendments are discussed and on what level the amendment had an effect.

First, a short summary is provided of the timeline of the VCC regime and when the uptake of the regime increased. The summary includes the total value of the VC asset class and the total number of transactions in the VC asset class per period as per the SAVCA reports.

In 2010 SAVCA published their first annual SAVCA venture Solutions VC Survey report which included a review of all the VC funding for the period 2000–2010. This report gave a holistic view of the activities in the VC industry for the ten preceding years (SAVCA, 2010). The report had three objectives which included past, current and future activities. First to gain knowledge of past investments and how funds were raised, and also which role-players should be included in the survey. The second objective were to give a summary of the investors and managers investing in VC in that specific period. And thirdly, to define the views on VC in South Africa's future including the investments activities and how the industry can be developed. SAVCA gathered information from sources including, but not limited to, the annual SAVCA year books, information readily available on the internet about the industry, and interviews with 33 stakeholders. The surveys from 2010 to 2022 were analysed and the information about the traction in the industry were gathered. This also gives an important indication of the uptake and success in the different periods of the regime. The information will now be discussed.

In 2010 after the promulgation of the VCC incentive the uptake of the regime was minimal. There were only R2.6 billion invested in the VC asset class in the period 2000 to July 2010 (SAVCA, 2010). In the years following the promulgation of the Act the VC investment class had various amendments which affected the uptake of the regime. The graph below (Figure 2) illustrates how the VC asset class grew over the period until the sunset clause was activated. This also gives an illustration of when the changes in the legislation had a negative effect on the uptake of the VCC regime or when the changes had a positive effect on the uptake.

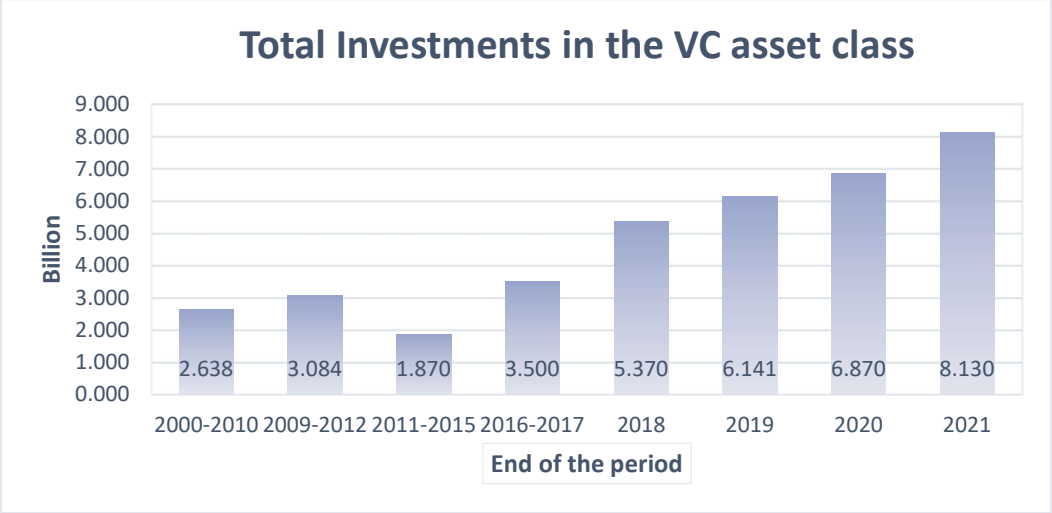

Figure 2: Total Investments in the VC asset class

(Source: Author's compilation of information obtained in the SAVCA reports)

The number of transactions entered into per year in terms of the VC asset class for the period 2009–2021 is analysed in the graph below (Figure 3). The information in the graph consists of information obtained from the SAVCA survey reports. The graph indicates the transactions entered into in the VC asset class and when there was an escalation of the amounts of transactions in the specific period.

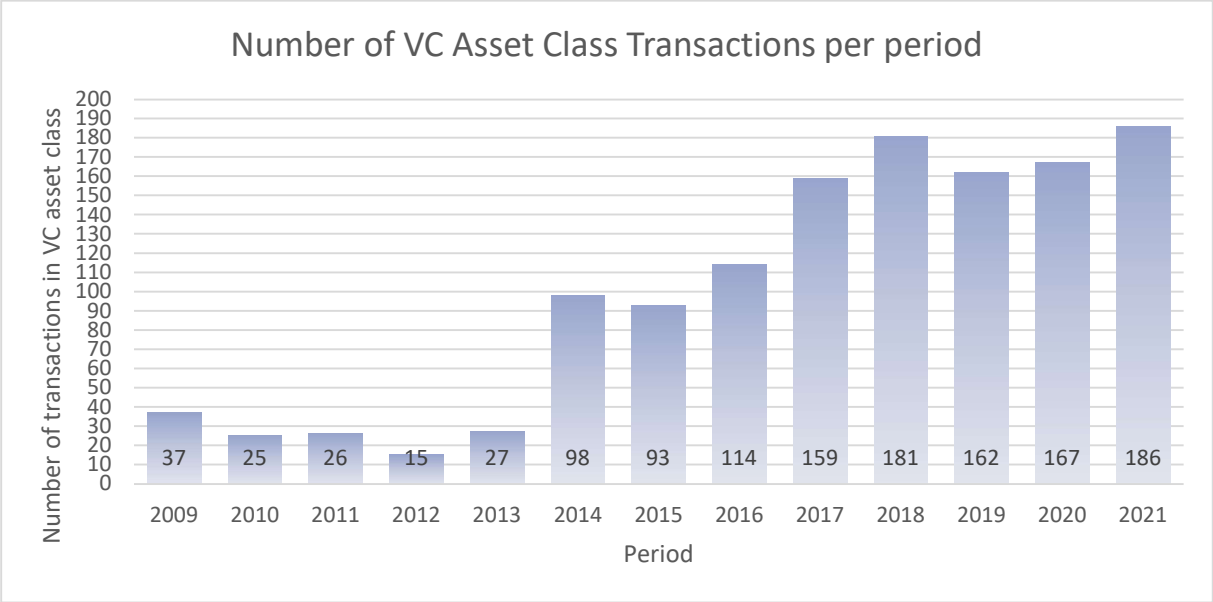

Figure 3: Number of VC Asset Class Transactions per period

(Source: Author's compilation of information obtained in the SAVCA reports)

As can be seen from these graphs the VCC regime only started getting traction in 2014 with 98 transactions in 2014, whereas there were only 27 in 2013. In 2014 the average transaction value

per investment were R7.34 million (SAVCA, 2015). This was all deductible tax expenditure as there were no deduction limitation in the Act in that period. In 2014 the Act was updated in terms of the recoupment requirement. In the 2017 period there was another jump in the number of transactions: there were 159 transactions in 2017 alone. The anti-avoidance measure in terms of the connected-person test were deferred to only be performed after 36 months since the first issue of shares by the VCC. During the two years after the amendment the industry saw another increase in the uptake of the VCC regime with an increase of 13.8 percent in the number of transactions (SAVCA, 2019).

In the period 2000–2010 the six industries with the most investments made by the VCCs were software (18 percent percent), biotechnology (25 percent), financial services (9 percent), medical devices and equipment (9 percent), business products and services (8 percent), and industrial energy (8 percent) (SAVCA, 2010). In the 2012 report by SAVCA the three major industries invested in by VCCs were telecommunications (16 percent), medical devices and equipment (13 percent), and software (13 percent) (SAVCA, 2012). In 2015 software were at the top of the list with 26 percent, e-commerce at 10 percent, and health at 9 percent (SAVCA, 2015). In the 2017 SAVCA report there were a spilt between the number of deals and the value of deals. The sectors with the highest number of deals were manufacturing (13.2 percent), software (10.1 percent), business products and services (8.1 percent), fintech specific (8.1 percent) and three industries at 7.8 percent namely, consumer products and services, e-commerce, and medical devices and equipment (SAVCA, 2017). Regarding the value of the deals the top five industries were manufacturing (14.9 percent), medical devices and equipment (12.2 percent), food and beverage (9.3 percent), and the two industries at 6.1 percent were software and other (SAVCA, 2017). In 2018 the top five industries by value of deals were manufacturing (14.2 percent), food and beverage (12.3 percent), medical devices and equipment (10.5 percent), energy (10.2 percent), and business products and services (7.2 percent) (SAVCA, 2019). Regarding the number of the deals the top five industries were consumer products & services (10.8 percent), manufacturing (10.4 percent), software (9.4 percent), fintech specific (7.9 percent), and energy (7.7 percent) (SAVCA, 2019). In 2019 the top five industries regarding value of deals were manufacturing (13.8 percent), food and beverage (12.7 percent), business products and services (10.9 percent), medical devices and equipment (8.3 percent), and fintech specific (6.9 percent) (SAVCA, 2020). In 2020 the top five industries by value of deals were food and beverage (13.5 percent), manufacturing (11.7 percent), fintech specific (8.8 percent), consumer products and services (8.8 percent), and medical devices and equipment (7.8 percent) (SAVCA, 2021). In 2021 the top five industries by value of deals were food and beverage (11.9 percent), fintech specific (11.6 percent), manufacturing (10.9 percent), consumer products and services (7.7 percent), and software (7.2 percent) (SAVCA, 2022).

The above information is an important indication when the amendments were perceived as positive or negative by the investors, when the regime gained traction, or the uptake were reduced. There is a clear link between the uptake of the VC asset class and the amendments in the legislation. The historical development starts at the top of the VCC structure which is the qualifying investor and the investment tax relief. In the second place an analysis is performed of the change in the VCC requirements and lastly the analysis of the change in the qualifying investee companies' requirements. Each of the three aspects listed is reviewed starting at the enactment as in 2009 and after that the development of the VCC until the sunset clause was activated. This includes the amendments in the Act and the reason for the amendments. It also includes the changes that were made to bring the VCC incentive closer to meeting the original objectives. This approach is followed for each aspect of the VCC incentive.

2.4 Qualifying investor and the investment tax relief available for investors

When section 12J was promulgated into the Act there were various requirements that had to be adhered to in order to get the upfront tax deduction. These requirements prohibited the VCC incentive to meet the initial objectives to encourage investors to invest in entities that would have struggled to get financing through the normal channels. This discouraged various investors from investing, and the various changes that were made to sections 12J(2) and 12(3) of the Act are discussed below.

2.4.1 Initial enactment

Section 12J(2) of the Act has undergone significant changes due to the fact that the requirements of the VCC incentive prohibited it from meeting its objectives. In the initial enactment the requirements were that only natural persons, listed companies, and controlled group companies in relation to a listed company were allowed a deduction of expenditure actually incurred[1] in acquiring shares in a VCC.

In the initial enactment[2] the deduction for a natural person were limited to R750 000 per year of assessment and the natural person could only get a deduction of R2.25 million in their lifetime. The deduction was also only allowed on newly issued shares and not the secondary transfer of the VCC shares, but the trading of secondary shares was allowed (National Treasury, 2008). When the natural person disposed of their shares in the VCC the expenditure previously allowed as a deduction had to be recouped in terms of section 8(4) of the Act (National Treasury, 2008). When the investor would sell the shares in the VCC there were no special CGT rules to minimize

[1] The deduction were determined in terms of section 12J(3).
[2] The initial enactment of section 12J(3)(*a*) of the Act

the tax due. As the full amount of the shares were allowed as a reduction the base cost of the shares was reduced to zero and the investor would be taxed at the full proceeds amount according to the CGT rules in terms of the Eighth Schedule of the Act. As the full amount allowed as a deduction from taxable income were recouped in the year the investor sold the shares the VCC incentive was only temporary, and once the shares were sold the taxpayer would be taxed on the full amount. Apart from the initial deduction of the value of the expenditure incurred by the investor the normal income tax rules applied (National Treasury, 2008).

For entity investors which were limited to listed companies and controlled group companies in relation to listed companies the deduction was not limited. Unlisted entities were not allowed a tax deduction for their uptake of any VCC shares as it would prohibit individual investors to exceed the R750 000 deduction through investing through entities that are close to the individual investor (National Treasury, 2008). A comment was also made by SAVCA and Finmark Trust that the limitation of the deduction for unlisted entities limits the providers of capital in the VCC regime but this adjustment was not accepted as the National Treasury wanted to stop investors to undermine the VCC regime and channel funds through controlled entities (Portfolio Committee on Finance, 2008). The entity investors were allowed a deduction of 100 percent of the expenditure actually incurred for the acquisition of the shares[1].There was, however, a limitation where any group of companies and the companies inside the group of companies were only allowed a deduction of up to ten percent of the equity shares of the VCC inside the group of companies (National Treasury, 2008).

The deduction[2] will only be allowed from the taxable income if the investor has a certificate from the VCC stating the amounts invested in the company and the Commissioner approved the company as a registered VCC (National Treasury, 2008).

The various amendments starting from the initial adjustments in 2009 to the sunset clause being activated is discussed in detail below.

2.4.2 Increase of the deduction thresholds for listed and group companies (TLAA 17 of 2009)

In the initial enactment of section 12J(3) of the Act it only allowed a deduction of ten percent of the value of the equity shares of the VCC for listed entities and controlled group companies in relation to listed entities[3]. In 2009 the National Treasury amended the ten percent limitation to 40 percent of the equity shares in the VCC. According to National Treasury the ten percent limit was

[1] As per section 12J(3)(*b*) of the Act.
[2] In terms of subsection 12J(4) of the Act
[3] The 2009 Taxation Laws Amendment Act (TLAA) adjusted section 12J(3) of the Act.

for the VCC to get access to anchor investors (National Treasury, 2009). SAVCA and Finmark Trust mentioned that the ten percent limitation was counter-productive to the objective of the VCC regime since the objective of the VCC incentive is to inject capital into small businesses and that the start-up costs needed might be significant and a controlling stake is required initially (Portfolio Committee on Finance, 2008). It was only adjusted to 40 percent as the Committee stated that the fund managers should arrange with the shareholders of the qualifying investee company to protect their interests (Portfolio Committee of Finance, 2008). The investors would not receive a tax incentive for investing in the capital of a qualifying investee company (Portfolio Committee of Finance, 2008).

2.4.3 Removal of deduction limitation and inclusion of the anti-avoidance rules for qualifying investors (TLAA 24 of 2011)

It was, however, noted by PWC that the tax benefit created for investors were insufficient to attract investors (PWC, 2012). In 2011 the first major adjustment was made to section 12J(3) of the Act. Until 2011 the VCC regime were not very successful, and the investment benefits were too small (National Treasury, 2011).

Subsection 12J(2) of the Act was updated[1] which changed the fact that only natural persons, listed entities, and controlled group companies in relation to listed companies could get the deduction. The update stated that any "taxpayer" could get the deduction for investing in an approved VCC. This meant that unlisted companies and trusts could also get the section 12J deduction. This was part of the general relaxations of the VCC incentive as there was a minimal uptake of the VCC incentive.

The limitation with regard to the deduction for the investor were completely removed from the Act[2]. It meant that the actual expenditure could be deducted from the taxable income of the taxpayer. There was no more monetary limitation for natural persons and no percentage limitation for entity investors. The deduction limitation ceilings were completely removed and the anti-avoidance measures were introduced (PWC, 2012). Due to the fact that the limitations were removed, and unlisted entities and trusts could also get the deduction, three anti-avoidance measures were included in the Act (National Treasury, 2011).

The first anti-avoidance provision was that the investor could not become a connected person to the VCC after the transaction was completed[3] (National Treasury, 2011).

[1] Subsection 12J(2) of the Act was updated by section 38(1)(i) of Act No. 24 of 2011 of the TLAA.
[2] Removed from section 12J(3) by section 38(1)(*j*) of Act 24 of 2011 of the TLAA.
[3] This anti-avoidance measure was brought into legislation in section 12J(3A) of the Act.

The connected-person rule in terms of section 1 of the Act is separated into certain requirements for different persons. Natural persons or trusts would be connected persons in relation to the VCC if the natural person or trust (or any connected person in relation to that person) holds 20 percent or more of the equity shares or voting rights of the VCC. For companies the investor would be a connected person to the VCC if the company (or any connected person in relation to that company) holds more than 50 percent equity shares or voting rights of the VCC. However, the 50 percent were reduced to 20 percent if no other person held the majority equity shares or voting rights in the VCC.

The definition of equity shares in section one of the Act was defined as any share that can participate in any amount beyond a specified amount in a distribution.[1] Section 7(1)(*h*) merely excluded any shares that could not participate beyond the specified amount in a distribution. Section 7(1)(*i*) defined equity shares as any share in a company including dividends or return of capital that has any right to participate beyond a specified amount in a distribution.

This anti-avoidance measure meant that taxpayers cannot reuse funds to get the same deduction in various connected-person entities (National Treasury, 2011). The intention of the anti-avoidance measure was that a tax deduction cannot be obtained by simply moving funds around between closely connected parties but rather by obtaining new investments from independent investors (PWC, 2012). This anti-avoidance measure ultimately ensured that investors does not obtain a tax benefit by simply investing in their own business (De Klerk, 2020).

