



A review of the South African venture capital company regime

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

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Graduation: May 2020

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ABSTRACT

SMMEs are of great importance to the economy of any country, therefore the government should encourage the establishment and growth of SMMEs as a tool to address unemployment and inequality. Consequently, in an attempt to encourage equity funders to invest in SMMEs, the government of South Africa enacted the VCC regime.

With effect from the 1st of July 2009, in terms of section 12J of the Act, investors (any taxpayer) can claim an upfront income tax deduction in respect of the expenditure incurred in exchange for the acquisition of VCC shares. The deduction allowed in the hands of investors will not be recouped if the investment is retained for a period exceeding five years. Consequently, after the restriction period the taxpayer should not be subject to normal income tax upon disposal of the VCC shares. The investor's base cost in the VCC shares will, however, reduce by the initial tax deduction claimed and, therefore, upon disposal of the VCC shares, the investor could be subject to CGT on the entire proceeds received.

The VCC regime is often criticised for being tax-inefficient as investors are fully taxed on the growth of the investment. Therefore, this literature review aims to address the research question: Does the current South African VCC regime achieve its underlying objectives and can the regime, in its current form, achieve these objectives in the future? As currently written, the VCC regime would expire on the 30th of June 2021. From the research conducted in this study, it is evident that the VCC regime only started meeting its objectives within the last five years, post significant amendments to section 12J of the Act.

Even though amendments were made to align the VCC regime to its objectives, several shortcomings to the South African VCC regime are noted when compared to the United Kingdom venture capital regimes. This is especially true with regard to the tax relief provided to VCC investors. In light of the shortcomings identified, the study includes various recommendations to improve the current section 12J of the Act.

Most significantly, it is recommended that the sunset clause of the VCC regime be revised, based on the fact that to date, the VCC industry did not have policy certainty and the economic impact of the VCC regime has not been fully assessed. It is further concluded, if National Treasury considers extending the sunset clause of the VCC regime, some amendments should be incorporated in the current section 12J of the Act, in order to enable the VCC regime to fully achieve its objectives and make a lasting impact on the South African economy.

AKNOWLEDGEMENTS

I am exceptionally appreciative of the opportunity I was granted to complete my master's in taxation. It has been an enriching journey of learning, self-discovery, and growth. Upon reflection, I realised that I have been blessed every step of the way.

During my honours year, I developed my passion for taxation when I realised that the tax profession presents an exciting career with many challenges. It is an ever-evolving field which affects every business and individual. Therefore, I thank Professor Pieter van der Zwan for his mentorship to each tax student attending his Mcom Tax lectures. I would like to thank him for his commitment to the tax profession and his determination in ensuring the growth of the tax faculty at the North-West University.

I would like to extend my heartfelt gratitude to my study supervisor, Corrie Meiring. She has been the epitome of hard work and dedication. I am sincerely grateful for her guidance, clarity of responses and insightful comments from the inception of this mini-dissertation to its fruition. I would like to thank her for the role she played in this study, sharing her vast knowledge and providing continuous support.

Thank you, Cillie Swart, from Transkarooo Communications, for the language editing of this mini-dissertation.

Ryan, thank you for your love, patience, sacrifices, and support during the past few years. Your continuous encouragement had a tremendous impact on my studies.

Finally, I would like to express my very profound gratitude to family and friends, but most importantly my parents for providing me with unfailing support and continuous encouragement throughout the seven-year journey of becoming a qualified CA(SA), and through the process of researching and writing this mini-dissertation. This accomplishment would not have been possible without you.

“Rise above the storm and you will find the sunshine.” (Mario Fernandez)

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KEYWORDS

Development

EIS

Growth

Investment

Section 12J

SMME

Tax incentive

Venture capital

VCC

VCT

LIST OF ABBREVIATIONS / DEFINED TERMS

BRICS	Brazil, Russia, India, China, and South Africa
CEO	Chief Executive Officer
CGT	Capital Gains Tax
Commissioner	The Commissioner of the South African Revenue Service (SARS)
Eighth Schedule	The Eighth Schedule to the Act, which comprises the CGT legislation
EIS	Enterprise Investment Scheme
FAIS	Section 8 of the Financial Advisory and Intermediary Services Act
GDP	Gross Domestic Product
HMRC	Her Majesty's Revenue and Customs
IRR	Internal Rate of Return
LSE	London Stock Exchange
OECD	Organisation for Economic Co-operation and Development
SAIT	South African Institute for Tax Professionals
SARS	South African Revenue Service
SAVCA	Southern Africa Venture Capital Association
SEDA	Small Enterprise Development Agency
SMME / SMMEs	Small, Medium and Micro-sized enterprises
Small Business Act	Section 1 of the National Small Business Act (102 of 1996)
TCGA	The Taxation of Chargeable Gains Act (c.12 of 1992)
the Act	The South African Income Tax Act (58 of 1962)
the UK Tax Act	Section 156 to 332 of the United Kingdom Income Tax Act (c.3 of 2007)
TLAA	Taxation Laws Amendment Act
TLAB	Taxation Laws Amendment Bill
VCC / VCCs	Venture Capital Company
VCT / VCTs	Venture Capital Trust

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CHAPTER 1: INTRODUCTION

1.1 Background to the research area

One of the fundamental difficulties for smaller trading companies to grow economically is access to financing. Therefore, to assist these entities in terms of equity finance, the South African government has implemented a tax incentive for investors to invest in such entities through a venture capital company (VCC) regime (SARS, 2018a).

With effect from the 1st of July 2009, in terms of section 12J of the South African Income Tax Act (58 of 1962) (the Act), investors (any taxpayer) can claim an upfront income tax deduction in respect of the expenditure incurred in exchange for the acquisition of VCC shares. Section 12J(11) of the Act determines that the VCC regime is subject to a 12-year sunset clause which ends on the 30th of June 2021. The sunset clause in terms of section 12J(11) of the Act implies that the upfront income tax deduction will only be available for the acquisition of VCC shares on or before the 30th of June 2021. Due to the fact that there is a sunset clause in the VCC regime, it will allow for a review of the efficacy of the VCC regime. The reasons for the initial implementation of the VCC regime as well as what this regime entails are discussed in the following paragraphs.