The second anti-avoidance provision was that deduction will only be allowed in the case of pure equity investments[2]. This adjustment included the definition of venture capital share in section 12J of the Act[3]. This provision excluded any equity shares with debt-like features (De Klerk, 2020). The definition stated that a venture capital share should not be a hybrid equity instrument in terms of section 8E(1) of the Act. However, the three-year prior period requirement as mentioned in subsection (b)(i) of the definition of hybrid equity instrument should not be considered when determining whether an equity share is a venture capital share. The VC share is also not allowed to be a third-party backed share in terms of section 8EA of the Act. This amendment constituted that the rights attached to the shares should include the participation in the distribution of profits and capital on an unrestricted basis (SARS, 2020:4). As per National Treasury the investor had to bear the economic risk associated with the investment in the VCC. If the VCC had to redeem the shares or had the option to redeem the shares it was most likely not venture capital shares

[1] This was updated by section 7(1)(*h*) and 7(1)(*i*) of the Act 24 of 2011 of the TLAA and came into effect on 1 January 2011 and the 1 April 2012 consecutively
[2] This was adjusted by section 38(1)(*j*) of Act 24 of 2011 of the TLAA.
[3] Included by s. 29 (1) (*i*) of Act No. 23 of 2018 deemed to have come into operation on 24 October 2018

because there was no risk involved in the acquisition of the shares. This ensured that investors only received a tax benefit if they invested in high-risk SMMEs which are in most instances not attractive investments (De Klerk, 2020).

The third anti-avoidance provision was that there had to be a risk-element attached to the investment. As per the National Treasury there had to be a risk element related to the investment in the high-risk SMMEs to get the tax deduction as the investment would in other cases not be attractive. The investor should "genuinely" be placed at risk (National Treasury, 2011). There was no risk when the investor used his own funds to invest (De Klerk, 2020). The risk element came in when the investor obtained a loan to invest in the VCC either by a credit facility or the VCC itself (SARS, 2020). The loan must be fully repayable even if the VCC did not reach the investment objectives as intended (National Treasury, 2011). There is no risk element if the loan or credit facility is only repaid after five years (National Treasury, 2011). If no revenue were received by the taxpayer in the future for the disposal of the shares there had to be an economic loss because of the expenditure incurred for the acquisition of the shares (SARS, 2020). This anti-avoidance provision was intended to stop the taxpayer from getting a deduction in an investment where there is no risk attached to the investment or that the repayment period was extended to a point where it became meaningless after inflation (PWC, 2012).

2.4.4 Making the tax deduction permanent with inclusion of the five-year non-recoupment rule (TLAA 43 of 2014)

In 2014 there was minimal uptake of the VCC regime: there were only five VCCs registered with SARS and only three of the VCCs were active (National Treasury, 2014). Although there were amendments in 2011 to increase the attractiveness of the VCC incentive the uptake was still minimal (SAICA, 2014). There was still an issue with the requirements being too restrictive even though there were adjustments to the VCC incentive in 2011. The National Treasury held consultations with the three active VCCs and concluded that there were adjustments to be made (National treasury, 2014).

Upon the disposal of the shares the investor company had to recoup the value of the expenditure actually incurred in terms of section 8(4)(*a*) of the Act. Section 8(4)(*a*) determines that the full amount that was allowed as a deduction from the taxable income of the natural person or entity investor would be recouped in the year of the disposal of the shares. This amount would have been taxed at the marginal tax rate of the natural person according to their respective tax rate in line with the tax schedules for the occurring year of the disposal. The capital gains would be calculated using the proceeds received from the sale of the shares, reduced by the recouped amount as mentioned above, minus the base cost of the shares. The natural persons would have

been taxed as per section 10(1)(*a*) of the Eighth Schedule of the Act on the capital gain. This would be at the marginal tax rate as per the natural persons individual tax calculation multiplied by 40 percent inclusion rate for natural persons. For entity investors the inclusion rate would be adjusted to 80 percent as per section 10(1)(*c*) of the Eighth Schedule of the Act multiplied by 28 percent which is the company tax rate in South Africa.

In 2014 the rules related to the disposals of the shares were amended[1]. There is no recoupment of the value of the shares as per section 8(4) of the Act if the shares were held for a period longer than five years (De Klerk, 2019). This also meant that there is no base cost if the shares were sold after five years, and the taxpayer is taxed on the full proceed amount (De Klerk, 2019). The amendment in the Act meant that the temporary deduction from taxable income would become permanent (De Klerk, 2019). The fact that there is no recoupment of the expenditure incurred meant that the base cost of the shares is reduced to zerol and the taxpayer is taxed on the full proceeds amount (Parker, 2014b). This amendment resulted in the investor not having a shield against the proceeds from CGT (Parker, 2014b). The amendment would have been more attractive if there was a shield against the subsequent CGT (Parker, 2014b). Due to the absence in the secondary market for VCC shares the shareholders had limited exit routes out of the investment that did not have a significant tax consequence (Parker, 2014b).

By including a timeline into the Act, the National treasury guided investors to invest for the proper investment strategy (Blake, 2022). The amendment was to ensure that the investors invested for the correct reason and not purely for a permanent tax deduction (National Treasury, 2014).

2.4.5 Deferral of the connected person test (TLAA 17B of 2016)

In 2016 the amendments were made due to the uptake of the VCC regime still being limited according to several sources. in 2016 it was noted that only 31 VCCs had been registered successfully but that certain investor criteria would still prohibit the uptake of the regime (PWC, 2016). The relaxation was insufficient as the uptake were minimal and that was the reason for the 2016 amendments of the VCC regime (PWC, 2016).

Angel investors were limited due to the connected person rule. The connected person rule stated that an entity may not own more than 20 percent of the equity shares or the voting rights after the investment in the VCC were made (National treasury, 2016). This was restrictive for anchor investors as in the initial stages of the VCC there were not a lot of seed capital available, and the anchor investors often would hold more that 20 percent of the equity shares for a period until smaller entities would buy shares. Due to there being the restrictive clause that the anchor

[1] Included section 12J(9) into the Act[1] by section 23(1)(*e*) of Act 43 of 2014 of the TLAA.

investors could not get the initial tax deduction they did not invest in VCCs, and it was difficult for the VCCs to get smaller entities to invest.

The Act was updated to state that the connected person test should only be performed 36 months after the VCC has issued the first shares[1]. This gave VCCs the chance to obtain anchor investors in the start-up phase (National Treasury, 2016).

To minimize the risk with regards to the connected person test only being performed after 36 months the following anti-avoidance measures were introduced if any taxpayer is a connected person after the 36-month period has expired:

- The Commissioner must withdraw the approval of the VCC to trade as a VCC, if the necessary corrective steps were not taken in the period as stated in the notice by the Commissioner.
- The VCC must include the expenditure incurred by the taxpayer for the issue of those shares at a rate of 125 percent in their taxable income during the year of assessment in which the approval was withdrawn.

2.4.6 Extending the scope of the non-recoupment rule to a return of capital (TLAA 17 of 2017)

The 2017 adjustment[2] included that if there were a return of capital after a five-year period has passed there will also be no recoupment in the hands of the taxpayer. This came into effect where the shares in the VCC were held for a period longer than five years and the investors wanted to realise the value of the investment in the form of a return of capital and it triggered a recoupment. The Act was not congruent in its dealings with the section 12J shares when the value of the investment was to be extracted (National Treasury, 2017). This was not a major adjustment it was merely to adjust the Act to be in line with the adjustment made in 2015 for the recoupment of the shares not to be included in the taxable income of the taxpayer.

2.4.7 Update of the connected person test to stop abusive structure (TLAA 23 of 2018)

In 2018 various abusive structures were identified in terms of the VCC regime. The amendments were wide and most of the amendments were made to stop the abusive structures in the VCC regime (National Treasury, 2018). In the public hearings report published by SARS the report

[1] This was included in section 12J(3A) of the Act
[2] Included by Section 28(1) of Act 17 of 2017 of the TLAA.

mentioned that there were various investment structures that were not in line with the objectives of the VCC incentive (Standing Committee on Finance, 2018).

This adjustment[1] were to minimize the abusive structures that was evident. The adjustment stated that an investor is not allowed to hold more than 20 percent of any class of shares since investment in the VCC after the period of 36-months has expired. This adjustment only applied to entity investors because of the 20 percent connected person rule. By including the amendment, the industry was destructed (Blake, 2022). Comments made by several tax professionals and SAVCA were that the incentive were being abused but the way the National Treasury wants to deal with the misuse was not sufficiently targeted and to extensive. The abuse should be targeted directly in corelation to the specific abusive structures (Ensor, 2018). The reasons given as to why the VCC industry needs different classes of shares were (Standing Committee on Finance, 2018) that different classes of shares are often issued to management to have interest in the VCC, without receiving a tax deduction. Secondly, that the VCCs used different classes of shares for different allocations of capital to ensure qualifying companies has access to capital in different stages of operations. And lastly, that VCCs also used different classes of shares to invest in different industries.

This meant that if the investor held more than 20 percent in any class of shares in the VCC the relief in section 12J of the Act did not apply. The VCC status will also be withdrawn if corrective steps are not approved by the Commissioner and 125 percent of the allowable deduction was included in the taxable income of the VCC (National Treasury, 2018).

This second adjustment[2] stated that an investor is not allowed a deduction for the value of the shares if the shares were issued for services rendered to the VCC or the qualifying investee company (National Treasury, 2018).

2.4.8 Targeted measure to limit excessive deductions with inclusion of deduction limitation (TLAA 34 of 2019)

It came to the attention of the government that there were still abusive structures in the regime (National Treasury, 2019). In the explanatory memorandum by the government, the National Treasury stated the abusive structures cannot be ignored as it undermines the progressive nature of the tax system and due to the fiscus being under constant constraint the abusive structures cannot be justified. National Treasury re-introduced the deduction limitation in an effort to protect the high-tax expenditure of the fiscus.

[1] The adjustment was brought into the Act by section 29(j) of the Act 23 of 2018 of the TLAA.
[2] The first adjustment was brought into the Act by section 29(i) of Act 23 if 2018 of the TLAA.

The limitations set by the government in section 12J were R5 million for companies and R2.5 million for any other taxpayer other than a company. This applied for expenditure incurred on or after 21 July 2019. There were also no roll-over relief available as this would have caused possible administration issues.

The anti-avoidance measures set by the National Treasury were also updated with the following:

- Section 12J(3A) which held the anti-avoidance provision for the connected person rule that only applies after 36-months. It was deemed that the anti-avoidance measure only came into effect on 21 July 2019 and only applied to taxpayers to whom VCC shares has been issued after that date.
- Section 12J(3B) of the Act which held the anti-avoidance provision for the 20 percent shareholder limitation stating that entity shareholders are only allowed to have 20 percent equity shares in any class of shares, only came into effect on the 21st of July 2019.

2.4.9 Update of the connected person test to be deferred by 6-month after notice has been received by the Commissioner (TLAA 23 of 2020)

There were several tax abusive structures available that was against the intended objective of the VCC regime (National Treasury, 2020b). Due to the anti-avoidance provisions introduced by the government an anomaly arose by what could actually happen in practise and what the Act stipulated. Several VCCs unintentionally breached the 20 percent shareholding measure within a VCC structure. The anti-avoidance provision was updated so that the VCC had six months after notification was received from the Commissioner that there was a breach in the 20 percent shareholding limitation in any class of shares, that the VCC has intended to cancel the class of shares. If the necessary steps were not taken by the VCC the provisions in section 12J(3B) of the Act was applied. This provision came into effect on the 31st of July 2020.

This element relating to the investor was not adjusted any further.

2.4.10 Summary of the changes in the requirements of the qualifying investor and the investment tax relief available

As can be seen from the discussion had there been multiple amendments in the legislation regarding the requirements of the qualifying investor and the investment tax relief available to investors. The first set of amendments that were made gave the illusion that the National treasury wanted to increase the uptake of the regime. The second set of amendments that were made were to stop the abusive structures that became evident from the 2016 amendments onwards. Due to the various amendments made to the incentive after 2016 it could be construed that the

National Treasury had difficulty in finding the right balance between increasing the uptake of the VCC regime and stopping the misuse of the regime.

In table 1 below is a summary of the amendments that were made to the requirements of the qualifying investor and the investment tax relief available to investors.

Table 1: Summary of the changes in the qualifying investor requirements

Initial enactment by section 27 of the Revenue Laws Amendment Act (60 of 2008)	**Tax Law Amendment Act 17 of 2009**	**Tax Law Amendment Act 24 of 2011**	**Tax Law Amendment Act 43 of 2014**	**Tax Law Amendment Act 15 of 2016 and Tax Law Amendment Act 17 of 2017**	**Tax Law Amendment Act 23 of 2018**	**Tax Law Amendment Act 34 of 2019**	**Tax Law Amendment Act 23 of 2020**
Deduction limitation of R750 000 annually and R2.25 million in their lifetime for entity investors of the actual expenditure incurred		This requirement was removed from the Act.				Deduction limitations were set by the government to only allow a deduction of R5 million for companies and R2.5 million limitation for any other taxpayers. There is also no roll-over relief available.	
100% deduction allowable for entity investors of the actual expenditure to acquire the VCC shares limited to **10%** of the equity shares in a VCC.	100% deduction allowable for entity investors of the actual expenditure to acquire the VCC shares limited to **40%** of the equity shares in a VCC.	This requirement was removed from the Act.					
No tax deduction available for unlisted companies and trusts.		Unlisted companies and trusts could also get the tax deduction.					
On the disposal of shares there is a recoupment of the deduction previously allowed in terms of section 8(4) of the Act.			There is no recoupment in terms of section 8(4) if the shares in the VCC were held for a period longer than 5 years.	The recoupment in terms of return of capital was also excluded if the shares were held for a period longer than 5 years (**Act 17 of 2017).**			
Investor should have a share certificate from the VCC stating the amounts invested in the VCC.							

Anti-avoidance measures							
		The deduction was not allowed if the investor became a connected person to the VCC after the investment. For natural persons and trusts the limitation was 20% and for any other entities the limitation was 50% (the 50% were reduced to 20% if no other person held the majority shares).		The connected person test should only be performed **after 36 months has passed** since the first issue of shares to the investor **and every subsequent year after that**. If the investor is a connected person after 36 months has passed, SARS may withdraw approval of the VCC. (**Act 15 of 2016).**	The rule stayed the same except that it was included that not more than 20% in **<u>any</u>** class of shares were allowed to be held by the entity investors after the 36-month period has passed. SARS may also withdraw the approval of the VCC in this matter in the current year that the VCC does not correct the connected person rule.	The connected person rule will only be applied for the period after 21 July 2019.	An additional element was added to confirm that after the 20% shareholding in any class of shares has been breached the VCC had 6 months to cancel the class of shares otherwise the provision in section 12J(3B) of the Act is applied.
		The deduction was only allowed if it was a pure equity investment. Not allowed to be loan with debt-like features.					
		There had to be a risk element attached to the investment.					
					An investor was not allowed to get a deduction for the VCC shares if the shares were issued for services rendered or for managerial services to the VCC or the qualifying investee company.		

(Source: Author's compilation of information presented above)

2.5 Venture capital company requirements

When section 12J was promulgated into the Act the requirements for an entity to be approved as a VCC were quite extensive. The discussion below will show that there were several relaxations in terms of an entity to be classified as a VCC. The VCC is merely a pooling mechanism for investors to put their funds together to invest in a qualifying investee company.

2.5.1 Initial enactment

Section 12J(5) was included in the Act to deal with the requirement to be met for a VCC to be approved by the Commissioner of SARS.

The following requirements deal with the type of company that can be registered and speak to the requirements of the VCC itself[1]:

- The VCC should be a resident company in South Africa.
- The company should have been an unlisted company as defined in section 41 of the Act or a junior mining company.
- The VCC should not have been a controlled group company as per paragraph (d)(*i*) of the definition of connected person as per section 1 of the Act.
- All tax affairs on the VCC should be in order and all laws should have been adhered to.
- The company is licensed in terms of section 7 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002).

The following were additional requirements that had to be met for the VCC to keep its approval as a VCC. These considered gross income requirements, control requirements, and what should have been included in the investment portfolio.

The first requirement to be met[2] was that within 36 months from the application for the approval as a VCC, 90 percent of the gross income of the VCC should have been due to services rendered to qualifying companies and financial instruments issued to the qualifying companies (National Treasury, 2008). Not more than ten percent of gross income should be from operations other than services provided to qualifying investee companies and/or other financial services (Deloitte, 2009). Initially, the VCC were only allowed income from financial instruments but because fund managers charge management fees to investee businesses for the management services provided, they included the ten percent limitation (Portfolio Committee on Finance, 2008).

[1] Included in Section 12J(5)(*a*) of the Act
[2] In terms of section 12J(5)(*b*) of the act

The second requirement[1] was the no control requirement. The VCC and any other connected person as defined in section 1 of the Act in relation to the VCC could not control the qualifying investee company. This meant that two entities could not hold more than 50 percent of the shares or voting rights of the qualifying investee company (National Treasury, 2008). This percentage was reduced to 20 percent if no other person held the majority shareholding in the qualifying investee company. The VCC was meant to be an 'angel investor' to various independent SMMEs—the VCC should have had the controlling share interest in the company (National Treasury, 2008).