Venture capital is equity financing that investors provide to start-up companies and smaller trading companies. Venture capital generally comes from wealthy individual investors, investment banks, or financial institutions (Investopedia, 2000). There are specific types of investments that help a company through the stages of its growth. At the very early stages, a company will receive venture capital, thereafter a company will seek private equity funding. Mezzanine capital is the bridge to the next stage which is an initial public offering and thereafter the entity will list on an exchange (Deeb, 2016). This study will focus on the early stages of a company which is ultimately the venture capital stage (Deeb, 2016).

Section 12J(1) of the Act refers to these smaller trading companies as qualifying investee companies which, subject to other requirements, includes all unlisted companies as defined in the Act. Even though section 12J of the Act refers to qualifying investee companies, reference is also made to Small, Medium and Micro-sized Enterprises (SMMEs) as one of the former South African Ministers of Finance, Mr Trevor Manuel, referred to support for SMMEs when the initial proposal of the VCC regime was included in his budget speech delivered in 2008 (Manuel, 2008).

Section 12J(2) and 12J(5) of the Act provides for the formation of an investment holding company, described as a VCC. In order to qualify for the tax relief, venture capital investments

must be made through an approved VCC in terms of section 12J of the Act. An approved VCC is a company designed to provide individual and corporate investors with access to a range of qualifying investee companies which have the potential for growth. The VCC raises funds by issuing equity shares to investors and the funds are subsequently allocated to designated qualifying investee companies. The designated qualifying investee companies are SMMEs which are determined by the VCC managers to have the best prospects of investment growth (Parker, 2014). The VCC is intended to be a marketing vehicle that will attract retail investors. It has the benefit of concentrating investment expertise in favour of the small business sector (Osher & Zuccollo, 2017). In short, the operation of a VCC is such that a qualifying investor invests in an approved VCC, in return, the approved VCC invests in qualifying investee companies. As the qualifying investee companies return profits, dividends will be paid out to the VCC, and the VCC will in turn pay dividends to the individual or corporate investor (SARS, 2018a). Refer to Figure 1 below which illustrates how a VCC operates.

Figure 1: Illustration of how a VCC operates



(Source: SARS, 2018a)

According to the SMME quarterly update done by the Small Enterprise Development Agency (SEDA), as at the 31st of March 2019, South Africa had an estimated 2.6 million SMMEs, which contribute roughly 36 percent to South Africa's gross domestic product (GDP). SMMEs provide about 40 percent of jobs to the South African labour force and contribute more than 48 percent to South Africa's total remuneration (SEDA, 2019). As per Trading Economics, the unemployment rate in South Africa was 27.6 percent in the first quarter of 2019. It is thus imperative for the South African government to support SMMEs to reduce the country's unemployment rate (Trading Economics, 2019b).

The enhancement of SMMEs is of great importance to the government of South Africa (Department of Trade and Industry, 2005:3) as was reiterated by South Africa's current President, Mr Cyril Ramaphosa, in his first state of the nation address on the 16th of February 2018 (Ramaphosa, 2018). The National Development Plan further emphasises the importance of SMMEs and focuses on a plan to reduce the high unemployment rate of South Africa by 2030 (Department of Trade and Industry, 2012).

The main objectives of the VCC regime are summarised below:

- To encourage the establishment and growth of SMMEs as a tool to address unemployment and inequality (National Treasury, 2017).
- To encourage equity funders to invest in SMMEs (National Treasury, 2016).
- To create a structure whereby investors could pool their funds in the VCC, which would then channel those funds to investments in qualifying investee companies (National Treasury, 2011).
- To have the VCC provide supportive management services to the qualifying investee companies (National Treasury, 2011).
- To reduce the risk of investing in these high-risk entities by providing an upfront income tax deduction to an investment which would have generally been of a capital nature, and would, therefore, not have qualified for a deduction in terms of the Act. The upfront deduction will consequently increase the internal rate of return (IRR) of the investment (SAICA, 2012).

The current status of the VCC regime will, therefore, be compared to the above objectives in order to reach a conclusion on whether the current South African VCC regime achieves its underlying objectives, and if the regime, in its current form, can achieve these objectives in the future.

1.2 Motivation of topic actuality

The South African government and many others around the world share the view that the development of SMMEs and similar institutions hold the key to economic growth and development. Various countries acknowledge the fact that SMMEs are playing an important role in the economies of these countries (Garwe & Olawale, 2010).

The development of SMMEs is seen as a fundamental component to solve the development issues of a country. Without the development of SMMEs, the economies are at risk of stagnation (Garwe & Olawale, 2010). Promoting SMMEs have been portrayed as one of the best strategies for achieving the national development goals (Kabongo & Okpara, 2009).

SMMEs do not only contribute significantly to the economy but also promote diversification through the development of new and unsaturated sectors in the economy. Furthermore, innovative and technology-based SMMEs can provide a platform for local, regional and international growth, especially in the economies of Brazil, Russia, India, China, and South

Africa (BRICS). SMMEs are considered to be imperative contributors to the economy as the drivers for diminishing unemployment, especially since the formal sector continues to shed jobs (The Banking Association of South Africa, 2015).

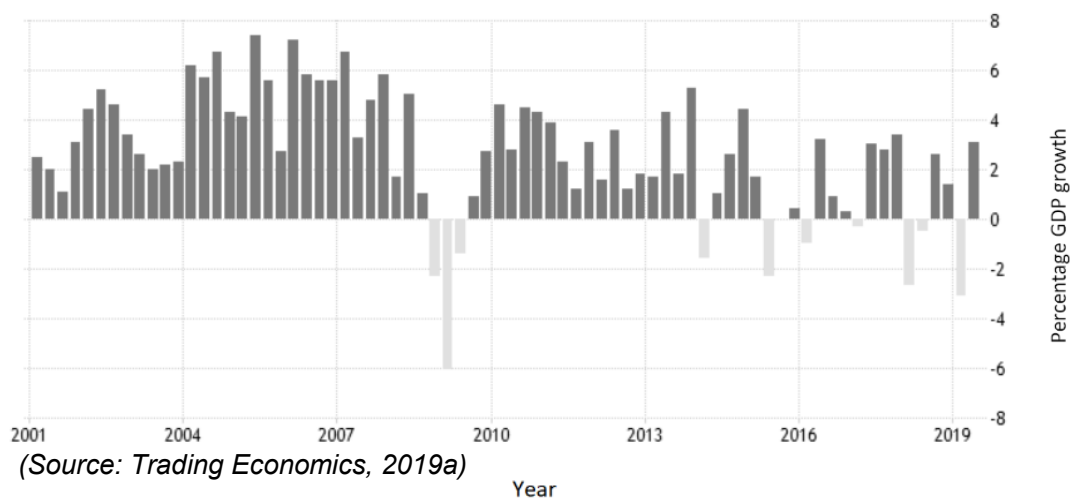
Due to the acceptance of the importance of SMMEs to bring about economic growth, the government of South Africa had to focus on what can be done to promote the growth of SMMEs and, more specifically, which tax incentives will assist in the achievement of this goal (Manuel, 2008).