The third requirement in terms of the expenditure of the VCC[2] was the requirements of the investment portfolio of the VCC. Within a period of 36 months after the date of application of the approval of the VCC:

- At least R30 million should have been expended by the VCC to obtain qualifying shares in a qualifying investee company, or R150 million if the qualifying shares were in any junior mining company.
- At least 10 percent of the expenditure incurred by the VCC had to be for the acquisition of qualifying shares in a qualifying investee company that held assets with a book value not exceeding R5 million immediately after the investment (National Treasury, 2008)[3].
- At least 80 percent of the expenditure incurred by the VCC had to be for the acquisition of qualifying shares in a qualifying investee company that held assets with a book value not exceeding R10 million after the investment. If the qualifying investee company was a junior mining company the book value could not exceed R100 million after the investment (National Treasury, 2008)[4]. The comments in this regard were, however, that the requirement impedes the balancing of the portfolio of the VCC, especially in the early stages of business that have high growth potential that requires funding for amounts of more than R10 million (Portfolio Committee on Finance, 2008).
- Only 15 percent of the expenditure incurred was allowed to be invested in any one qualifying investee company (National Treasury, 2008)[5]. The purpose was that the VCC maintained a reasonable portfolio of investments (National Treasury, 2008).

The objective of the government was that the VCC was merely a pooling mechanism for investors to pool their money together to invest in high-risk entities. The objective was, however, for the

[1] As per section 12J(5)(*c*) of the Act
[2] As per section 12J(5)(*e*) of the Act
[3] This was included in section 12J(5)(*e*)(*ii*) and (iii) of the Act.
[4] This was included in section 12J(5)(*e*)(*ii*) and (iii) of the Act.
[5] This was included in section 12J(5)(*e*)(*iv*) of the Act.

VCC to not only invest in one company but to invest in several high-risk companies that could not get access or had difficulty getting access to finance.

The withdrawal of approval regulation[1] mentioned that if the Commissioner was not satisfied that a VCC has met the requirements as stated above during any year of assessment, the Commissioner must issue a notice to the VCC to amend the investment portfolio within a time frame given by the Commissioner. If corrective steps have not been taken by the VCC to amend the regulations not met within a period as mentioned in the notice by the Commissioner, the Commissioner will withdraw the approval of the VCC from the start of that year (National Treasury, 2008). Upon the withdrawal of the VCC status the VCC had to include 125 percent of the expenditure incurred by investors to acquire the shares in the VCC (National Treasury, 2008).

2.5.2 Revised upfront SARS approval requirements and deferral of investment expenditure requirement (TLAA 17 of 2009)

In 2009 SARS noted that there were various administrative issues regarding the approval of the VCC. The necessary evidence regarding the investment expenditure requirements to approve the VCC could not be obtained (National Treasury, 2009). SARS mentioned that they will only be able to confirm that the main objective of the VCC is that it is a fund manager of qualifying investors. The rest of the approval requirements will only be confirmed after 36 months have passed after approval and every consecutive year after that. There was however a new requirement that had to be met: the sole object of the VCC was to manage investments in qualifying investee companies (De Klerk, 2020). This requirement was included to ensure that the sole purpose of the VCC was investor pooling and to give management services and finance to SMMEs.

The National Treasury also updated the first requirement to be met[2], stating that 80 percent of the gross income of the VCC should have been due to services rendered to qualifying companies and financial instruments issued to the qualifying companies. The other 20 percent may consist of other investment income. The investment income does not include dividends received from the qualifying investee companies or the proceeds from the sale of shares in qualifying investee companies (National Treasury, 2009).

The third requirement was also updated due to administration issues (National Treasury. 2009). The 36-month investment expenditure allocation requirements were updated to reflect that the requirements only have to be met after the 36 months has passed and every consecutive year after that and not within the first 36-month period. SARS does not have to confirm this for approval,

[1] in terms of section 12J(6) to (8) of the Act
[2] in terms of section 12J(5)(*b*) of the Act

but they have to adhere to the above requirements for approval. The requirement that at least 10 percent of investments should be in qualifying investee companies with a book value of not more than R5 million after the investment by the VCC was removed. The restrictions were too narrow and investments in companies with high growth potential were a risk for the VCC because of non-compliance with regulations (De Klerk, 2020).

The removal of the above-mentioned requirements was a positive update to the regime because these requirements were unnecessary and difficult to administer (De Klerk, 2020).

2.5.3 General relaxation of venture capital company requirements (TLAA 24 of 2011)

In 2011 there have been limited uptake of the VCC regime and there have been no successful VCC applications until the date of the report, and the applications were few (National Treasury, 2011). This was confirmed by PWC in 2012. It was also stated that the requirements were too restrictive, too complex, and the VCC could not operate successfully and adhere to the restrictive requirements (National Treasury, 2011). In 2011 the requirements were significantly relaxed to simplify the regime. The following amendments were made in 2011:

- The listed entity requirement was removed as there was no need for this requirement as it had no effect on whether the company was a pooling mechanism for investors (PWC, 2012).
- The non-controlling group company requirement were removed which meant that the VCC and a connected person could own more than 20 percent or 50 percent depending on the requirements. There were ownership limitations retained for qualifying investee companies to mitigate the risk of removing the non-controlling group company requirement (PWC, 2012). The deduction limitation was, however, still set for the connected persons and they could not get the deduction, as explained in point 2.2.2.3 above.
- The gross income requirement was removed from the legislation completely. Initially it stated that 90 percent of the income received should have been due to the services rendered to qualifying investee companies (subsequently it was changed to 80 percent) or from financial instruments. This was to confirm that temporary cash injections into the VCC does not cause the regime not to be effective (National Treasury, 2011). A temporary cash injection to the VCC would not cause the disqualification of the VCC (PWC, 2012).
- The minimum investment requirement was also removed as it caused unnecessary restrictions to the regime that was against the initial objectives of the VCC incentive
- Section 12J(6A) was introduced into the Act which included the requirements that the investment portfolio had to meet in order to be approved as a VCC. The 15 percent

restriction were increased to 20 percent. This amendment ensured that the SMMEs still got access to enough funding, and this also forced the VCC to invest in a minimum of five qualifying investee companies (PWC, 2012). The limitation that stated that at least 80 percent of the expenditure incurred by the VCC had to be for the acquisition of qualifying shares in a qualifying investee company that held assets with a book value not exceeding R10 million after the investment was still included in the Act. However, the R10 million book value was adjusted to R20 million after the investment by the VCC. If the qualifying investee company was a junior mining company the book value could not exceed R150 million after the investment.

2.5.4 Clarification on the 36-month deferral period and the 80% gross income requirements (TLAA 43 of 2014)

In 2014 there were anomalies evident from the 36-month period with regard to the 80 percent rule of the gross income and the 20 percent rule in the investment portfolio as initially included in the Act.

The following clarification matters were given. With regard to the 80 percent gross income rule which stated that at least 80 percent of the expenditure incurred by the VCC had to be for the acquisition of qualifying shares in a qualifying investee company could be interpreted that 80 percent of the total income had to be invested in the qualifying investee companies; this included dividend income and any other income received for services rendered by the VCC. It was also noted that the Act stipulated that the 80 percent gross income rule only applied for a period of 36 months and thereafter the VCC could invest in any asset after that period, which was not the intention of the legislation (National Treasury, 2014)

With regard to the 20 percent subscription rule which stipulated that only 20 percent of the expenditure incurred was allowed to be invested in any one qualifying investee company was not practical. When the VCC had to use the expenditure incurred as a measure and they only invested in five qualifying companies and sold one of the qualifying companies, they would not meet all the requirements to be approved as a VCC (National Treasury, 2014). The new regulation[1] stated that the measure that should be used is the subscription moneys received by the VCC as the measure to confirm that only 20 percent of the capital received is invested into one qualifying investee company.

[1] This regulation was updated by section 23(1)(*d*) of the Act no 43 of 2014 of the TLAA.

2.5.5 Failure of connected person test and the withdrawal of the VCC status (TLAA 23 of 2018)

In 2018 several administrative and technical issues was noted by SARS and the National Treasury which prohibited the VCC regime from getting more attraction (National Treasury, 2018). The administrative amendment was made to only include 125 percent of the allowable deduction in the taxable income of the VCC in the year the status as a VCC was withdrawn because the connected person test failed. SARS should also only withdraw the status as a VCC in the year the VCC fails to take corrective steps to correct the connected person rule (National Treasury, 2018).

2.5.6 Consequential anti-avoidance amendment (TLAA 34 of 2019)

This adjustment was made to change the 36-month limitation period[1] to permit a grace period of 48 months for the VCC to ensure that more than 80 percent of the expenditure incurred was used to acquire shares in qualifying investee companies.

2.5.7 Summary of the changes in the VCC requirements

As can be seen from the discussion there had been multiple amendments in the legislation regarding the requirements the VCC had to meet to keep trading as a VCC. The requirements had administration difficulties for SARS, and the Act had to be amended to clarify the rules. It could be construed that the various amendments to relax the VCC requirements to keep its status as a VCC was due to the fact that there was no clear indication of what was expected of the VCC. The amendments made from 2014 onwards were to give clarification on the rules regarding the requirements of the VCC and made the administration easier to regulate.

In table 2 below is a summary of the amendments that were made to the requirements to be a VCC.

[1] In section 12J(6A) of the Act

Table 2: Summary of the changes in VCC requirements

Initial enactment by section 27 of the Revenue Laws Amendment Act (60 of 2008)	Tax Law Amendment Act 17 of 2009	Tax Law Amendment Act 24 of 2011	Tax Law Amendment Act 43 of 2014	Tax Law Amendment Act 15 of 2016 and Tax Law Amendment Act 17 of 2017	Tax Law Amendment Act 23 of 2018	Tax Law Amendment Act 34 of 2019
Preliminary requirement						
VCC should be a resident company.						
The company should be an unlisted company as per section 41 of the Act or a junior mining company.		This requirement was removed from the Act.				
Should not be a controlled group company as per paragraph (d)(i) of the definition of connected person of the Act.		This requirement was removed from the Act but there was still a deduction limitation for connected persons.				
All tax affairs should be in order.						
Licensed in terms of section 7 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002).						
	The sole object of the VCC should be to be a fund manager for qualifying investee companies.				.	

Gross income requirement						
Within 36 months of application of approval of the VCC, **90%** of gross income should be from services rendered to the qualifying investee company or financial instrument.	Within 36 months of application of approval of the VCC, **80%** of gross income should be from services rendered to the qualifying investee company or financial instrument. The 20% limitation does not include dividends received from qualifying investee companies, also proceeds from sale of shares of a qualifying investee company.	This requirement was removed from the Act.				
Control requirement						
The VCC together with any other connected person could not control the qualifying investee company.						
Investment expenditure allocation requirements						
Below requirements should have been met **within 36 months after** the date of application for approval as a VCC.	Below requirements should **be met after 36 months from** the date of application for approval as a VCC.					
Minimum of R30 million invested in qualifying investee companies. Increased to R150 million if it was invested in junior mining companies.		This requirement was removed from the Act.				

Minimum of 10% of investments should have been qualified investee companies with a book value not exceeding R5 million after the investment.	This requirement was removed from the Act.					
Minimum of 80% of investments should have been qualified investee companies with a book value not exceeding **R10 millio**n after the investment.		Minimum of 80% of investments should have been qualified investee companies with a book value not exceeding **R20 million** after the investment.	Minimum of 80% of investments should have been qualified investee companies with a book value not exceeding **R50 million** after the investment.			This particular provision only has to be met within 48 months and not 36 months.
Maximum of **15%** of expenditure incurred should be in one qualifying investee company.		Maximum of **20%** of **expenditure incurred** should be in one qualifying investee company.	Maximum of **20%** of **moneys received in respect of shares issued** should be invested in one qualifying investee company.			
Withdrawal of approval						
If the above requirements are not met the Commissioner may issue a notice to withdraw the approval of the VCC from the beginning of that year of assessment.				If the connected person test has failed in respect of the investor the Commissioner should also withdraw approval if the appropriate steps are not taken by the VCC (**Act 15 of 2016).**		
Include 125% of the deductions allowed for the investors into the taxable income of the VCC.				Include 125% of the deductions allowed for the investors into the taxable income of the VCC if the connected person test fails in the year the rest fails (**Act 15 of 2016).**	The taxable income is only included in the taxable income of the VCC in the year that the connected person test fails and VCC status is withdrawn and not in prior years.	

(Source: Author's compilation of information presented above)

2.6 Qualifying investee company requirements

National Treasury had a specific type of qualifying investee entity in mind when the VCC regime was enacted. The problem as stated in various sections of this document was that SMMEs had trouble getting access to finance and that SMMEs was one of the most important sectors of the economy. The VCCs had to promote SMMEs in growing the economy by helping them financially and in the managerial aspect of the operations.

2.6.1 Initial enactment

The initial requirements that had to be met for a company to be a qualifying investee company as per section 12J of the Act were the following:

- The first requirement was that the VCC should be a resident company in South Africa.
- The company should have been an unlisted company as defined in section 41 of the Act or a junior mining company.
- The company should not have been a controlled group company as per paragraph (d)(*i*) of the definition of connected person as per section 1 of the Act.
- All tax affairs of the company should be in order and all laws should be adhered to.

The above requirements are the same overall requirements that must be met for a VCC to be approved as VCC. There were, however, additional requirements that had to be met for the company to qualify as a qualifying investee company.

The first additional requirement related to the trading of the qualifying investee company. The definition of qualifying investee company as per section 12J was that the qualifying company does not carry on any impermissible trade[1]. The company also had to trade within a period of 18 months from the initial investment and in the case of junior mining companies the company had to start trading within 36 months. The company was also not allowed to carry on an impermissible trade which was defined as follows (National Treasury, 2008):

- Any trade carried on in respect of immovable property, other than a trade carried on as a hotel keeper
- Any trade carried on by a bank, long-, or short-term insurer, or any trade in respect of money lending or hire-purchase agreements

[1] Included in subsection (e) of the Act of the definition of “impermissible trade”

- Any trade including financial or advisory services, which included legal services, tax advisory services, share trading services, management consulting services, auditing, or accounting services
- Any trade in respect of gambling
- Any trade carried on whether manufacturing, buying or selling of liquor, tobacco, or firearms
- Trading as a franchisee; or
- Any trade that is carried on mainly outside the republic.

SAVCA and Finmark Trust mentioned that the definition was too narrow and excluded industries such as tourism-type activities which holds a property or land element but is still operating entities, for instance, guest houses, hotels, or game-farms (Portfolio Committee on Finance, 2008).

The second requirement was that the gross income of the qualifying investee company should constitute the following and had to be adhered to within 36 months after the shares were issued to the VCC[1]:

- The total investment income of the company was not allowed to be more that 20 percent of the gross income (National Treasury, 2008).
- Within 18 months of the issue of the shares the company had to incur expenditure that was equal to the amount received for the shares issued that is deductible in terms of the Act for the purposes of carrying on any trade (National Treasury, 2008). All the funds received from the investment in the VCC should have been invested in an asset that produces income or in deductible expenses as part of the trading operations of the entity (Deloitte, 2009).

These were the requirements that had to be met to be classified as a qualifying investee company.

2.6.2 Removal of deferred investee company requirements (TLAA 17 of 2009)

In 2009 various administration issues were noted by SARS and amendments were made. The 18-month referral period for the qualifying investee company to be carrying on a trade was removed, and the qualifying investee company no longer had to spend all the moneys received from the VCC for the investment within 18 or 36 months. These requirements caused administrative difficulties for SARS and were removed from the Act given their predictive nature (National Treasury, 2009).

[1] As per subsection (f) of the definition of qualifying investee company.

2.6.3 Inclusion of a franchise as qualifying investee company (TLAA 24 of 2011)

The amendments in 2011 with regard to the qualifying investee company was that it was allowed to be a franchise. The National Treasury noted that franchises are sometimes SMMEs and that they also need support in order to operate (National Treasury, 2011). This requirement was removed from the Act.

2.6.4 Clarification of the controlled group company requirements and anti-avoidance measures to mitigate the abusive structures evident (TLAA 23 of 2018)

The reason for the investment income not to be more than 20 percent of the total gross income is due to the fact that the funds received from the issue of the shares to the VCC should assist the underlying business to grow (National Treasury, 2018). This is not always sustainable as there are SMMEs that require time and infrastructure before income other than investment income can be generated by the SMME. The Act was subsequently adjusted such that the 20 percent investment income rule only be applied after 36 months have passed since the investment in the qualifying investee company by the VCC and every subsequent year after that.

There was uncertainty regarding the “controlled group company” in relation to a group of companies’ requirements as per paragraph (b) of the definition of “qualifying company” (National Treasury, 2018). A controlled group company is a company that has a corporate shareholder that holds a minimum of 70 percent of the company’s shares, directly or indirectly. The qualifying investee company must have an independent shareholder that holds a minimum of 30 percent of the shares. Clarification was needed as some of the investors in the VCC obtained shares in the qualifying investee company outside of the VCC framework but also obtained shares in the VCC which were, in return, invested in the same qualifying investee company. This rule was clarified to state that the controlled group company rule only applied within the VCC framework: it did not regard investors investing in the qualifying investee company outside the VCC framework. This gave investors the opportunity to invest in their own business and obtain a significant tax deduction (National Treasury, 2018).