In 2008, one of the former South African Ministers of Finance, Mr Trevor Manuel, introduced a tax incentive in his budget speech to encourage venture capital equity investments in SMMEs. The initial proposal was a tax incentive amounting to a 30 percent upfront income tax deduction for venture capital investments in non-mining companies (Manuel, 2008). After the announcement in the budget speech, National Treasury introduced section 12J into the Act in 2009. Since the enactment of section 12J of the Act, there have been various amendments to this section in order to align it more closely to its initial objectives (National Treasury, 2017). This study will review the VCC regime as it currently stands, in light of its initial objectives.

Section 12J of the Act was specifically enacted to boost the investment in SMMEs by increasing access to equity finance, as this is one of the barriers or constraints found in the development of SMMEs (Gree & Thurnik, 2003).

South African's economy has been growing at a low rate for a considerable number of years. as can be seen in Figure 2 below which illustrates the history of the South African GDP growth rate.

Figure 2: History of the South African GDP growth rate



As can be seen in Figure 2 above, the South African GDP growth rate averaged 2.71 percent from 1993 until 2019, achieving an unsurpassed high of 7.60 percent in the fourth quarter of 1994 and a record low of minus 6.10 percent in the first quarter of 2009 (Trading Economics, 2019a).

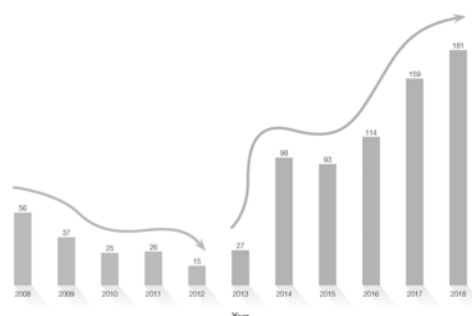
The GDP growth rate has reverted to positive territory since the VCC regime has been enacted in 2009. The South African economy potentially saw the benefit of the VCC regime due to the fact that the assets under management by the VCCs, since the enactment of the VCC regime, grew to R8.3 billion (Zuccollo, 2019). The Southern Africa Venture Capital Association (SAVCA) publishes an annual venture capital industry survey that reports on the venture capital activity for a specific year. The survey provides valuable insights about the South African venture capital landscape for fund managers, investors, entrepreneurs and policymakers. The survey process entails gathering and processing data through questionnaires and interviews with venture capital fund managers and other investors conducting venture capital type investments. The number of active fund managers that participated in the 2019 survey amounted to 52 participants. From the 2019 survey results, it is evident that the venture capital sector in South Africa is continuing to grow. This is substantiated by the number of deals, as well as the value of deals reported during the 2018 calendar year (SAVCA, 2019).

For the first time since 2010, when the first survey was undertaken by SAVCA, the overall value of deals recorded in the 2017 calendar year, amounted to more than R1 billion. According to SAVCA CEO, Tanya van Lill, South Africa is likely to see this upward trend in annual deal flow activity continue in the future (SAVCA, 2019). Some highlights of the survey are as follows:

- Based on the first SAVCA survey conducted, the reported value of investments in qualifying investee companies during 2009 was just over R300 million. The reported value of investments in qualifying investee companies increased from R872 million in 2016 to R1.1 billion in 2017 and to R1.5 billion in 2018, an increase of 33 percent and 36 percent respectively (SAVCA, 2010 & SAVCA, 2019).
- The total number of investments in qualifying investee companies in 2009 was about 37. The total number of investments in qualifying investee companies per year increased from 114 in 2016 to 159 in 2017 and to 181 in 2018, an increase of 39.5 percent and 13.8 percent respectively (SAVCA, 2010 & SAVCA, 2019).
- In 2010, the venture capital asset class had R2.64 billion invested in 251 deals. At the end of 2018, the venture capital asset class had R5.37 billion invested in 665 deals. This number has doubled since the first SAVCA survey in 2010 (SAVCA, 2010 & SAVCA, 2019).

It is not the objective of this study to provide a detailed analysis of how the VCC regime has directly impacted the South African economy. Economic data and the effect thereof will not be analysed in detail in this study. However, achieving economic growth is an objective of the VCC regime and, therefore, it is important to gain an understanding of the current economic climate of South Africa to conceptualise the growth of the venture capital industry. The venture capital industry is still in its growth phase as can be seen in the SAVCA industry survey results. Refer to Figure 3 below which is an extract from the SAVCA venture capital survey report, which further indicates that the industry is in its growth phase.

Figure 3: Number of venture capital investments recorded over the years from 2000 to 2018



(Source: SAVCA, 2019)

Currently, there are 158 approved VCCs on the SARS list of approved VCCs. Before 2015, only one or two VCCs got approved per year but this has significantly increased to 18 additional approvals in 2015, 16 in 2016, 45 in 2017, 56 in 2018 and there are already 23 approvals in 2019 (SARS, 2019). This further corroborates the fact that the venture capital industry is in its growth phase.

Due to the fact that the VCC tax relief is subject to a sunset clause which ends on the 30th of June 2021, this study focuses on the VCC regime in light of its objectives. This study will specifically focus on whether the VCC regime as implemented by the South African government, assists SMMEs by attracting investors, and as a result will achieve economic growth, and whether the sunset clause should be revised. This study will also include a comparison of the VCC regime to the United Kingdom venture capital tax incentives to identify any strengths and weaknesses of the South African VCC regime in light of its objectives.

The VCC regime is based on the United Kingdom venture capital regimes (Zuccollo, 2019). According to Bates, Cowling, Jagger & Murry (2008:13), the availability of venture capital for start-up entities has been a key policy issue for the United Kingdom government to ultimately promote economic development through the growth of SMMEs. Therefore the United Kingdom government has enacted liberal tax reliefs targeted at investors to increase venture capital investments (Baygan, 2003). The United Kingdom government introduced the Enterprise

Investment Scheme (EIS) and the Venture Capital Trusts (VCT) tax incentives to promote investments in SMMEs. Other than dividing this into two different incentives, the premise of the United Kingdom incentive is the same as the South African incentive, that is, an income tax deduction in respect of expenditure incurred for the acquisition of VCC/EIS/VCT shares, provided that certain anti-abuse provisions are met (Baygan, 2003). The first incentive, the EIS regime, was enacted by the United Kingdom government in 1994, which was 15 years before the South African VCC regime was enacted (Baygan, 2003).

There are various reasons why the United Kingdom has been chosen as a comparative country. Firstly, the overarching objectives of both countries' venture capital regimes are aligned. Secondly, the incentive, which is an upfront tax deduction for venture capital investments, are similar in nature between the two countries. Lastly, due to the fact that the United Kingdom first enacted this regime in 1994 means that South Africa can leverage off the successes and failures of this established regime. The reasons for choosing the United Kingdom as a comparative country have been discussed in more detail in paragraph 4.2 of this study.

The reason for the selection of the VCC regime in this study is because the topic is relevant in the current economic climate of South Africa and SMMEs are a key link in the South African government's plan to achieve growth.

1.3 Problem statement

As was seen above, the South African government introduced the VCC regime to increase investments in SMMEs to ultimately decrease unemployment and increase economic growth. However, due to the statistics presented above, a problem exists where the South African economy has only really seen the benefits of the VCC regime materialise during the last few years of its existence. Furthermore, due to the sunset clause in the VCC regime, the South African economy might never realise the entire potential benefit of the VCC regime. The venture capital industry is in its growth phase and therefore the benefit as originally intended might only materialise at a later stage of the economic cycle.

A secondary problem exists that, should National Treasury decide to extend the sunset clause in order to really materialise the benefit of the VCC regime, one would still need to consider all the flaws of the regime and conclude whether it is, in fact, an incentive that investors should consider. According to the South African Institute for Tax Professionals (SAIT), a significant reason why VCCs are struggling to attract investors is that for potential high growth investments, it is often tax-inefficient as investors are fully taxed on the growth of the investment, as detailed further in this study (SAIT, 2017). National Treasury has also

acknowledged the concerns regarding the difficulty of finding initial investors to provide funding to the VCC without breaching the requirements of the legislation (National Treasury, 2016).

Due to the problems identified above, this study will focus on addressing the research question: Does the current South African VCC regime achieve its underlying objectives and can the regime, in its current form, achieve these objectives in the future?

1.4 Research objective

1.4.1 Main objective

The main objective of this research study is to determine the underlying objectives of the South African venture capital tax regime and to critically compare the regime, in its current form along with the sunset clause, to its underlying objectives, in order to reach a conclusion on whether the current South African VCC regime achieves its underlying objectives and if the regime, in its current form, can achieve these objectives in the future.

1.4.2 Secondary objectives

Within this study, multiple secondary objectives are met in order to ultimately achieve the main objective. The secondary objectives of this study include the following:

- (i) To critically analyse previous research studies and the literature relating to the importance of SMMEs in the South African economy. This research objective is addressed in Chapter 2 of this study.
- (ii) To explore the historical development of the South African VCC regime, to understand the reasoning for the enactment of the regime, and to ultimately determine the underlying objectives of the regime. This research objective is addressed in Chapters 2 and 3 of this study.
- (iii) To understand the current policies regarding the venture capital tax relief found within section 12J of the Act as well as to critically analyse previous research studies based on the current venture capital tax relief. This research objective is addressed in Chapter 3 of this study.
- (iv) To perform a critical comparison of the venture capital tax relief measures available in South Africa with those available in the United Kingdom using the theoretical construct as an underpin, to make recommendations for a possibly improved or revised section 12J of the Act, based on the shortcomings identified in the critical comparison. This research objective is addressed in Chapters 4 and 5 of this study.

1.5 Research methodology

The research process has three major dimensions, namely the researcher's ontology, epistemology and methodology. Ontology and epistemology are critical in determining the research methodology as this specifically impacts the research paradigm within which the research will be conducted (McKerchar, 2008).

Ontology in business research can be defined as “the science or study of being” and it deals with the nature and idea of the real world. Ontology is a system of belief that reflects an understanding by an individual about what comprises reality (Dudovskiy, 2016). In particular, epistemology is concerned with potential outcomes, nature, sources and limitations of knowledge in the field of study. Methodology refers to how the researcher goes about practically finding information about whatever he or she believes can be known (Dudovskiy, 2016).

There are traditionally two core research philosophical paradigms which are commonly referred to as positivism and interpretivism (McKerchar, 2008). Within each paradigm there certain ontological and epistemological beliefs about the reality and how we can gain knowledge of that reality.

As a theory, positivism adheres to the view that only verifiable information gained through observation (the senses), including estimation, is trustworthy. In positivism studies, the role of the researcher is limited to the accumulation of data and interpretation of the data in an objective way (Dudovskiy, 2016). Positivism is more scientific and objective; it sees the reality as something independent from its participants (realism ontology and objectivism epistemology). Interpretivism, also known as interpretivist, involves researchers' interpretation subjectivity and understanding of components of the study (understanding the reality and interpretation thereof). Interpretivism incorporates human interest into a study (relativism ontology and subjectivism epistemology). In addition, interpretivism studies usually focus on meaning and may employ numerous methods in order to reflect different aspects of the issue (Dudovskiy, 2016).