The amendments were made to reduce the scope for tax structuring (De Klerk, 2020). The abusive structures that became evident in the public comments regarded the trading between the investor in VCC shares and qualifying investee companies trading with the relevant investor (Parker *et al*, 2019). The target structures the amendments were supposed to stop were designed as follows (Parker *et al*, 2019): (1) The qualifying investor invests in the equity shares of the VCC. (2) The VCC in return injects the equity funding into a specific qualifying investee company. (3)

The qualifying company purchased assets and traded with the qualifying investor in its normal operations.

These targeted structures were considered to be operating as captive units while functioning as an entity on their own. The following anti-avoidance measures were included into the Act in 2018 as a way for the National Treasury to mitigate abusive structures in the regime.

- Not more than 50 percent of the income of the qualifying investee company from carrying on a trade may be from an investor in the VCC.
- It was also included that VCC shareholders may not hold more than 50 percent participation rights or voting rights in the qualifying investee company as defined in section 9D(1) of the Act.
- The third provision is that a VCC shareholder may not sell their shares in a qualifying investee company to the VCC and then be a shareholder in the VCC or a connected person to the VCC. The shares will not fall within the ambit of the VCC regime.

2.6.5 Summary of the changes in the qualifying investee company requirements

As can be seen from the discussion had the requirements relating to the qualifying investee company not been amended as much as the requirements of the qualifying investor, the available investor tax relief, and the VCC. The misuse of the regime at the qualifying investee company level accompanied the connected person rules that needed clarification and the impermissible trade requirement being wide and subject to subjective interpretation. Anti-avoidance rules included in 2018 were to mitigate the structures evident from the misuse of the connected person requirements.

In table 3 below is a summary of the amendments that were made to the requirements to be a qualifying investee company.

Table 3: Summary of the changes in the qualifying investee company requirements

Initial enactment by section 27 of the Revenue Laws Amendment Act (60 of 2008)	Tax Law Amendment Act 17 of 2009	Tax Law Amendment Act 24 of 2011	Tax Law Amendment Act 23 of 2018
Preliminary requirement			
The Company should be a resident company.			
The company should be an unlisted company as per section 41 of the Act or a junior mining company.			
Should not be a controlled group company as per paragraph (d)(i) of the definition of connected person of the Act.			The legislation was adjusted to confirm that the controlled group company test only applies within the VCC regime and does not apply to investors that invest outside the VCC regime.
All tax affairs should be in order.			
Impermissible trade requirement			
Any trade carried on in respect of immovable property, other than a trade carried on as a hotel keeper.			
Any trade carried on by a bank, long- or short-term insurer or any trade in respect of money lending or hire-purchase agreements.			
Any trade including financial or advisory services, which included legal services, tax advisory services, share trading services, management consulting services, auditing, or accounting services.			
Any trade in respect of gambling.			
Any trade carried on whether manufacturing, buying or selling of liquor, tobacco, or firearms.			
Trading as a franchisee.		This requirement was removed from the Act.	
Any trade that is carried on mainly outside the republic.			

Trading requirements			
The qualifying company had to start trading within 18 months since the investment from the VCC and within 36 months if it was a junior mining company.	This requirement was removed from the Act.		
The company had to incur expenditure of an amount equal or more to the expenditure incurred by the VCC within 18 months of the initial investment by the VCC in the carrying on of their specific trade.	This requirement was removed from the Act.		
Investment income is not allowed to be more than 20% of the total gross income.			The 20% investment income test will only be applied after 36 months since the date of the investment by the VCC and every subsequent year after that.
Anti-avoidance rules			
			The total income from carrying on a trade of a qualifying investee company, from an investor in the VCC, may not be more than 50% of the total income of carrying on a trade.
			VCC shareholders may not hold more than 50% participation or voting rights in the qualifying company.
			The VCC shareholders may not sell their shares in a company to the VCC and then be a shareholder in the VCC.

(Source: Author's compilation of information presented above)

2.7 Sunset clause

In the enactment of section 12J of the Act on 30 June 2021 the National Treasury included the sunset clause of the VCC incentive[1]. The original reason for the sunset clause was to provide the National Treasury an opportunity to evaluate the effectiveness of the VCC and consider whether the VCC incentive is meeting its intended purpose (National Treasury, 2008). This, however, was not extended and the VCC regime came to an end on 30 June 2021 when the sunset clause was activated.

2.8 Conclusion

As per the discussions above it is evident that the objectives of the regime stayed in line over the period that the VCC incentive was included in the Act. The objectives of the VCC incentive stayed the same over the years namely:

- Increasing the access to equity financing as mentioned by the National Treasury in 2009 and 2016 and to increase supportive managerial services to SMMEs as mentioned by the National Treasury in 2009 and 2011.
- Creating a pooling mechanism for investors to pool their funds together to invest in qualifying investee companies and reducing the risk related to investing in the equity of SMMEs by giving an upfront tax deduction as mentioned by the National Treasury in 2011.
- The development of growth and the use of growth as a mechanism to decrease unemployment and inequality as mentioned by the National Treasury in 2017.

The amendments were in line with the objectives. Despite the various amendments to the VCC incentive there were still some misuses of the incentive. The first set of amendments were to increase the uptake of the regime. The second set of amendments were to stop the abusive structures that became evident from the 2016 amendments and onwards. The anti-avoidance measures included in the Act and the amendments after 2016 were meant to stop the misuse of the VCC incentive due to the structures and transactions between the investors and the qualifying investee companies.

As stated in chapter 1 of the study was the first secondary objective to determine what the initial objectives of the VCC incentive were by reviewing the historical development of the regime. Paragraph 1.7.2 specified that a review was performed on how the initial VCC incentive was promulgated into the Act and what the specific requirements and specifications were regarding the VCC incentive. Second, an analysis was done on how the requirements and specifications

[1] As per section 12J(11) of the Act

changed in the following years leading up to the sunset clause being activated in 2021. An overview was given of the initial objectives as described by the National Treasury and whether amendments in the legislation changed the objectives of the VCC incentive.

In order to give insight into the misuse of the VCC regime and how the misuse could have been prevented by changing the design of the VCC incentive, a review had to be performed on the historical development of the VCC incentive and how it was amended over the years. The review of the historical development of section 12J of the Act addressed how the requirements changed for the three sections in the VCC regime namely the qualifying investor and the investment tax relief available, the VCC, and the qualifying investee company. The changes in the rules and regulations in terms of the three sections were reviewed since enactment and it became evident that the National Treasury had difficulty in finding a balance in increasing the uptake of the regime and stopping the abusive structures in the VCC regime.

CHAPTER 3: CRITICAL ANALYSIS OF THE CHARACTERISTICS OF THE VCC INCENTIVE AGAINST THE MOST IMPORTANT DESIGN PRINCIPLES OF A TAX INCENTIVE

3.1 Introduction

Tax incentives that increase the access to finance for SMMEs are of great importance in a growing economy as this is one of the most important limiting factors the sectors struggle with (Blake, 2022). The VCC incentive was one of the National Treasury's incentives to help the economy grow. The VCC would serve as a pooling mechanism of funds from investors. By creating this mechanism, it would reduce the exposure risk of the investors as the investors would be better protected (Blake, 2022). In return the qualifying investee company would get access to additional capital and management services that would help the SMME grow (Blake, 2022). The VCC would share in the profits of the qualifying investee company and the investors would share in the profits of the VCC. The National Treasury struggled to achieve the balance between creating an incentive that would help the SMMEs get access to finance and stopping the abusive structures emerging from the design of the incentive as discussed in chapter 2. Due to the various amendments made to the VCC incentive and the uncertainty created by the amendments the regime did not meet its full potential (De Klerk, 2020).

This chapter will address how the design of the tax incentive failed in stopping the misuse of the VCC incentive. It will also identify how the design of the VCC incentive were used as a measure to create abusive structures. The purpose of the study is to identify the concerns in the design of the VCC incentive and what aspects of the design made it susceptible to misuse.

The first consideration in this chapter includes what the motivation is for the governments to use tax incentives. It will include what the cost of tax incentives is to the fiscus and in what circumstances a tax incentive would be effective. An analysis is performed on the most common abusive structures that are evident in tax incentives and where the design in tax incentives should mitigate these risks. Second, to identify what aspects of the design of tax incentives made it susceptible to misuse, an analysis is done on the design principles of a tax incentive. It will also include the three most important design principles as published by Zolt (2017), the International Monetary fund (IMF) (2015), and the European Commission (2017). The considerations as described above are used to perform a critical analysis on the design features in the VCC incentive which made it susceptible to misuse. Chapter 3 will therefore address the secondary objective to critically analyse the characteristics of the VCC incentive against the most important

design principles as published by several scholars to identify which aspects of the design made it susceptible to misuse.

3.2 Motivation for using tax incentives by governments

A revenue system that is operating efficiently adopts taxes that are simple, fair, and efficient (IMF, 2015). It is not a simple task to set up a tax system that is fair and efficient, especially for developing countries that want to become integrated in the international economy (IMF, 2019).

Tax incentives are firstly described as “those special provisions” that allows for certain exclusions from income, additional credits, favoured tax rates, or the deferral of tax payable (Zolt, 2017:526). Another definition for tax incentives is that it is a special provision that would reduce a taxpayer’s tax liability (Blake, 2022). This definition is extended by further research stating that the reduction in the tax liability is due to a special project (Zolt, 2017:526). It can be stated that tax incentives will reduce the tax burden of a specific project due to a special tax provision. Governments use these special provisions and specific projects to increase investments in a country.

Tax incentives are often used in a country for three reasons (OECD, 2007:5):

- It is easier for a government to provide a tax incentive to correct certain deficiencies in the market than it is to correct the investment climate or increase the labour force.
- The incentive would not require actual expenditure by the investor.
- Tax incentives are politically easier to provide than funds.

Many countries offer various tax incentives to increase the investments. In a report by the United Nations (UN) it was noted that governments used incentives to further a certain economic goal (United Nations, 2018). Tax incentives are not part of the normal tax system and is only available to a set of pre-selected taxpayers and often become an issue when the country has a comprehensive tax system that applies to all taxpayers (Blake, 2022). Incentives are being justified to correct market deficiencies in certain sectors of the market, targeting new industries with tax competition, and subsidize companies during an economic downturn (United Nations, 2018). It sometimes happens that tax incentives are justified as there are disadvantages in the competitive investments compared to other countries (United Nations, 2018). Tax incentives do not affect the budget of the country. They do, however, cause revenue loss, lots of administration, tax planning, tax evasion, and may cause tax base erosion. The nature of tax incentives causes revenue loss for the government because in most cases the investor would have invested without the incentive (Holland *et al,* 1998). The cost effectiveness of using tax incentives to increase investments in countries is still inconclusive, but economists have made headway in determining the link between increased investments and additional tax incentives although there is uncertainty

in whether the tax incentive caused the original investment (Zolt, 2017:525). It is thus important to consider what the costs of tax incentives are before it is promulgated into legislation to decrease revenue leakage and tax abuse.

At first it may seem as if tax incentives are costless but upon further investigation the cost that is not always considered is the revenue loss, low economic efficiency, increased administration, and compliance costs (United Nations, 2018). The cost of tax incentives is usually high comparing to the modest benefit the investor would receive from the incentive (Holland *et al,* 1998). Another consideration is the excessive tax planning that can be performed and the tax evasion that could cause tax base erosion. The tax avoidance that is usually connected to the incentive adds to the revenue cost of the incentive (Holland *et al,* 2022). Incentives are often criticized that they cause tax base erosion without any material effect on the investment levels of the country (United Nations, 2018). The general best practise principles are to not use special tax incentives as these often cause pitfalls and tax planning: a simpler approach should be used which takes into consideration both old and new capital investments (OECD, 2007). In South Africa the corporate income tax rate for companies was decreased from 28 percent to 27 percent, but from a government perspective the broadening of the tax base by implementing the cap on the rollover of the assessed loss and the cap on the deduction of interest in terms of section 24M is in contradiction with incentives as they will cause tax base erosion. The fact that the South African government wants to broaden the tax base means that they need to investigate the design of incentives that could erode the tax base which is not effective and efficient.

For a tax incentive to be effective, policy makers need to ensure that the tax incentive is transparent, simple, stable, and there must be no uncertainty in the application of the legislation (OECD, 2007:5). Tax incentives should also not be instated if the social cost will exceed the social benefit (Zolt, 2017:535).

When measuring the effectiveness of tax incentives the social benefits need to be compared to the social costs (IMF, 2015). The social benefit should always exceed the social cost. The considerations that need to be included when measuring the social benefit of a tax incentive will include the following (IMF, 2015):

- The size of the investments and the investment should not have happened if it was not for the tax incentive.
- New employment that is created should be compared to the employment that is lost and the wages and productivity should also be considered. This was also confirmed by James (2013).

- Where productivity is spilled over the benefit should be considered in the other sectors of the market where the income is increased.
- There is higher revenue because of the additional investment (James, 2013).

The considerations that need to be considered when measuring the social cost of tax incentives include the following (IMF, 2015):

- The revenue loss in the national budget should be considered due to the incentive causing revenue leakage and abuse.
- The administration cost of incentives can be extremely high due to complex incentives, rent seeking, and corruption. Indirect costs such as leakage cost and economic distortion should be considered (James, 2013).
- Tax revenue has a higher value than private income as the tax revenue finances the public expenditure. If the public funds are scarce and the tax incentive distorts the tax revenue, there is less money that could be justified to be moved from public to private sector.
- If the tax incentive is available for only a certain type of investment it should be noted that it could be construed as if taxes rather than productivity effects the resource allocations.

A tax incentive is beneficial for the government if:

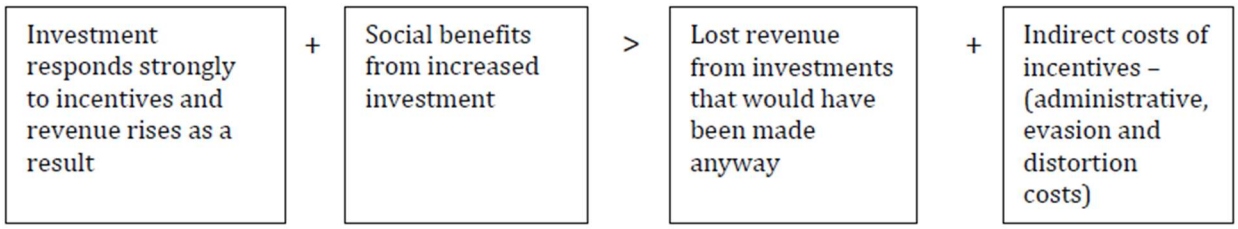

Figure 4: Beneficial investment decision (James, 2013)

The above figure illustrates that for an incentive to be successful when taxes in a specific sector of the economy is lower and there is increased indirect costs, the higher capital investment should increase the revenue in the sector and in return there should be higher social benefits available (James, 2013). However, it will also reduce the revenue that the National Treasury will receive and there are additional indirect costs to the economy. In simple terms, if the social cost is less than the social benefit the incentive is beneficial to the country and the fiscus. It is evident that a tax incentive is successful if the lower revenue received by the government and the indirect cost associated with the incentive is compensated for by the higher revenue and social benefits received from the additional investment (James, 2013). The problem that arises with tax incentives increasing investments in a specific sector is that the balance of the resource allocation is different than what the market is able to consume (Holland *et al*, 1998).

In theory tax incentives are seen as ineffective as these distort the investment decisions of the investors and in practice these are seen as inefficient and often cause corruption due to abuse (Zolt, 2017:524). There are many positives in a government using tax incentives to increase investments but due to the incentives being designed in a way that is ineffective, inefficient, and causes abuse and corruption much consideration needs to be given to the design aspect of the incentive to decrease the above-mentioned social costs.

3.3 Design of tax incentives

Properly designed tax incentives could be an important investment decision and could be the cause for increase in investments as they would have an integral effect on the investment decision. Governments can offer tax advantages in areas where the investments would have left the country (Blake, 2022). There are already various risks and difficulties for investors that include, but are not limited to, a lack of infrastructure, confusing and outdated laws, or the governance in a country is not effective and frequently the government will provide tax breaks to compensate for those risks and difficulties (Blake, 2022). Incentives are usually used to offset the disincentives evident in the country, however, tax incentives on their own are usually not sufficient to mitigate the disincentives (Holland *et al.*, 1998).

The main areas that need consideration when a tax incentive is designed are what type of investment is eligible for the tax incentive, what the qualifying conditions are that has to be met in order for an investor to qualify for the incentive, what the ongoing conditions are that have to be met, how compliance will be monitored, and what the duration of the tax incentive is (Zolt, 2017). The European Commission stated that the most important considerations when designing a tax incentive are the scope of the tax incentive which includes the form and the timing of the incentive, the qualifying criteria that will restrict the eligibility of the incentive for the investor and the investee, and who administers and monitors the tax incentive (European Commission, 2017). The three core design principles for incentives as per the IMF are the choice of the tax instrument, the qualifying criteria that should be used for the investment, and lastly the reporting and monitoring requirements during the incentive's lifetime (IMF, 2015).