In order to achieve the research objectives, the research mainly consisted of doctrinal research where a systematic process was followed to analyse and assess National Treasury's decision to implement the VCC regime as well as to add a sunset clause to the regime. Further research will be based on the identification of successes in the United Kingdom legislation relating to venture capital tax relief.

Before commencing with this study, a detailed literature review was performed in order to identify previous relevant research performed in this area and to gain a comprehensive

understanding of knowledge that has already been accumulated. Only literature that included research on the importance of SMMEs, the venture capital regimes in the United Kingdom and South Africa, and previous comparisons between the two systems, were considered for purposes of this study.

This study was completed through the use of a comparative analysis of the existing literature available on the VCC regime in South Africa, with the equivalent United Kingdom venture capital tax relief literature. The source of literature will be the relevant legislation governing these incentives in the above-mentioned countries, including information supplied by each country's relevant tax authority and previous research on the relevant venture capital investment tax regimes.

Available literature was analysed in detail in order to determine the similarities and differences between the South African and United Kingdom venture capital regimes in order to reach conclusions regarding possible shortcomings of the South African VCC tax incentive as well as to point out where the South African VCC regime might possibly not meet its objectives.

As can be seen above, factual knowledge through doctrinal research and a literature review was used to provide a background to the study. However, to reach a conclusion on the study, to add insights into an existing problem and to ultimately address the objectives, the factual knowledge gained in the research was interpreted, therefore incorporating human interest into the study (Dudovskiy, 2016). Therefore, the interpretivist approach will be the most suitable approach for the current research study.

1.6 Overview of the study

Chapter 1: Introduction

Chapter 1 sets out the background to the study. This chapter briefly describes venture capital and how a VCC operates and includes a summary of the underlying objectives of the VCC regime. It further motivates the relevance of the topic, formulates the problem statement, outlines the main objective and secondary objectives of the study, describes the research method, and finally stipulates the chapter division.

Chapter 2: Literature review regarding the importance of developing SMMEs in South Africa and the initial enactment of section 12J of the Act

As part of obtaining an understanding of the historical development of the VCC regime, Chapter 2 critically analyses previous research studies and literature to explore the current SMME market condition in South Africa. Financing as a constraint for the development of

SMMEs is discussed in the context of the reasoning behind the enactment of the VCC regime. To understand the reasoning of the enactment of the VCC regime, in addition, to examine any criticism against section 12J of the Act, this chapter also includes an overview of the initial section 12J of the Act as enacted in 2009. Chapter 2 addresses the secondary research objective as identified in paragraph 1.4.2(i) and partially addresses the secondary research objective as identified in paragraph 1.4.2(ii) of this study.

Chapter 3: Historical development of the South African VCC regime in terms of section 12J of the Act

Chapter 3 includes an overview of the historical development of section 12J of the Act. This chapter critically explores the current investment tax relief available to qualifying investors that invest in an approved VCC in terms of section 12J of the Act. It focuses on all the requirements to be met in order to qualify for the tax relief, including requirements and potential tax consequences after the initial deduction in terms of section 12J(2) of the Act. Chapter 3 addresses the secondary research objectives as identified in paragraphs 1.4.2(ii) and 1.4.2(iii) of this study.

Chapter 4: Literature review of the United Kingdom venture capital regimes

The venture capital tax relief available to investors in the United Kingdom in terms of sections 156 to 332 of the United Kingdom Income Tax Act (c.3 of 2007) (the UK Tax Act) are considered in Chapter 4. Similar to Chapter 3, this chapter will focus on all the requirements to be met in order to qualify for the tax relief, including requirements and potential tax consequences after the initial deduction in terms of the UK Tax Act. The evaluation of the venture tax relief offered to investors in the United Kingdom is used in Chapter 5 as the basis for the comparison of the South African tax relief provided as per section 12J of the Act and sections 156 to 332 of the UK Tax Act. The reason for using the United Kingdom as a comparative is also discussed. Chapter 4 partially addresses the secondary research objective as identified in paragraph 1.4.2(iv) of this study.

Chapter 5: Critical comparison of the South African and the United Kingdom Venture Capital tax regimes

Chapter 5 critically compares the venture capital tax relief measures available in South Africa with those available in the United Kingdom, in order to make recommendations for a possibly improved or revised section 12J of the Act, based on the shortcomings identified in the critical comparison. This chapter addresses the secondary research objective as identified in paragraph 1.4.2(iv) of this study.

Chapter 6: Summary and conclusion

Chapter 6 presents a summation of the research findings and conclusions on the research question and the main objective of the study. Several key aspects of section 12J of the Act are assessed against the research findings, while important findings to be considered by policymakers are highlighted. Possible areas for future research are also identified.

CHAPTER 2: LITERATURE REVIEW REGARDING THE IMPORTANCE OF DEVELOPING SMMEs IN SOUTH AFRICA AND THE INITIAL ENACTMENT OF SECTION 12J OF THE ACT

2.1 Introduction

To obtain an understanding of the historical development of the VCC regime, the SMME market condition in South Africa, along with financing as a constraint for the development of SMMEs, are discussed in the context of the reasoning behind the enactment of the VCC regime.

Furthermore, to understand the reasoning for the enactment of the VCC regime, in addition to determining any criticism against section 12J of the Act, this chapter includes an overview of the initial section 12J of the Act as enacted in 2009.

This chapter addresses the objectives of understanding the importance of SMMEs in the South African economy as well as understanding the reasoning for the enactment of the VCC regime as per secondary objectives in paragraphs 1.4.2(i) and 1.4.2(ii) of this study.

2.2 SMME market condition in South Africa and financing constraints of SMMEs

2.2.1 SMME market condition in South Africa including the economic importance of SMMEs

In 2008, Mr Trevor Manuel, a former South African Minister of Finance, introduced a tax incentive in his budget speech to encourage venture capital equity investments in SMMEs (Manuel, 2008). Section 12J of the Act refers to qualifying investee companies and has specific requirements for an SMME to be eligible as a qualifying investee company. These requirements will be discussed in further detail below. However, due to the fact that Mr Trevor Manuel referred to 'encouraging venture capital equity investments in SMMEs' upon introducing the VCC regime, it is important to understand the economic definition of an SMME.

Section 1 of the National Small Business Act (102 of 1996) (Small Business Act), defines an SMME as a separate and distinct business entity in any sector of the economy managed by one or more owners and which can be classified as a micro-, very small, small or medium enterprise. The Small Business Act further determines that classification as a micro-, very small, small or medium enterprise is determined by various factors such

as sector, total full-time employees, total annual turnover and total gross asset value (excluding fixed property) of the entity. Depending on the sector of the entity, to be classified as an SMME in terms of the Small Business Act, these entities can employ up to 200 full-time employees, have a turnover of up to R50 million, and have a total gross asset value of up to R18 million (the Schedule, Small Business Act).

To obtain an understanding of the objectives of the VCC regime, it is necessary to understand why the South African government encourages venture capital equity investments.

The South African government and many others around the world, share a view that the development of SMMEs and similar institutions hold the key to economic growth and development (Garwe & Olawale, 2010).

The importance of SMMEs in the drive to grow the South African economy is indicated by the statistics below:

- South Africa has an estimated 2.6 million of SMMEs;
- SMMEs contribute 36 percent to the South African GDP;
- SMMEs employ 40 percent of the South African labour force; and
- SMMEs contribute 48 percent to the total remuneration in South Africa (SEDA, 2019).

Even though SMMEs are considered as the drivers for diminishing unemployment, according to Marx, van Rooyen, Bosch and Reynders (1998:730) the SMME sector can play a significantly positive role in the economic growth of the country through management experience, innovation, interdependency, competition and the development of risk-takers.

Small business owners or managers operating SMMEs have the opportunity to gain managerial experience, which could enable them to manage larger entities or even more than one SMME at a later stage (Marx *et al.*, 1998:730). To maintain and enhance their competitive advantage, SMMEs need to be more innovative than larger enterprises. Small business owners can thus be seen as driving the process of innovation. Innovation provides a platform for new possibilities for the expansion of existing entities and the establishment of new entities (Booyens, 2011). Large entities rely on these innovative ideas from SMMEs. Instead of limiting innovation within the sources of one entity, large

entities would rather commercialise and market the ideas of SMMEs, by either partnering with them or buying out these SMMEs (Winston, 2013).

Large entities often rely on small businesses and vice versa. SMMEs often supply vital services to large entities and SMMEs are often relied upon to be the suppliers of specific components of a product that is produced by a large manufacturer. Furthermore, large entities are usually the suppliers for SMMEs who will initiate the final step of providing the products to customers (Winston, 2013). SMMEs seldom compete with large entities. SMMEs complement larger entities by finding a niche product to place themselves in the broader supply chain. SMMEs are susceptible to the threat of new entrants and, therefore, due to the increased competition in the SMME market, SMMEs are required to increase innovation, be more productive, and operate more efficiently to remain competitive (Cass, 2012).

2.2.2 Financing as a constraint for the development of SMMEs

The absence of adequate capital and credit is often seen as being a significant constraint for the development of SMMEs, especially in their initial growth stages. Most start-up SMMEs in developing countries depend entirely on personal funding from their owners or loans from friends and family (Cook and Nixon, 2000).

SMMEs often struggle to obtain debt financing for longer-term growth as they do not have sufficient collateral as security for the loans. These businesses could have excessive outstanding debt, which results in negative affordability assessments. Furthermore, the owners of SMMEs often lack proven business skills (Cook and Nixon, 2000).

According to Falkena, Abedian, von Blottnitz, Coovadia, Davel, Madungandaba, Masilela, Rees (2001:30) debt-financing more often than not does not satisfy the needs of SMMEs. Economists argue that equity financing rather than debt-financing has considerable advantages for SMMEs in their development stage. Some of the advantages of equity financing over debt financing are as follows:

- The distribution of dividends is a resultant feature of the SMME returning profits and, therefore, investors only receive dividends, if and when the SMME has retained sufficient earnings to do so.
- The board of the company can decide when it wants to distribute dividends, thus, ensuring sufficient cash flow during the start-up phase of these entities.

- The shareholders contribute to the business by providing financial, management and corporate governance support.
- Lastly, there is no obligation on the SMME to repay the long-term funding provided by equity shareholders.

According to the 2008 Budget Review, one of the main challenges to the growth of SMMEs and the SMME sector of South Africa, is access to equity finance. As discussed above, equity investments offer some critical advantages for SMMEs as it allows these entities to overcome economic downturns and re-invest cash in the business rather than using it to pay off their debt (National Treasury, 2008).

From the above, it can be concluded that SMMEs are of great importance to the economy of any country and that the government should step in to promote equity investment in SMMEs by considering tax incentives for equity investments in SMMEs.

2.3 Initial enactment of section 12J of the Act

Due to the acceptance of the importance of SMMEs to bring about economic growth, and that equity investments in SMMEs would possibly help achieve the required economic growth, the government of South Africa introduced a tax incentive in 2008 to encourage venture capital equity investments in SMMEs.

Section 12J was promulgated into the Act on the 8th of January 2009 in terms of section 27 of the Revenue Laws Amendment Act (60 of 2008). The general rule in tax is that the expenditure incurred for investments in shares is of capital in nature which means that such expenditure is not deductible by the taxpayer for income tax purposes (Deloitte, 2009). The objective of section 12J of the Act is to address this by determining that in certain circumstances equity investments will be a deductible expense for income tax purposes. The tax concession in terms of Section 12J of the Act resulted in VCC investments to be attractive for prospective investors.

The initial VCC regime promulgated into the Act in 2009 will be discussed below. In short, how a VCC operates is that a qualifying investor makes a tax-free investment in an approved VCC, and in return, the approved VCC invests in qualifying investee companies (refer to Figure 1 of this study).

2.3.1 Tax benefits for individual investors (natural persons)

Sections 12J(2) and 12J(3)(a) of the Act determined that a natural person will be allowed a 100 percent income tax deduction of the expenditure actually incurred by the natural person, for the investment in a VCC. However, the deduction was limited to R750 000 per year of assessment and was further limited to a lifetime deduction of R2.25 million. The deduction would, however, be recouped (included in taxable income) in terms of section 8(4)(a) of the Act if the natural person subsequently disposed of this investment. The recouped amount would have replenished the lifetime deduction limit.