In the three studies performed by Zolt (2017), the European Commission (2017), and the International Monetary Fund (2015) it became evident that the following principles are the most important to consider when a tax incentive is considered for legislation. When the design of an incentive is analysed it is critical to consider the following principles:

- Instrument choice of the tax incentive

This entails what type of tax instrument should be used to incentivise the investments and what form the tax incentive should take on.

- Qualifying criteria of the tax incentive
  This principle includes the eligibility criteria used in the selection of who receives the incentive and when, what the criteria are that have to be met to qualify for the incentive, and the four areas where a tax incentive have to have specific targeting mechanisms.
- Administration and monitoring of the tax incentive
  This principle includes the reporting and monitoring requirements and who performs the monitoring of the qualifying criteria of the incentive and the sunset and recapture provisions.

The three principles as mentioned above are described in more detail below considering the characteristics of the VCC incentive and where the design failed and made the VCC incentive susceptible to misuse. It is, however, important to consider the common areas where a tax incentive could be misused and how the misuse of an incentive is in some circumstances linked to the design of an incentive.

3.3.1 Common abusive structures in tax incentives

Tax avoidance in incentives is often linked to the design of the tax incentive and administration difficulties that the government face (Holland *et al.*, 1998). Tax incentives should be constantly monitored to detect tax avoidance or evasion (Zolt, 2017: 550). Common abuse of tax incentives includes, but is not limited to, old entities that do not qualify for the incentive, convert to new entities that would qualify for the tax incentive, transfer pricing schemes with connected persons (sales, services, loans, etc.), and concealing non-qualifying activities as qualifying activities.

The first structure is when old entities that do not qualify for the incentive convert to new entities that would qualify for the tax incentive. This is also considered to be called “double dipping”. The “double dipping” will occur when there is a restriction on the tax incentive and the tax incentive is only available for new investors (Zolt, 2017:551). The government is so intent on creating new investments that they neglect old investors (James, 2013:27). This is applicable to entity investors. The owner of an entity will simply incorporate a subsidiary that will carry on the same activities as the original entity with a few differences and in return the owner of the entity or the entity itself will claim the tax incentive. The usual response from existing investors is to create new entities to receive the tax relief from the incentive (James, 2013:27). In some instances, the related-party connection is unclear (Zolt, 2017:551). If taxpayers are similar in nature and they are treated differently with regards to receiving tax benefits it will enhance anti-competitive behaviour and increase tax avoidance schemes (James, 2013:29). When the qualifying criterion

of an incentive is designed it is important to mitigate the risks relating to related-party trading that would cause “double dipping”.

The second structure is to transfer pricing schemes with connected persons (sales, services, loans exedra). The common approach to transfer pricing is that it only occurs in international transactions between connected parties (Zolt, 2017:551). The same effect can however be achieved between connected persons in the same country by allocating profits to entities with a tax incentive (Zolt, 2017:552). Transfer pricing also occurs between related parties in the same country when they have similar activities or one entity’s operation is congruent to the second entity’s operations. Taxpayers will reallocate their profits or sales to another entity in the same jurisdiction and they manufacture the same products just to acquire the tax benefit that the first entity was not eligible to receive (James, 2013:30). This is the case if one entity qualifies for a tax benefit and the other does not (Zolt, 2017:552). Generous investment allowances will allow firms to simply have a flow-through mechanism and most of the profits are made in the entity with the tax benefit (Holland *et al*, 1998).

The third structure is when investors conceal non-qualifying activities as qualifying activities. The transaction would be done in a manner that it seems as if one thing happens but in effect the transaction is disguising some other transaction.

Incentives are more open to abuse when the officials have to use discretion when determining who has the right to receive the tax benefit (Zolt, 2017:539). Reducing discretion will decrease corruption opportunities (James, 2013:29). There should be minimal room for personal interpretation or the option for negotiation (IMF, 2015). As legislation cannot always consider all the different facts and circumstances in a country, there needs to be some sort of discretion involved. The discretion, however, should be kept to a minimum to reduce the possibility of corruption, misuse, rent seeking, and abuse. James (2013:vi) also noted that “Incentives should be awarded with as little discretion and as much transparency as possible, using automatic legal criteria.” Qualification for incentives should be automatic and it should be received if certain criteria are fulfilled (James, 2013:28).

James (2013:29) mentioned that in order to reduce discretion in an incentive the incentive should only be provided by tax law which will verify that the incentive is transparent and available to all taxpayers. Second, the criteria for the taxpayer in the tax law should be clear and easy to understand and there should be no discretion involved during the implementation of the legislation. Last, the administering of the incentive should be left to tax administrators and not an external agent.

The above-mentioned requirements should all be included in an incentive that works efficiently and will meet its specific objective. To mitigate the risks of a tax incentive being misused, the design of tax incentives must include several principles to stop misuse, corruption, and rent-seeking. Several studies are available on the most effective way to design tax incentives and what principles should be considered when designing the tax incentives. The three principles relating to the design of the incentive which include the instrument choice, qualifying criteria, and the administration and monitoring requirements were further investigated to determine where the design of the VCC incentive failed in stopping the misuse of the regime.

3.4 Instrument choice of the tax incentive

When an investment is made there are certain factors that need to be considered before an investor would decide where and in what industry they would invest their funds. Tax planning is becoming more important when investment decisions are made. The fact that a country has a favourable tax incentive available does not influence the investor's decision. If there is an unattractive investment climate such as poor infrastructure, macroeconomic instability, and weak governance and markets it will desensitize investors (James, 2009:7). Incentives should only be awarded to investors who would not have invested in the entity if it was not for the tax incentive (Zolt, 2017:542). It is difficult to say whether and to what extent the tax incentive caused the initial and additional investment: the results are usually inconclusive (United Nations, 2018).

Although tax incentives may make investing in a particular country more attractive, the incentive will not compensate for any deficiencies in the design of the tax system or inadequate physical, financial, legal, or institutional infrastructure (United Nations, 2018). The government has to determine what their objective is and how they will stimulate growth and development in the country. That should be the key to which sort of tax instrument they would use to incentivise the investment. It is important when designing the incentive that you should determine what tax instrument is used and what form of tax incentive should be adopted (United Nations, 2018).

The choice of a tax instrument is usually between cost-based tax incentives and profit-based tax incentives (IMF, 2015). Cost-based tax incentives generally includes specific allowances that are closely linked to investment expenses. This includes accelerated wear and tear and special tax deductions and credits (United Nations, 2018). These incentives lower the cost of capital of the investments because of the special tax deduction. Profit-based tax incentive reduces the tax rate applicable to taxable income. The profit-based incentive means that the government forego revenue to make profitable investments more profitable but is less effective in encouraging investment (United Nations, 2018). Profit-based tax incentives include tax holidays, preferential tax rates, and income exemptions (IMF, 2015).

The VCC incentive is a cost-based tax incentive. The tax benefit received by the investor was linked to the expenditure incurred to buy the VCC shares. The cost of capital and the risk of the investors were reduced. The VCC inventive was promulgated into the Act to give SMMEs access to equity funding (Blake, 2022:52). It was unclear from the objectives stated by the government what the equity should have been used for. Thus, it could be said that the government incentivised capital expenditure for the investors. One of the objectives of the VCC regime were to increase the access to equity financing to increase managerial support services for the qualifying investee companies. More information on this point is included in section 2.2.1 of this document. The VCC was supposed to attract investors who could pool their funds together and also their knowledge as assistance for the SMMEs to grow (Blake, 2022:53). However, the incentive was linked to the capital expenditure and not the promotion of growth for SMMEs.

After the choice between a cost-based tax incentive and a profit-based tax incentive is made the form that the tax incentive will take needs to be determined. The normal form that a tax incentive relating to venture capital takes on is tax exemptions, tax deferrals, tax deductions, tax credits, and loss relief (European Commission, 2017:69). The incentive will either be applied to the taxable income or the tax liability. Tax credits and exemptions are usually applied to the tax liability itself where tax deductions and loss relief measures are usually applied to the taxable income of the investor (European Commission, 2017:69). A tax allowance will reduce the taxable income of the investor (Holland *et al*, 1998). The VCC incentive applied to the taxable income of the investor. There was thus a specific tax deduction in the form of a tax allowance (Blake, 2022). The more favourable the tax incentive is the higher is the chance that the reason for the investment is the tax incentive. The deduction was only allowed for natural persons, listed entities, and controlled group companies. The deduction limitations in the initial enactment were R750 000 per year for natural persons and R2.25 million limitation in the natural person's lifetime. Listed entities and controlled group companies were only allowed a ten percent deduction of the equity value of the equity shares. The percentage was increased to 40 percent in 2009. In 2011 all the deduction limitations were removed to increase the uptake of the regime. The National Treasury mentioned that the benefits were too small and the uptake of the VCC incentive should be increased (National treasury, 2011). In 2014 the investors' benefits were increased by making the tax benefit permanent if the incentive were held for at least five years. In 2018 various abusive structures were identified by the National Treasury that were not in line with the objective of the incentive (Standing Committee on Finance, 2018). The National Treasury also updated the connected person test to stop the abusive structures in that year. In 2019 the National Treasury included the deduction limitations of investors in an effort to constrain the abuse and revenue leakage of the incentive. The more favourable the incentive became to the investors the more the system was being misused.

Investment allowances and credits may apply to all sorts of capital investment as this may encourage investors to rather invest in the equity of the entity than providing related-party debt capital in the initial capital structure of the entity (Zolt, 2017:547). Investment allowances and tax credits are incentives that will provide a tax benefit to the investor to the value of the expenditure incurred on making the initial investment (Holland *et al,* 1998). This measure, however, does not favour employment creation. One of the objections of investment allowances and credits is that they favour capital intensive investment, but they are less favourable towards employment creation (United Nations, 2018). Issues arising from investment incentives are that incentives to create employment are subject to manipulation and administrative difficulty (Holland *et al,* 1998:18).

The investment allowance and credits incentive are seen as an input-based incentive. Input-based tax incentives are given at the start of an investment and the deduction is based on the amount of expenditure by the investor. Output-based incentives is received at the disposal of the investment and the amount of the incentive is linked to the return on investment when the investor sells the investment. An output-based tax incentive considers that the investment must be a success before the tax benefit is received, and input-based tax incentives do not consider the growth of an investment or whether the investment met its intended purpose (Blake, 2022:37). By only receiving a tax benefit when the investment is a success would encourage the investor to provide knowledge and encourage growth of the entity, and it would also align the interests of the investor and the investee (European Commission, 2017:71).

The difficulty in the design of legislation is that the government has to be clear on the eligible deductible amount. The definition of the eligible deduction must be precise and it must draw the investment amount to the specific operation or activity that the incentive was intended for to minimize the revenue leakage (Holland *et al,* 1998). The rate or the amount of the taxable deduction is directly linked to the revenue leakage of the government. The form of a tax allowance and credit incentive is not open ended, the revenue cost for the government is directly related to the invested value, and the cost of the incentive to the government should be easily calculated (Zolt, 2017:547-548). When the taxable deduction is too high there is an increase in the possibility that the incentive could be misused (Holland *et al,* 1998:6). Tax incentives should be constrained so that the total tax liability cannot be completely eliminated, and for investment allowances it should be restricted to some percentage of taxable income to ensure that the fiscus does not completely lose all of the revenue of the transaction (Holland *et al,* 1998). Excessive incentives provided on investments often create distortion which cause more pressure on the tax base for existing investors (James, 2013:27).

In the literature review it became evident that most of the investments that were made by VCCs into the qualifying investee companies were to finance assets. The 12J Association of South Africa conducted a survey in 2020 about the Section 12J industry. The survey included how much capital was raised by the industry, how much and in what industries was invested, how much employment was created, and the overall impact of the VCC regime on the economy of South Africa. Figure 5 below represents information about investments made by the VCCs in various underlying investment industries (The 12J Association of South Africa, s.a.).

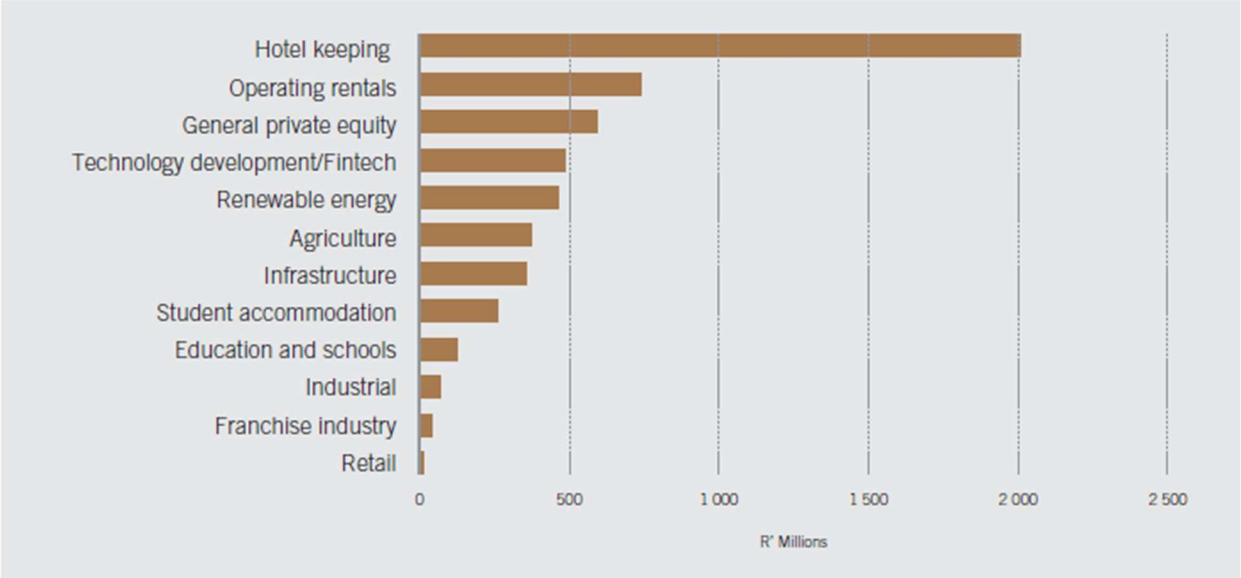

Figure 5: Underlying investment industries (The 12J Association of South Africa, s.a.)

Figure 5 illustrates that most of the investments were made in companies that traded in hotel keeping, operating rentals, renewable energy, infrastructure, and student accommodation. These types of entities are all asset intensive. Most of these qualifying investee companies could have raised some financing as the qualifying investee companies had assets that could have been given up as collateral to get financing from banks or other third parties. Asset-based lending is a form of financing where the SMME uses the asset as a form of collateral to get the finance (Modansky *et al,* 2011). Asset-based lending focuses on the value and quality of the collateral rather than the credit rating of the entity (Modansky *et al,* 2011).

The VCC incentive is seen as an input-based incentive as the tax allowance is received at the initial investment. One of the goals of the VCC incentive was that the qualifying investee companies should get managerial support from the VCC and the investors to achieve growth. By giving an upfront tax deduction the investors did not have any incentive in helping the SMME to grow. By providing an incentive on the disposal of the investment may encourage investors to promote growth and contribute to the growth and overall improvement of the investment (Blake, 2022:39). If the intent was that the SMME should receive help from the investors and the VCC,

the National Treasury should have given an incentive that was based on the output of the investment rather than the input. If the incentive was based on the output of the investment, it would have encouraged investors to grow the SMMEs. In such cases the SMMEs would have received capital to finance their operations but they would have received managerial support as well. The growth in the qualifying investee company would have encouraged employment creation and growth in the SMME.

The incentive was promulgated into the Act to get access to SMMEs that would not be able to raise finance and give qualifying investee companies additional assistance to grow the business (National Treasury, 2009, 2011). In the table above it is evident that most of the underlying investments were in hotel keeping, operating rentals, general private equity, technology development, and renewable energy. These companies would be able to raise financing if they applied from banks or other third parties. If the government's idea was to incentivise capital expenditure, they should have incentivised the portion of the investment that would not be able to get financing from banks or other third parties. The portion relating to the working capital should have been financed where no collateral could be provided.

One of the principles that was used to frame the budget was sustaining employment growth and expanding training opportunities (Manuel, 2009). The instrument choice was cost based which does not encourage growth or employment creation. The incentive was a specific tax deduction in the form of an investment allowance which applied to the taxable income of the investor. The tax incentive was to increase capital investments and the investments were made into capital assets that would have gotten financing if they applied at third parties. Due to the incentive being an input-based incentive it did not encourage investors to help create growth in the qualifying investee companies which in return would have created employment. One of the reasons that the National Treasury gave to why the sunset clause was enacted is that it did not create jobs. It is thus evident that due to the form of the incentive it would have had difficulty to encourage investors to help create employment and the qualifying investee companies would not have received managerial support as intended. The instrument choice and the form of the incentive were not in line with the objective the National Treasury had in mind. To increase the access to managerial support to help the SMME grow the incentive should have been received at the disposal of the investment and not at the initial stages, as that would have encouraged investors to use their knowledge to develop growth in the SMME. The eligible deduction for the investor must be precise and it has to draw the investment to the activity the National Treasury wants to incentivise, otherwise investors might not use the incentive for the right intent.