2.3.2 Tax benefits for entity investors (listed companies and controlled group companies)

In order to prevent natural persons from breaching their deduction limits by making investments through controlled investee companies, no tax benefits were allowed for investments made by unlisted companies or trusts. However, sections 12J(2) and 12J(3)(b) of the Act allowed for a 100 percent deduction of the expenditure actually incurred by a listed company and a controlled group company (as defined in the Act) of that listed company, for the acquisition of VCC shares. Even though there was no monetary deduction limit for these entity investors, the deduction granted to the entity and its group was limited to the consideration paid for 10 percent of the equity shares in the VCC (Deloitte, 2009).

For both individual investors and entity investors, the deduction would further only be allowed if the investment is supported by a certificate issued by the VCC stating the amount of the investment and that the VCC invested in, is a SARS approved VCC (National Treasury, 2008).

An income tax deduction for the investment in the equity shares of a company seems to be an attractive incentive provided by National Treasury for both individual investors and listed entity investors. However, before getting entangled in the hype of a tax-free investment, investors need to understand the intricacies or limitations of such investments. The requirements to be met to be approved as a VCC along with the qualifying investee company requirements are therefore discussed below.

2.3.3 Requirements to be met in order to be approved as a VCC

Section 12J(5)(a) of the Act determined that in order to be approved as a VCC by SARS, the following overall preliminary requirements for entry as a VCC had to be met:

- the company had to be a resident company as defined in the Act;
- the company must not have been a controlled group company in relation to a group of companies as contemplated in paragraph (d)(i) of the definition of a connected person included in section 1 the Act;
- all tax affairs of the company had to be in order;
- the company must have been an unlisted company as defined in the Act; and
- the company must have been licensed in terms of section 8 of the Financial Advisory and Intermediary Services Act (FAIS).

Over and above the preliminary requirements for approval as a VCC, the following gross income, no control, and investment portfolio requirements had to be met:

- The gross income requirement in terms of section 12J(5)(b) of the Act determined that within 36 months from the application for approval as a VCC, a minimum of 90 percent of the gross income of the VCC must have been from a financial instrument source or from services rendered to a qualifying investee company.
- The no control requirement in terms of section 12J(5)(c) of the Act determined that the company applying to be a VCC together with connected persons as defined in the Act, is not allowed to hold 50 percent or more shares or voting rights in the qualifying investee company, or 20 percent if no other person holds the majority voting rights in the qualifying investee company (i.e. the VCC was not allowed to be a connected person to the qualifying investee company).
- In terms of section 12J(5)(e) of the Act the VCC's investment portfolio must have, within a period of 36 months from the application for approval for VCC status, complied with the following requirements (Deloitte, 2009):
 - there must have been a minimum of R30 million expenditure incurred by the VCC for the acquisition of qualifying shares in qualifying investee companies as defined in section 12J of the Act;

- there must have been a minimum of 10 percent expenditure incurred by the VCC for the acquisition of qualifying shares in qualifying investee companies that held assets with a book value of R5 million or less, immediately after the VCC investment;
- there must have been a minimum of 80 percent expenditure incurred by the VCC for the acquisition of qualifying shares in qualifying investee companies that held assets with a book value of R10 million or less, immediately after the VCC investment; and
- a maximum of 15 percent was allowed to be invested in any one qualifying investee company.

From the above requirements, it can be seen that it was National Treasury's objective to ensure that the VCC operates as an investment housing entity which facilitates the investments made in qualifying investee companies. It is also clear that it was not the objective of National Treasury to allow a VCC to act as a pure conduit entity wherein a qualifying investor invests in only one company through a VCC, and obtain a tax benefit for such investment.

2.3.4 Withdrawal of approval

If the VCC does not continue to meet the requirements to be met in order to be approved as a VCC, then SARS will give notice to the VCC to take corrective steps within a period as specified in the notice. If the VCC does not take these corrective steps within the specified period, then SARS can withdraw the status of the VCC from the commencement of that year. The former VCC will then have to include 125 percent of all the funds received from the investors in its taxable income (National Treasury, 2008).

The provision above further strengthens National Treasury's view that the objective of the VCC must not be to provide any one investor with the opportunity to unduly obtain a tax benefit from his/her/its capital investments.

2.3.5 Investee company qualification requirements (impermissible trade and qualifying company definitions)

For a company to be a valid qualifying investee company, it had to satisfy the overall preliminary requirements in terms of the qualifying company definition in section 12J of the Act. These overall preliminary requirements were as follows:

- the company had to be a resident company as defined in the Act;
- the company must not have been a controlled group company in relation to a group of companies as contemplated in paragraph (d)(i) of the definition of 'connected person' included in section 1 the Act;
- all tax affairs of the company had to be in order; and
- the company must have been an unlisted company as defined in the Act.

These overall preliminary requirements were similar to the preliminary requirements for entry as a VCC as described above.

Over and above the preliminary requirements for approval as a qualifying investee company, the company had to comply with the general trade rules as well as not carry on any impermissible trades. The general trade rules for a company to be a valid qualifying investee company in terms of the qualifying investee company definition as included in section 12J of the Act are considered below.

- The qualifying investee company must have carried on a trade or would have carried on a trade within 18 months after the investment from the VCC was made. Within these 18 months, all the investment funds received from the VCC must have been invested in deductible expenditure incurred for purposes of any trade carried on by the qualifying investee company.
- The amount of investment income included in the gross income of the qualifying investee company was limited to 20 percent of the gross income of that company.
- The company would further not have been considered as a qualifying investee company if it conducted any of the impermissible trades, as defined in section 12J of the Act, which includes:
 - any trade in respect of immovable property, except for trade as a hotel or bed and breakfast;

- any financial service provider activities specifically, banking, insurance, finance provider or hire-purchase financing;
- being a provider of financial or advisory services, specifically including legal, tax advisory, stockbroking, management consulting, auditing or accounting services;
- any trade carried on in respect of gambling;
- manufacturing, buying or selling liquor, tobacco, arms or ammunition;
- trading as a franchisee; or
- any trade conducted mainly outside of the Republic.