3.5 Qualifying criteria of the tax incentive

The tax incentive that is used should be well targeted and a clear criterion about what constitutes a qualified investment should be formulated. The targeting mechanism is an integral part of the design of the tax incentive (Blake, 2022:39). The criteria about whether it is a qualified investment should identify the specific type of investment that should be attracted, and it should lower the fiscal cost of the government (IMF, 2015:21). Revenue leakages might be decreased by restricting who can receive the incentive (European Commission, 2017:73).

Because of the above-mentioned facts, it is clear that the targeting should be direct and that it forms an integral part of the design of the incentive. The rules of tax incentives are often complex and due to governments including anti-avoidance measures into legislation the tax planning is inevitable (Holland *et al*, 1998). Regardless of the fact that the incentive has an intended use, the incentive should be designed for a specific group of taxpayers with only specific characteristics (Blake, 2022). The three commonly used criteria are that the investment should have a special size, it should be in a special sector, or it should be in a special economic zone/region (IMF, 2015). The European Commission stated that the four categories in an investment incentive that should have a qualifying criterion are the business, the investor, the investment, and the duration of the incentive (European Commission, 2017:73). The business can be targeted in terms of its age, size, and sector. The qualifying criteria for the investor are its status and connection to the investee, the investment should be either for debt or equity instruments, and the incentive should be held for a certain period before the tax benefit is received (European Commission, 2017:73). When the decision is made into what the type of business is, it needs to be clearly defined in legislation. The unpredictability of tax incentives often time discourages investors to invest (Holland *et al,* 1998).

The four criteria used by the European Union are used to consider how the VCC incentive should have been targeted considering the business (qualifying investee company requirements), the investor (qualifying investor and the investment tax relief available), the investment (VCC requirements), and the duration of the investment.

3.5.1 The business (qualifying investee company requirements)

The business criteria that have to be met pertains to the entity that receives the investment. In the case of the VCC incentive it is the qualifying investee company. The age, size, and sector criteria that have to be met have different qualifications, but the qualifications still have to be related (European Commission. 2017:73). The qualifications all have to relate to the same positive outcomes as intended by the government to achieve the economic objective as intended.

When the age of a business is determined it will differentiate between business at different growth stages (European Union, 2017:74). If market deficiencies are detected in SMMEs at different stages of their growth the incentive should be targeted to those specific growth areas in the entities. If the intent of an incentive is to increase access to capital for SMMEs it should particularly focus on new entities (Blake, 2022:40).

In terms of the business size criteria, it is directly linked to the definition of SMME for the country (European Commission, 2017:74). If the SMME is at the lower end of the spectrum for SMMEs the entity is more vulnerable to market deficiencies and is more prone to failure (Blake, 2022:40). The size of an entity is difficult to monitor, as the company can have a certain book value on paper but the true book value is not that easy to determine. Tax incentives would often be limited to new entities that has a certain asset value (IMF, 2015).

If the investment is targeted in terms of a specific sector the incentive's reach could be narrow. If the incentive is only available to a specific sector the fairness of the incentive is also questionable as it will stop entities in other sectors to utilise the incentive even if they have the same constraints (Blake, 2022).

One of the VCC incentive's goals was to increase funding for SMMEs. There was no specific age restriction evident in the qualifying investee company requirements. The qualifying criterion was that the qualifying investee can be a start-up or a SMME (Blake, 2022:58). This is vague because it means that even if the SMME has been operational for a while the entity could still qualify as a qualifying investee company. This criterion makes it easier for SARS to administer the incentive. This ensures that the incentive cannot be misused by incorporating a new business every few years to receive the tax incentive (European Commission, 2017:74).

The size of the business was not a part of the qualifying investee company criteria but part of the VCC investment expenditure requirements. The requirement in terms of the size of the qualifying investee company was updated three times. Initially the VCC had to invest 80 percent of investments in qualified investee companies with a book value not exceeding R10 million after the investment. In 2011 the size of the qualifying investee company was updated to not exceed R20 million and in 2014 the asset value was increased to R50 million after the investment. As stated above, the business size criteria are directly linked to the definition of an SMME. In 2019 the definition of SMME was updated by the Department of Small Business Development to state that the total gross asset value will not be used to determine if an entity is a small enterprise as it is difficult to monitor and to measure (Department of Small Business Development, 2019).

BPR 242 dealt with the R50 million threshold requirement amongst other principles (SARS, 2016). The qualifying investee company will use the proceeds from the share issue to acquire sectional title units to the value of R50 million. After the first investment by the VCC the qualifying investee company will exercise an option to acquire additional sectional title units using debt financing. The value of the two transactions is more than the R50 million threshold. Although the qualifying investee company has an option to acquire additional sectional title units it does not have an effect on the book value of the initial investment by the VCC (SAICA, 2017a).

The first principles evident from the ruling was that the valuation of the asset value is measured at book value and not market value (SAICA, 2017a). The second principle is that the book value of the qualifying investee company has to be calculated at the time of investment by the VCC and directly afterwards. The fact that the option is exercised after the first transaction will not constitute non-compliance with the R50 million book value threshold (SAICA, 2017a). The fact that the book value of the qualifying investee company increases soon after the initial investment does not have an effect on the status of the VCC.

National Treasury mentioned that most of the investments were in investments with high asset values. The design was flawed as it did not target qualifying investee companies at the lower end of the SMME spectrum. From the above example it is evident that the design of the incentive did not stop the VCCs from investing in entities that has a high asset value. Most of the investment went to real estate VCCs (Blake, 2022:59). The sector that received the most investments was in the hotel keeping business which had 98 investments and received R2 billion of investments (The 12J Association of South Africa, s.a.). These entities could have obtained funding from other sources and were not in need of venture capital (Blake, 2022:59). The design flaw evident in the BPR is that the size of the qualifying investee company should have been more clearly targeted.

In the six BPRs issued by SARS, four of the BPRs were due to the assets of the qualifying investee companies. BPR 242 considered that the purchase of sectional title units was seen as if the qualifying investee company were carrying on the trade as a hotel keeper. The sectional title units were bought with the subscription moneys of the VCC. BPR 274 considered that the solar panels bought by the qualifying investee company was seen as movable assets and there was no impermissible trading. BPR 333 stated that the purchase of the vacant land to farm blueberries did not constitute a trade in respect of immovable property. Lastly BPR 341 stated that the subscription moneys were used to pay a developer for the acquisition of hotel units and were not carrying on an impermissible trade.

When the incentive was designed the term “qualifying investee company” was defined in legislation. In the definition of “qualifying investee company” the only qualifying criterion in terms

of the sector is that the qualifying investee company is not allowed to be carrying on an impermissible trade. The definition of impermissible trade was a negative test which means that the criterion set under the definition of impermissible trade was excluded, but by excluding only a few of the sectors the VCC incentive was still open to a wide range of other sectors. Most sectors or industries were still permitted to qualify as qualifying investee companies (Blake, 2022:59). The legislation did not state what the type of investment is that could have been invested in and what industry was allowed to be invested in. There was never a positive test that specifically had to be met to qualify as a qualifying investee company.

Any trade in immovable property was specifically excluded from qualifying as a qualifying investee company. However, property was used as an asset class by VCCs when they invested in industries such as hospitality and tourism (Balfour, 2021). The definition of impermissible trade included that a qualifying investee company could not be carrying on any trade in respect of immovable property except trading as hotel keeper. This was also an issue in BPR 242. Trading as a hotel keeper includes that the qualifying investee company has to provide accommodation and meals at the same premises (SARS, 2020:15). The meals do not have to be prepared by the hotel keeper, but the hotel has to supply the meals and receive moneys for the supply (SARS, 2020:15). The hotel is not allowed to lease a portion of the property to a third party to run a restaurant as it would constitute rental income and not income derived from the supply of food. The restriction was circumvented by acquiring shares for the purchase of hotel rooms under a sectional title unit in an existing hotel. Included in the value of the sectional title unit is the undivided share in the common areas which included the reception area, restaurant, canteen, and parking areas which were concluded to be a going concern and the structure was seen as a hotel keeper which is not an impermissible trade.

The objective of the National treasury was not to finance SMMEs which could get finance from other parties but rather including trades that would encourage employment growth. That is also the reason for the National Treasury to include trading as a hotel keeper as there is room for employment creation. For every R1 million invested in the hotel keeping industry, seven jobs are created (The 12J Association of South Africa, s.a.:26). The incentive could have been more clearly targeted in terms of what qualifies as a qualifying investee company, what the purpose of the qualifying investee company is, and what size the qualifying investee company is supposed to be.

The design of the VCC incentive was not linked to qualifying investee companies at the lower end of the SMME spectrum. There was also no requirement for the qualifying investee company to create employment and most of the investments were made in real estate VCCs. The investments made by the VCCs were in qualifying investee companies that had a high asset value and did not

promote employment creation. These qualifying investee companies could have obtained funding from third parties and did not need venture capital.

3.5.2 The investor (qualifying investor requirements and the investment tax relief available for investors)

The investor is targeted in terms of the connection between the investor and the investee (European Commission, 2017:76). By including qualifying criteria on the investor, the government will decrease the number of investments, but the quality of the investments will increase (European Commission, 2017:76). There needs to be a balance between increasing the uptake of an incentive and the incentive meeting its objective in terms of the business (qualifying investee company). For a venture capital incentive to be successful there needs to be a scale between the uptake and quantity of investments to ensure capital flow but the design of the tax incentive should still promote a positive outcome for the qualifying investee company such as knowledge spill overs (European Commission, 2017:77). The incentive should promote a beneficial outcome for the investor, the investee, and the government. For the scheme to be beneficial for the government a more pragmatic design feature needs to be included in the incentive (European Commission, 2017:77). Transactions used for tax planning purposes could be limited by excluding related-party trading.

An example of a poorly structured incentive where revenue is extracted out of the tax system (Holland *et al,* 1998:7*)* is seen in Figure 6:

The real cost to the company is $100. However, it establishes a subsidiary to supply it with the service. The subsidiary pays out the cost of $100 and adds a profit margin of $50 to the amount it charges the parent company. It is assumed that the parent is eligible for a tax credit of 40 percent on its cost of $150 and so earns a credit worth $60. The $150 is fully deductible against other income and this has a tax value of $60, assuming a 40 percent tax rate. The subsidiary adds the $150 to income and is allowed to deduct its costs of $100, for a net tax on the subsidiary of $20.

Tax Calculation in the Subsidiary		Tax Calculation in the Parent	
Income from parent	$150	Payment to Subsidiary	$150
Costs	$100	Value of tax deduction	$60
Taxable income	$50	Value of credit	$60
Tax payable	$20	Total tax benefit	$120

When the results for both companies are added together, washing out the intra-company transactions, the subsidiary has costs of $100 plus the $20 of tax. The parent has a tax deduction worth $60 plus a tax credit of the same amount, for a total tax benefit of $120, which just offsets the costs of the subsidiary. The tax system has therefore completely subsidized the company's expenditures.

Figure 6: Example of a poorly structured tax incentive (Holland *et al*, 1998:7)

The example explains that the leasing between related parties would completely eliminate the tax liability of companies due to the tax benefits that could be shared between private sector parties (Holland *et al.,* 1998:8). Taking the above information into account the following example (Figure 7) is applicable for the lessor of the equipment (Qualifying investee company) where the lessor would almost completely eliminate its tax liability:

Table 1. Equipment Lease

(In local currency)

Year	1	2	3	4	5	6	7	8	9	10
Loan principal	100	90	80	70	60	50	40	30	20	10
Interest	10	9	8	7	6	5	4	3	2	1
Principal repayment	10	10	10	10	10	10	10	10	10	10
Accounting income										
Lease payment	20	19	18	17	16	15	14	13	12	11
Interest	10	9	8	7	6	5	4	3	2	1
Depreciation	10	10	10	10	10	10	10	10	10	10
Accounting income	0	0	0	0	0	0	0	0	0	0
Tax Position										
Lease payment	20	19	18	17	16	15	14	13	12	11
Interest	10	9	8	7	6	5	4	3	2	1
Accelerated depreciation	33	33	33	0	0	0	0	0	0	0
Taxable income	-23	-23	-23	10	10	10	10	10	10	10

Figure 7: Example of a leasing between related parties (Holland *et al*, 1998:7)

In the above example two factors should be considered. The first is the trading between related parties, and second, the use of additional tax incentives in correlation with the VCC incentive.

Related parties are often excluded from incentives as it has been proven that it would lead to abuse (Blake, 2022:40). One of the frequently used investor criteria is the restriction that is placed on the related parties connected to the investor and the trading between the related parties (European Commission, 2017:77). By including a requirement that related parties are not allowed to participate in certain transactions limits the abusive structures that owner-managed businesses utilise for tax planning purposes. One of the most common abusive structures is the trading between related parties which is mentioned above.

The related-party restrictions between the investors and the qualifying investee companies in the VCC regime were only included in 2018. Before the amendments in 2018 there were no restrictions on related-party trading and the investors in the VCC were allowed to hold majority shares in the qualifying investee company. The anti-avoidance measures were included in legislation due to the various “targeted structures” that were introduced by investors (National Treasury, 2018). The structures involved the investor who would invest in their own business via the VCC who was a qualified investee company in the VCC. The investor would still keep participation and voting rights in the qualifying investee company (National Treasury, 2018). The investor received a tax benefit for investing in their own company.

The second consideration is additional tax incentives in congruence to the VCC incentive. Additional tax benefits could be received by the qualifying investee company as normal tax rules applied to the companies. In BPR 205, 242, 274, and 314 the transactions between the investor and the qualifying investee company involved leasing arrangements where the lessor was allowed additional tax benefits due to allowance tax incentives on the capital assets.

The anti-avoidance measures for related-party trading and transfer pricing were included in 2018 in legislation. The investors used leasing as a mechanism to create tax benefits. The design of the incentive did not stop the misuse due to related-party trading until 2018. The investor would invest in their own business via the VCC. The investor would create a new company with the same operations as the initial business to carry out the operations. The qualifying investee company would lease the assets to the new entity created by the investor and the new entity would receive the operating lease expenses as a taxable deduction. The qualifying investee company might also receive additional tax allowances depending on the asset. The investor received the benefit for investing in the VCC, the new entity would receive the taxable deduction for the operating lease expenses, and the qualifying investee company might receive an allowance for wear and tear depending on the asset. The related-party trading between investors

and the qualifying investee companies should have been limited since the initial enactment of the VCC regime. Due to related-party trading the tax liability could be completely eliminated, and the only loser in structures as mentioned would be the government (Holland *et al,* 1998).

3.5.3 The investment (VCC requirements)

When the policymakers want to attract new investors they often forget about the existing investments, and when the existing investors are forgotten it is difficult to attract new investments (James, 2013). An easy response by the existing investors would be to pose as a new investor and still receive the benefit of the incentive. In the VCC incentive the trading of second hand VCC shares did not receive a tax benefit. This reduced the resale market of the shares of the VCC. This was one of the positive outcomes of the incentive as companies could not simply buy second hand shares and receive the tax benefit multiple times.

The investment criteria also have to be specified in terms of the debt or equity criteria (European Commission, 2017:78). The investor criteria have to be split between debt and equity (Blake, 2022:41). The VCC in various occasions paid more for the qualifying investee company shares than what the shares were worth. This could mean that the excessive amount of subscription moneys paid by the VCC to the qualifying investee company were debt financing. The disproportionate amount of subscription moneys gave the investor with the specific class of shares a preferential right to a first distribution of capital and profits, but it remained equity shares (SAICA, 2017). If the rights of the specific shares are analysed against the definitions in section 8E of the Act which deals with equity instruments it is seen as debt financing when the rights of the shares are analysed.

> The definition of an equity instrument in section 8E(1) of the Act is *"*any right or interest- the value of which is determined directly or indirectly with reference to a share or an amount derived from a share".
>
> The definition of hybrid equity instrument in section 8E(1)(ii)(aa) is "that share does not rank pari passu as regards its participation in dividends or foreign dividends with all other equity shares in the capital of the relevant company or, where the equity shares in such company are divided into two or more classes, with the shares of at least one of such classes".
>
> The meaning of *pari passu* is that the shares should all be equal to each other and the one cannot have more rights than the other.

From the above-mentioned definitions it can be said that if one class of shares has more rights than another class of shares in the entity there is a hybrid equity instrument. In BPR 264 the rights attached to the shares were as follows:

Class A ordinary shares of the VCC (SARS, 2017a)

- Share in the distribution from only the target company which is attached to the class A ordinary shares. The class A shareholders are not allowed to share in any other distribution from any other target company in which the VCC may invest.
- Share in the net assets of the VCC upon its liquidation together with the other ordinary shareholders of the VCC (*pari passu*).

Class A ordinary shares of the qualifying investee company:

- Paid the full amount of each distribution in respect of the class A ordinary shares.
- The distribution is in priority to the holders of the qualifying investee companies' ordinary shares and or the holders of any other class of shares in the company.
- Share with the qualifying investee companies' ordinary shareholders in the net assets of the qualifying investee company upon its liquidation (*pari passu*). In respect of all other distributions the full amount of each distribution must be made only to the holders of the qualifying investee companies' class A ordinary shares.

All the classes of shares ranked *pari passu* upon liquidation, but it does not mean the different classes of shares did not have preference rights attached to it. The different classes of shares of the VCC were only allowed to participate in the distributions of a specific section of the income linked to a specific qualifying investee company. In the BPRs issued it was stated that the test for a controlled group company is the amount of shares that the VCC subscribes for and not the value of the investment. The structures were specific that the VCC will not hold more than 70 percent equity shares and thus will be compliant. The National Treasury wanted to close the abusive structures by stating that qualifying investee companies were not allowed to issue more than one class of shares as that led to the misuse of the regime. The problem was not the different classes of shares but rather the subscription moneys in excess of what the company was actually worth.

One of the objectives of the incentive as mentioned in chapter 2 is that the incentive should provide SMMEs with equity financing. There is a constraint for SMMEs getting access to equity finance (Manuel, 2009). The reason for using equity financing is that the qualifying investee company will receive more than just capital and the investor holds voting rights: the right to receive dividends or capital on distribution in the VCC (SARS, 2020). The definition of qualifying share in

section 12J of the Act included the link between the hybrid equity instrument in 8E and third-party backed shares in 8EA. The definition of a qualifying share was included in legislation in 2011. The requirements were, however, complex and difficult to understand. The link between a complex anti-avoidance rule and a complex incentive in the Act was difficult to administer. It should have been clearly stated that the instrument that could receive a tax benefit is an equity instrument, as the anti-avoidance requirement was too complex and left policy uncertainty.

3.5.4 Duration of the investment

The timing of the incentive is also an important consideration as the incentive could be received either at the initial investment when income is received by the investor due to the investment, or at the disposal of the investment (European Commission, 2017:70). The VCC incentive was received at the initial investment when the qualifying investor subscribed for the VCC shares. If the incentive is received at the initial investment, it will reduce the high risk for investing in start-ups and SMMEs as the value of the investment has to reduce extensively before a loss is made and this will increase capital investments (European Commission, 2017:70). Equity investments is usually high-risk investments, and by providing an upfront tax deduction for the investors it would most likely encourage investors to accept the risk (Blake, 2022). However, it is also stated that by giving tax relief at the initial stages of the investment would cause that investors to not invest for the reason as intended by the government. The investor would not necessarily support the growth of the entity, which would decrease the economic benefits of job creation and growth in SMMEs (European Commission, 2017:70).

The tax deduction for the VCC incentive was at the initial investment. At the initial promulgation the incentive amount would have been recouped by the investor when the shares are sold. This effectively meant that the investor received an interest-free loan from the National Treasury for an unlimited period or until the shares were sold when they were liable for the tax of the incentive. The National Treasury amended the recoupment requirement in 2014 and stated that if the shares were held for a period longer than five years there is no recoupment of the value of the investment. If there were, however, no recoupment and the shares were held for a period longer than five years the deduction became permanent but the side effect to the investor was that upon disposal of the shares the base cost of the shares were zero.

By putting a timeline in the legislation of the incentive the National Treasury came closer to bringing the incentive in line to the objectives as stated in chapter 2. The effect of the benefit becoming permanent for a company was:

	Recoupment of incentive amount	Making the tax deduction permanent with inclusion of the five-year non-recoupment rule
	R	R
Income tax consequences:		
YEAR 1		
Incentive deduction	-100 000	-100 000
Tax loss by fiscus @28%	28 000	28 000
YEAR 5		
Recoupment on sale of shares	100 000	-
Tax received by fiscus @28%	-28 000	-
Tax loss by fiscus	R nil	28 000
CGT consequence:		
YEAR 5		
Proceeds	200 000	200 000
Base cost	(100 000)	(-)
Capital gains for investor	**100 000**	**200 000**
Inclusion rate at 80%	80 000	160 000
Tax @28%	22 400	44 800
Tax effect for the fiscus		
Initial deduction	-28 000	-28 000
Recoupment	28 000	-
Capital gains tax	22 400	44 800
Tax revenue received by fiscus	**22 400**	**16 800**

Figure 8: Benefit of five-year non-recoupment rule

Although the investor (Figure 8) did not have the shield against the CGT consequence and the revenue received is less than the original incentive, the National Treasury was closer to bringing the incentive in line with the objectives. The National Treasury were guiding investors to invest for the proper reasons and not purely investing for a tax deduction. By placing a minimum holding period on an incentive there is a degree of stability for the business, and this will also reduce the effect for short term investors to misuse the incentive (European Commission, 2017:80). By including a minimum period, the financial structure of the SMME is more stable and the investors who want to use the incentive for speculative behaviour is blocked (Blake, 2022:41).

3.5.5 Summary for qualifying criteria

The key takeaway from the section relating to the qualifying criteria is broad and includes varies points that need to be considered. Overall, the qualifying criteria was not targeted well enough and certain issues arose that made the VCC incentive susceptible to misuse. The qualifying criteria for the incentive should have four separate qualifications namely, (1) the business (qualifying investee company requirements), (2) the investor (qualifying investor requirements and the investment tax relief available for investors), (3) the investments (VCC requirements), and (4) the duration of the investments.

The targeting structure of the incentive promoted capital expenditure and not the promotion of growth and employment creation. The misuse of the incentive was related to the investments in high-asset value entities, but the qualifying criteria had policy uncertainty in terms of the type of qualifying investee companies that were targeted. Due to the uncertainty of the targeting aspect of the incentive, and the qualifying criteria being open to subjective interpretation the administration and monitoring requirements of the incentive were difficult.

3.6 Administration and monitoring the tax incentive

The reporting and monitoring requirements during the different life stages of an incentive are part of the administration process. The administration of an incentive means that administrative resources that could have been allocated to revenue collection have to be diverted to compliance to verify that the rules and regulations are continuously checked and verified (Blake, 2022). The reason for constant verification would be to verify that the incentive is not misused. As soon as certain taxpayers qualify for an incentive the rest of the taxpayers that do not qualify for the incentive have an opportunity to misuse the system and that will cause revenue leakage (James, 2013).

To ensure good governance the incentive should be subjected to a legislative process, it should be included in the tax law, and the fiscal cost should be part of an annual review to confirm that the cost is not more than the benefit (IMF, 2015). Special investment incentives have the possibility of complicating tax administration, and it enables wealthy taxpayers to misuse the incentive as they have the funds available to develop loopholes to avoid or evade tax (Blake, 2022).

If there is a high tax administrative burden connected to an incentive it will most likely cause the investor not to invest (Braunerhjelm, 2021). If there was a high tax administrative burden and the regulations require additional registrations or regulations, the investors will most likely not invest as the cost would be higher than the benefit. The VCC has to be registered as a financial service provider in terms of the Financial Advisory and Intermediary Services Act (De Klerk, 2020:18). The registration as a financial service provider is handled by the Financial Sector Conduct Authority (FSCA) (SARS, 2020:3). Registering with the FSCA is a time-consuming process. For a VCC to be registered there should be someone in employment who fits the criteria of a “key individual” (Van Zuydam, 2017). A key individual must have the correct industry experience and be willing to write an exam to further their studies (Van Zuydam, 2017). An entity must comply to various standards to keep operating as a financial service provider (Blake, 2022:62).

Because of the strict regulations of the VCC incentive it made it difficult to administer due to the constant monitoring needed. The high administrative burden on SARS, because of the constant changing of the requirements, made it difficult to monitor and to identify tax avoidance or evasion (Blake, 2022). The specifications in the law that must be met, must be simple, there should be as little room as possible for subjective interpretation or negotiation, and the process should be largely automatic (IMF, 2015). By excluding subjective interpretation the risk relating to rent-seeking is reduced and the process will also be less time-consuming and cumbersome (European Commission, 2017:81).

The following requirements in the incentive included subjective interpretations or time-consuming tests as the design of the VCC incentive was complex and had policy uncertainty in the qualifying criteria:

Investor specific requirements

- If the investors acquired a loan to make the investment, there had to be a risk element attached to the loan amount and it had to be repayable within a certain time.
  The risk element of the loan was open to subjective interpretation as it needed constant monitoring to confirm that the loan agreement did not change, the loan was going to be repaid, and the investor had a risk of losing the capital if the investment were not a success.

VCC specific requirements

- The sole object of the VCC had to be the management of qualifying investee companies. The VCC was not allowed to operate another entity that was not a qualified investee company (Blake, 2022:60). However, it was never stipulated in the Act what the VCC is allowed to do with the moneys received from investors and before the investment is made in the qualifying investee company. If the VCC has extra space available the VCC is allowed to rent out the extra space to a third party (SARS, 2020:2). The issue is tested on a case-by-case basis. The VCC can buy additional space with the main purpose of renting the space out, but the test is subjective, and it will need to be proven by SARS what the intent was. This increased the administrative burden.
- The connected person test had to be adhered to 36 months after the VCC has filed for approval as a VCC. This was a subjective test as it could not be confirmed before the 36-month period has passed. It was then updated that the connected person test had to be adhered to 36 months from the date of approval as a VCC. The restriction had to be updated because some of the VCCs were not able to comply with the regulation and be

approved as a VCC. The upfront approval process is impractical (National Treasury, 2009). SARS cannot provide upfront approval on whether the company will satisfy the requirement if the 36-month period has not passed: this can only be done after the required time frame, not before (National Treasury, 2009). After the 36-month period there is constant monitoring of the VCC to confirm that the connected person test is adhered to which is a costly process because more resources have to be employed to confirm that the rules are not broken. Should the resources not be allocated to the monitoring it will expose the regime to misuse.

- The VCC had to invest a minimum of 80 percent in investments not exceeding a book value of R10 million in 2008. In 2011 the book value was updated to make the investment amount R20 million and in 2014 the minimum amount was again updated to be R50 million. The test is not subjective. However, it only considers the R50 million book value threshold, and does not take into consideration the options or market value of the entities. This made administration difficult as qualifying investee companies were approved because they effectively passed the test but were not in line with the objective of the regime.

Qualifying investee company requirements

- The qualifying investee company could not be a controlled group company. SARS had to monitor this constantly to confirm that the qualifying investee company does not become a controlled group company after initial investment by the VCC.
- The qualifying investee companies were not allowed to be trading in terms of any of the trades listed as impermissible. This had to be constantly monitored. The test also included subjective interpretation in terms of hotel keepers. And as can be seen in BPR 242 the ruling was that the qualifying investee company was not trading in immovable property but as a hotel keeper.

Even though an incentive could have the best intentions, if the design of the tax incentive is not efficient and the administration is difficult the incentive is open to abuse and rent-seeking. Active tax planning is evident in incentives with a high administrative burden and the revenue loss by the government will have nothing to do with the stated goal of the incentive (Blake, 2022:42). The initial compliance requirement of the incentive should include some positive measurement that specifically has to be met for the investor to be able to receive the incentive (Zolt, 2017:549). The incentive should also include qualifying criteria for initial compliance and stipulations of what requirements should be met during the investment life cycle (Zolt, 2017:549). The criteria that should be met in the different stages of the investment should be constantly monitored, otherwise the incentive is open to abuse. Incentives that use technical criteria which is well defined will less

likely be abused (Blake, 2022:42). Many of the monitoring requirements were tied to the performance of the VCC and not the qualifying investee company. The constant monitoring that was needed increased the administrative burden for SARS (Blake, 2022:64).

The complex requirements of the legislation also made the monitoring requirement difficult to administer. The discretion involved due to policy uncertainty became evident in the BPRs where the rulings that were made were not in line with the objective of the regime. There were multiple areas where the legislation was not clear about what the specific criteria were that had to be met, and the abusive structures had tax rulings in favour of the structures. There were six BPRs issued and most of them dealt with the controlled group company test or if the qualifying investee company is carrying on an impermissible trade. This speaks to the wide interpretation of the legislation. Since enactment in 2009 the legislation was updated seven times in 12 years with regards to the qualifying investee company, six times in 12 years in terms of the VCC requirements, and four times in 12 years for the qualifying investee company. The amendments included several adjustments each year in terms of the three separate criteria of the VCC incentive. A lack of stability often deters uptake of an incentive (European Union, 2017:82). The law that provides for the tax incentive should be clear and without the use of discretion (James, 2013:29). If the law is unclear and difficult to understand it includes subjective interpretation and discretion which opens the incentive up to abuse.

If the incentive was more clearly targeted and the legislation was not as complex, there would have been no need for the anti-avoidance rules. The anti-avoidance rules were brought into legislation due to the incentive being unclear in its targeting structure, having complex requirements, and being open to subjective interpretation. This increased the administration difficulty and opened the VCC regime up to abuse.

3.7 Conclusion

Tax incentives are important in a growing economy. The incentive will not deter the budget of the country and the cash flow of the fiscus will also not be affected. However, the design of a tax incentive is an integral part in the effectiveness of the incentive. The objective of the National Treasury should be clearly stated, and the legislation should bring the intent forward. A tax incentive that is designed in a manner that is beneficial for the investor and the investee could become an important part of a growing economy. With the design of an incentive the National Treasury should consider the instrument choice, the qualifying criteria of the incentive, and the administration and monitoring requirements of the tax incentive. If these three criteria are not considered when the tax incentive is designed, it will be open to misuse. In the discussion it became evident that the design of an incentive must link directly to the objective.

The VCC regime had three objectives as stated in the previous chapter. If the three objectives are considered and simplified to the activities that the National Treasury wanted to promote there is only two activities. First, the National Treasury wanted to increase the access to finance for SMMEs. To increase the access to equity financing a pooling mechanism was created for the investors in the form of a VCC to pool their funds together. The pooling mechanism was also intended to reduce the risk for the investors. Second, the National Treasury wanted to increase employment and equality by the developing of growth in SMMEs. The National Treasury had to give the SMMEs managerial support to create employment, growth, and development in the SMME sector of the economy. The National Treasury wanted to promote two separate activities in the regime.

After the objective of the incentive has been determined the legislation should be designed to draw the investor to the objective of the incentive. It should be considered that the incentive might be misused. Certain principles should be included in the design to stop potential abusive structures and activities. There are common principles in a tax incentive that need to be addressed otherwise it has been proven that the incentive will be open to abuse or revenue leakage. The common abuses of a tax incentive are “double dipping”, transfer pricing schemes, and entities concealing non-qualifying activities as qualifying activities.

The characterises of the VCC regime was critically analysed to confirm where the design of the VCC incentive made it susceptible to misuse and caused tax abuse and revenue leakage. The characteristics of the VCC regime were the following:

Choice of the tax instrument

The choice of the tax instrument is the first consideration as this is where the National Treasury must determine what they want to incentivise. The choice of instrument will include the choice between a cost-based or profit-based incentive, the form that the incentive will take, and if the tax benefit is received on the input of the investor or on the disposal of the investment.

The VCC incentive was a cost-based tax incentive. A cost-based tax incentive lowers the cost of capital for the investor due to a special tax deduction. The incentive was linked to the capital expenditure of the investor and not the promotion of growth for the qualifying investee company. Growth in the qualifying investee companies might have been promoted if the tax benefit was linked to the performance of the qualifying investee company rather than the capital expenditure of the investor.

The form of the incentive was an investment allowance on the input of the investors. This form will increase the investments in equity instruments, but it does not encourage employment

creation. The VCC incentive gave the investor a special tax deduction from taxable income. The more favourable a tax incentive is, the better the possibility that the investment was made for the tax benefit. The measurement of the incentive should have been linked to the output of the investment to encourage the investors to help the SMMEs grow. The form did not encourage investors to give managerial support to the qualifying investee companies to encourage growth. The eligible deduction for the investor must be precise and it must draw the investment to the precise activity the National Treasury want to incentivise.

Qualifying criteria of the tax incentive

The key takeaway from the section relating to the qualifying criteria is wide and includes various points that need to be considered. The targeting of an incentive should be direct and not open for subjective interpretation. By restricting the participation in an incentive, the revenue leakage and potential tax abuse of the incentive will be decreased. The incentive should be targeted in terms of the business (qualifying investee company), the investor (qualifying investor requirements and the investment tax relief available), the investment (VCC), and the duration of the investment. Overall, the qualifying criteria should have been targeted more directly and that could have prevented some of the misuse of the incentive.

The business criteria must be targeted in terms of the business age, size, and sector. The important principle in this section is that the three qualifications must be related. The size of the SMMEs was not specified clearly and VCCs invested in qualifying investee companies which had a high asset value. The second objective of the National Treasury was to create employment. The qualifying criteria for the qualifying investee company was wide and the test to be a qualifying investee company was a negative one. The businesses at the lower end of the VCC spectrum should have been targeted directly in industries that would have created employment.

The investor must be targeted in terms of structures that could arose due to related-party trading. The anti-avoidance measures for related-party trading were included in 2018 into legislation. Investors sold their entities to the VCC but kept the voting and participation rights, and in return invested in the VCC for a tax deduction. The related-party restrictions should be included from the start to mitigate the risk of related-party trading.

The second consideration in terms of the investor is the additional tax incentives congruent to the VCC incentive. Structures were invented where the investor received a deduction for the investment in VCC shares, the investor would have received a taxable deduction in some form from leasing assets from the qualifying investee company, and the qualifying investee company would have received an additional allowance for wear and tear depending on the assets. The

investments were in high asset entities and there were no transfer pricing rules before 2018. The related-party, anti-avoidance measures should be included from the initial promulgation.

The investment requirements were not clear between debt or equity instruments. The rulings on the BPRs were that although shares in different classes had preference rights the shares did not rank *pari passu* to the other classes of shares and the instruments were still seen as equity instruments. The definition for qualifying share was included in the legislation in 2011 and after that there were still uncertainty due to the complex requirements of what constitutes a qualifying share, or a VC share. The complex requirements that were difficult to understand made the monitoring and administration difficult and made the incentive susceptible to misuse.

By including a timeline into legislation, the National Treasury brought the incentive closer to its intended purpose. Stability in the investments were created for the VCC and the qualifying investee company. The five-year timeline closed the scheme for investors who wanted to invest only for speculative reasons and misuse the incentive.

Administration and monitoring the tax incentive

The subjective interpretation and the complex requirements in the legislation increased the difficulty of administering and monitoring the incentive. There were policy uncertainties in the legislation with regard to the controlled group company requirement, the impermissible trade requirement, and what constitutes a qualifying share. These principles were used in some form or manner to misuse the tax incentive. The requirements were also difficult to monitor and understand as they had a wide meaning and were complex. There was also a lack of stability in the incentive which deterred the uptake of the incentive.

As stated in chapter 1 of the study the second secondary objective is to critically analyse the characteristics of the VCC incentive against important design principles of a tax incentive to identify which aspects of the design of the VCC incentive made it susceptible to misuse. In chapter 3 the VCC incentive was measured using three principles: instrument choice, form of the tax incentive, and administration and monitoring requirements. In the discussion above it became evident that if the objective is stated the design must be directly linked to the objective of the incentive to prevent misuse.

The characteristics of the VCC regime was critically analysed to confirm where the design of the VCC incentive was inadequate in bringing the objective of the VCC incentive to light and decreasing the misuse. Instead, it caused tax abuse and revenue leakage. The National Treasury wanted to incentivise two separate activities in the regime. It is concluded that the incentive met the objective of increasing the access to finance for SMMEs as that was what the design of the

incentive promoted. The misuse of the incentive was due to policy uncertainty and complex requirements and regulations that were difficult to monitor and administer. The chapter achieved the second secondary objective as mentioned in chapter 1.7.2 to state where the design of the VCC incentive made it susceptible to misuse.

CHAPTER 4: SUMMARY AND CONCLUSION

4.1 Introduction

Chapter 1 of this study stated the reason why the VCC incentive was enacted and why the National Treasury had to provide an incentive to promote equity financing in SMMEs. The chapter included a short summary of the VCC inventive and why the National Treasury activated the sunset clause. The regime was misused which in certain instances led to tax abuse and revenue leakage. The design of the incentive failed in stopping the misuse despite several amendments in the Act. With the above problems in mind the problem statement and research objectives were defined. The research methodology that addressed these objectives was also explained.

Chapter 2 determined what the initial objectives of the VCC regime were and whether the objectives of the National Treasury changed over the period the incentive was active. Consideration was given as to why the specific objectives are important in a growing economy. An analysis on the historical development of the VCC incentive was done and whether the amendments made to the legislation increased or decreased the uptake of the regime. The historical development was performed in the three separate sections of the VCC incentive: (1) first the qualifying investor requirements and the investment tax relief available; (2) second, the historical development of the VCC requirements, and (3) last, requirements of the qualifying investee company. The chapter made a conclusion that the amendments were in line with the objectives of the National Treasury. It further concluded that amendments made from 2009 to 2015 were to increase the uptake of the VCC regime, and the amendments from 2016 onwards were to stop the abusive structures evident in the VCC regime.

Chapter 3 provided a motivation for the use of tax incentives by governments and in what instances a tax incentive will be effective. The underlying costs of tax incentives and their benefits were considered. The most common areas where tax incentives are misused were described as well as the important design principles when designing a tax incentive to mitigate the risk relating to tax incentives. The VCC incentive was compared to the design principles and a critical analysis was done on legislation and where the design of the VCC incentive failed in stopping the misuse. A conclusion is made that the National Treasury wanted to incentivise two separate activities in the VCC regime. First, to increase access to equity finance for SMMEs and second, to promote growth in SMMEs and use that as a mechanism to increase employment creation. Further, a conclusion was made about the design aspects that made the VCC incentive susceptible to misuse.

The purpose of chapter 4 is to provide a summary of the findings and recommendations in the previous chapters. This chapter provides a summary of the most important findings of the research about how and when the design of the VCC incentive made it susceptible to misuse. The chapter lastly includes future research directions for the design of tax incentives in South Africa.

4.2 Research objectives

The objective of this study is contained in chapter 1 of this document. The main objective of this study was to identify aspects in the design of the legislation of the VCC incentive which made it susceptible to misuse. The study further aimed to provide considerations into what characteristics should be evident in the design of a tax incentive that has the objective of increasing the financing of SMMEs and provide growth.

By addressing the secondary objectives of the study, the conclusion could be made about the primary objective of the study. The secondary objectives that guided this study were:

- To determine what the initial objectives of the VCC regime were by reviewing the historical development of the regime. This objective was addressed in chapter 2.
- To critically analyse the characteristics of the VCC incentive against important design principles of a tax incentive in order to identify which aspects of the design made it susceptible to misuse. This objective was addressed in chapter 3.

4.3 Summary of research results

The findings of the research are addressed in detail in the following section. The summary states the primary accomplishments of the study's secondary objectives.

4.3.1 A review of the historical development of the VCC incentive

In chapter 2 the historical development of the VCC incentive was analysed. First, the objectives of the VCC regime were determined and why the regime was promulgated into the Act. The three objectives of the VCC incentive were determined to be an integral part in a growing economy. The three objectives were the following:

- Increasing the access to equity financing and supportive managerial services to SMMEs.

  Access to finance is a major constraint for South African SMMEs as they often do not have the collateral available to apply for debt financing. Equity financing contains less risk, there is no regular repayments or interest rate spikes, and it will also provide the SMME with

management services to achieve growth in the entity. The investor has a higher risk attached to the investment compared to that of the SMME. It was thus confirmed that an incentive is required for the investor to decrease the risk of the investment.

- Creating a pooling mechanism for investors to pool their funds together to invest in qualifying investee companies and reducing the risk relating in investing in the equity of SMMEs by giving an upfront tax deduction.

  The risk of investing in SMMEs is quite high due to low success rates. Due to the high risk of investing in SMMEs, it is important to reduce the risk relating to the investment.

- The development of growth and to use the growth as a mechanism to decrease unemployment and inequality.

  SMMEs play a major role in developing countries due the increase in social-political stability of the countries. In 2030 ninety per cent of South Africa's workforce will be employed by SMMEs, and it is thus important to develop the growth of SMMEs.

It has thus been determined that the VCC incentive is an important incentive for the development of SMME. The objectives of the incentive are also an integral part of a developing country.

Thereafter, the historical development of the VCC incentive was analysed. It was confirmed that the flow of funds as intended by the National treasury was that the investor invests funds into a VCC that will use the investment capital to invest in the equity of qualifying investee companies. The investor will qualify for a tax deduction of the expenditure incurred. The investments made by the VCC are subject to certain criteria. The qualifying investee company will use the share capital to grow its operations and will receive managerial support from the VCC and the investors.

It was found that the uptake of the regime was minimal until the amendments were made. The amendments made were either seen as positive or negative by the investors. There was a clear link between the amendments made and the uptake of the VCC incentive. From the information it became evident that the amendments made until 2015 were to increase the uptake of the regime. The amendments made from 2016 onwards were to stop the abusive structures in the regime.

The following amendments were made to the VCC regime to increase the uptake of the regime:

- In 2009 the National Treasury increased the deduction thresholds for listed and group company investors for the VCC to get access to anchor investors. The main objective of the VCC was to be a fund manager for qualifying investee companies and many of the requirements causing administrative issues were removed from the Act. The qualifying investee company did not have to trade within 18 months since the investment from the VCC has been received and did not have to spend all the subscription moneys within 18 or 36 months.
- The amendment in 2011 allowed any 'taxpayer' to get the deduction for investing in a VCC and the deduction limitation was completely removed from the Act. The amendments were met with three anti-avoidance provisions: (1) the connected person test, (2) the fact that the investment must be a pure equity investment, and (3) there must be a risk element attached to the investment. The VCC did not have to be a listed entity. The following requirements were removed from the VCC requirements: (1) the non-controlling company requirement; (2) the rule stating that 90 percent of the gross income should be due to services rendered to qualifying investee companies, and (3) the minimum investment requirement. Several limiting factors were introduced in terms of the investment portfolio of the VCC. A franchisee was allowed to be a qualifying investee company.
- The non-recoupment rule was included in the Act in 2014 as an incentive to increase the uptake of the regime. The deduction will only be permanent if the shares were held for a minimum of five years to ensure that investors invested for the correct reason and not purely for a permanent tax deduction. The amendments for the VCC were to clarify what the legislator meant with certain inclusions and how the anomalies that arose should be addressed. The clarification stated that 80 percent of capital received should be invested in qualifying investee companies and 20 percent of the subscription moneys received is allowed to be invested in one qualifying investee company.
- The connected person test was deferred to state that the test must be performed at the end of the 36-month period and not at the beginning, due to angel investor being restricted in how much capital they are allowed to invest.

The following amendments were made to the VCC regime to stop the abusive structures evident to the National Treasury:

- The investor was only allowed to hold 20 percent shares in <u>any</u> class of shares, or else the relief was not available. The amendments to the qualifying investee company requirements were that not more than 50 percent of the income of the qualifying investee company were allowed to be from an investor in the VCC and VCC shareholders were not allowed to hold more than 50 percent participation rights or voting rights in the qualifying

investee company. Business owners are also not allowed to sell their shares in the qualifying investee company to the VCC and then in return be shareholders of the VCC.

- The deduction limitations were re-introduced in 2019. The deduction limitations were R5 million for companies and R2.5 million for any taxpayer other than a company.
  The deferral period of 36 months that allowed the VCC to invest 80 percent of the capital received into qualifying investee companies was increased to 48 months.
- In June 2021 the National Treasury activated the sunset clause due to the abusive structures and the VCC incentive not meeting its intended purpose, and the VCC regime came to an end.

A conclusion can be made that the amendments were in line with the objectives of the VCC regime. However, the amendments were not sufficient in stopping the misuse of the VCC incentive. The National Treasury also had difficulty in finding the right balance between increasing the uptake of the VCC regime, stopping the misuse of the VCC incentive, and decreasing the administrative difficulty.

4.3.2 Critical analysis of the characteristics of the VCC incentive against the most important design principles of a tax incentive

Tax incentives are important in a growing economy. The incentive will not deter the budget of the country and the cash flow of the fiscus will also not be affected. Tax incentives are often used to correct deficiencies in the market, correct the investment climate and it could in return encourage employment creation.

In chapter 3 the VCC incentive was measured using three principles: instrument choice, qualifying criteria of the tax incentive, and administration and monitoring requirements. In the discussion above it became evident that the design of an incentive must directly link to the objective itself.

The VCC regime had three objectives but the objectives could be simplified into two activities. First, the National Treasury wanted to increase the access to finance for SMMEs by creating the pooling mechanism for the investors to pool their funds together and in return reduce their risk. Second, the National Treasury wanted to increase employment and equality by the development of growth in SMMEs. The SMMEs needed managerial support to create employment, growth, and development in the SMME sector of the economy. The National Treasury wanted to promote two separate activities in the regime.

The characteristics of the VCC regime were critically analysed to investigate where the design of the VCC incentive was inadequate, in bringing the objective of the VCC incentive to light. Contrary to the intention of the VCC regime, it caused room for tax abuse and revenue leakage. The

objective of the incentive and the activities the legislation promoted did not deliver the outcomes that the National Treasury had envisioned.

From the findings in the study it is evident that the various principles in the design of the VCC incentive made it susceptible to misuse. The main objective of the study was to identify aspects in the design of the legislation of the VCC incentive which made it susceptible to misuse and the following principles answer the research question.

Instrument choice of the tax incentive

The choice of instrument will include the choice between cost-based or profit-based incentive, the form the incentive will take, and whether the tax benefit is received on the input of the investor or on the disposal of the investment. The choice of tax instrument of the VCC regime was a cost-based one. The form of the VCC incentive was an investment allowance which applied to the taxable income of the investor. The incentive was also seen as an input-based incentive on the initial capital expenditure of the investor. The investors received the deduction from their taxable income at the start of the investment and did not have any incentive to create growth in the SMME as their investment risk was already reduced. The eligible deduction for the investor has to be precise and it has to draw the investment to the activity the National Treasury wanted to incentivise, or else investors might not use the incentive for the right intent.

Qualifying criteria of the tax incentive

The qualifying criteria were broad and made room for subjective interpretation and included complex requirements. The incentive should be targeted in terms of the business (qualifying investee company), the investor (investor requirements and the investment tax relief available), the investment (VCC), and the duration of the investment. Overall, the qualifying criteria could have been targeted more directly and the requirements could have been more easily stated which would have made the incentive less susceptible to misuse.

Business criteria (qualifying investee company)

The business criteria must be targeted in terms of the business age, size, and sector. The important principle in this section is that the three qualifications must be related. The first activity the National Treasury wanted to incentivise was to give qualifying investee companies access to finance that could not get access from other parties. The second activity was to develop growth in the SMMEs and in return create employment.

The qualifying criteria for the size of the qualifying investee company was only tested at the initial stages of the investment. The size of the SMMEs was not specified clearly and VCCs invested in

qualifying investee companies which had a high asset value or had the option to acquire additional assets after the initial investment by the VCC. Most of the investments went to real estate VCCs which could have obtained funding from other sources. These type of activities also do not create employment. The purpose of the qualifying investee companies could have been stated more clearly to finance SMMEs at the lower end of the spectrum which would have created employment.

Investor (Investor requirements and the investment tax relief available)

The investor must be targeted in terms of structures that could arose due to related-party trading. The investors sold some of the shares in their business to the VCC and would also buy shares in the VCC. The investor would receive the tax benefit of the VCC incentive but would also keep participation rights and voting rights in their own company. The VCC incentive was open to misuse as investors could invest in their own entities and receive a taxable deduction for the investment.

The second consideration is the additional tax incentives in congruence to the VCC incentive. Most of the investments made by the VCC went to qualifying investee companies which had a high asset value. The investors invested in their own entities through the VCC. The investor would then create a second entity with the same operations and lease assets from the qualifying investee company and create tax deductible expenditure. If normal financing were received the capital portion of the loan would not have been tax deductible. The investor received a tax benefit for investing in the VCC shares and a taxable deduction for the operating lease expense. The qualifying investee company could have received a tax allowance in the form of wear and tear depending on the asset. The 2018 amendments stopped the misuse when the anti-avoidance measures for related-party trading were included into the Act.

Investment (VCC)

The investment requirements could have stated more clearly that the investments should be pure equity instruments. The VCCs and the qualifying investee companies issued shares with different rights attached to different classes of shares. It was confirmed that the rights of the different classes of shares had preference rights and all the shares ranked *pari passu* at liquidation but not at normal distributions. The amount of subscription moneys paid by the investors was effectively debt financing but without the taxable interest received. The inclusion of the definition of qualifying share had complex requirements which referred to hybrid equity instruments in section 8E and third-party backed shares in section 8EA. The requirements were difficult to understand and administer and the VCC incentive was susceptible to misuse due to these complex requirements.

Administration and monitoring requirements of the tax incentive

The complex requirements in the legislation also increased the difficulty of administering and monitoring the incentive. The policy uncertainty made administering of the requirements difficult and most of the rulings in the BPRs were not in line with the objectives of the VCC regime. There was policy uncertainty in terms of the impermissible trade requirement and controlled group company requirements which were mostly used by investors to misuse the incentive. Due to the incentive not being clearly targeted and the legislation being complex and open to subjective interpretation the ability of the investors to misuse the incentive increased. This also increased the difficulty in monitoring the compliance of the VCCs.

It can be concluded that it was not clear what activity the incentive should have promoted. The outcomes of the incentive were not clear, and the incentive fell short in its deliverables of creating employment and growth for SMMEs (Balfour, 2021). The size, age, and sector of the qualifying investee company might have had a better targeting structure if it were positively specified. The form, instrument choice, and targeting structure of the incentive drew the investments to capital-intensive industries and not necessarily industries that would have created employment and economic growth. The misuse of the incentive was due to policy uncertainty, complex requirements, and regulations that were difficult to monitor and administer.

4.4 Limitations of the study

A critical analysis was performed of the design principles of the VCC incentive which made it open to misuse. The study did not consider how the VCC regime compares to the same incentives available in other countries. The design principles that are included in the recommendations section of this document should be compared to the design principles of the same types of incentive in other countries. The comparison with the legislation of other countries should consider the most effective incentive that could be used to increase access to equity finance and in return would promote growth and employment creation in SMMEs.

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