From the above, it can be seen that it was National Treasury's objective to ensure that SMMEs use funds received from investors for activities that will enhance the economy of South Africa and to exclude entities which are generally asset-backed and entities that are retailers/producers of sin-taxed products.

2.3.6 Disposal of VCC shares

Section 8(4)(a) of the Act determined that the full amount deducted in terms of section 12J(2) of the Act would have been recouped (included in taxable income) upon disposal of the VCC shares by the individual or entity investor. The investor would further have been taxed, at a maximum rate of 18 percent (being the 40 percent inclusion rate as per paragraph 10(1)(a) of the Eighth Schedule to the Act multiplied by the highest marginal income tax rate for individuals of 45 percent) if the investor is an individual or 22.4 percent (being the 80 percent inclusion rate as per paragraph 10(1)(c) of the Eighth Schedule to the Act multiplied by the South African company's tax rate of 28 percent), if the investor is a company, on the capital gain on the investment (the difference between proceeds received, reduced by the recouped amount, and cost of the initial investment). However, there would have only been a capital gain when the proceeds received upon sale exceeded the initial investment cost.

2.3.7 Sunset clause

No deduction shall be allowed in terms of the VCC incentive in respect of shares acquired after the 30th of June 2021. The reason for the inclusion of the sunset clause is to provide an opportunity for the evaluation of the effectiveness of the VCC regime (Deloitte, 2009).

2.3.8 General commentary regarding the VCC regime as enacted in 2009

Prior to various amendments to section 12J of the Act, it was acknowledged by National Treasury that the VCC regime did not prevail in its objectives of encouraging equity funders to invest in SMMEs and to ultimately succeed in its objectives as set out in paragraph 1.1. of this study. By the end of 2011, before significant amendments to section 12J of the Act, there were less than five VCCs registered with SARS, which indicated that the financial benefits were too small and the qualifying requirements unnecessarily prohibitive and complex (PWC, 2012).

As per the public hearings in 2008 regarding the Revenue Laws Amendment Bill (published for public comment before the Revenue Laws Amendment Act), the following commentary has been received from PWC, Finmark Trust and SAVCA (Portfolio Committee on Finance, 2008):

- The fact that the deduction for investment in a VCC is limited to only natural persons and listed entity investors is limiting the potential capital providers of the VCC and, therefore, limiting the objectives of the VCC regime.
- It was noted that the investment portfolio requirements to be met in order to be approved as a VCC, might be unnecessarily confining. The fact that the VCC is required to ensure that at least 80 percent of investments are made in qualifying investee companies that hold assets with a book value of not more than R10 million, is considered as too narrow as these high growth potential start-up entities generally require more than R10 million to be invested, due to the capital intensive nature of these entities.
- The 18-month grace period for the general trade requirement of a qualifying investee company, requiring that the investee company must have carried on a trade or would have carried on a trade within 18 months after the investment from the VCC was made, was considered too short. It was noted that the underlying business of these SMMEs is capital intensive and reliant on infrastructure.

Consequently, the SMME will only generate revenue and commence its trade upon completion of the infrastructure.

- Concern was raised over the fact that qualifying investee companies are not allowed to be controlled group companies. This requirement was considered to be counter-intuitive to the objectives of the VCC regime due to the fact that the reality of start-up businesses is that their valuations are low and, initially, these businesses will need support from an established entity to get their business up and running.
- A request has also been made that the deduction which is allowed in terms of the VCC regime, must not be recouped upon the sale of the VCC shares. It has been suggested that the recoupment requirement should be removed, which will result in the full proceeds received upon sale minus the base cost of the shares (which will, in terms of paragraph 20(3)(a)(i) of the Eighth Schedule to the Act, be reduced by the initial investment tax deduction obtained) to only be subject to capital gains tax (CGT) at a maximum rate of 18 percent if the investor is an individual or 22.4 percent if the investor is a company.

2.4 Conclusion

The aim of this chapter was to obtain an understanding of the current SMME market condition in South Africa and to give an overview of section 12J of the Act, as it was initially enacted in 2009.

The purpose of obtaining an understanding of the current SMME market condition in South Africa was to fulfil the first secondary objective listed in paragraph 1.4.2(i) of this study, namely, to critically analyse previous research studies and the literature relating to the importance of SMMEs in the South African economy.

The key takeaway from this secondary objective is that SMMEs are of great importance to the economy of any country and therefore the government should encourage the establishment and growth of SMMEs as a tool to address unemployment and inequality. Consequently, in an attempt to encourage equity funders to invest in SMMEs, the government of South Africa enacted the VCC regime.

As stated in Chapter 1, the second secondary objective of this study, as listed in paragraph 1.4.2(ii) of this study, is to explore the historical development of the South African VCC regime to understand the reasoning for the enactment of the regime and to determine the underlying objectives of the regime. The purpose of giving an overview of

section 12J of the Act, as it was initially enacted in 2009, is to obtain a benchmark for comparison of section 12J of the Act, as it was initially enacted, to the current requirements of section 12J of the Act after numerous policy amendments.

In light of the general commentary regarding the VCC regime as enacted in 2009, it was accepted by National Treasury that the requirements of the VCC regime needed to be amended in order to align the regime with its objectives. It has been established that the benefit of investment is too small and that the criteria for approval as a VCC and as a qualifying investee company are too limited (National Treasury, 2011).

This chapter has, therefore, met the first secondary objective of this study and partially met the second secondary objective of this study. To give a complete overview of the historical development of the South African VCC regime, and therefore to meet the second and third secondary objectives of this study, Chapter 3 includes an overview of the policy amendments, the reasons for the policy amendments, the current requirements of the VCC regime as well as a comparison of section 12J of the Act, as it was initially enacted, to the current requirements in section 12J of the Act.

CHAPTER 3: HISTORICAL DEVELOPMENT OF THE SOUTH AFRICAN VCC REGIME IN TERMS OF SECTION 12J OF THE ACT

3.1 Introduction

The purpose of this study is to focus on the South African VCC regime, therefore, it is necessary to understand the provisions of section 12J of the Act. This chapter aims to explore the historical development of the South African VCC regime from the initial enactment of section 12J of the Act up to the latest relevant Taxation Laws Amendment Act (TLAA).

This chapter critically analyses the investment tax relief available to qualifying investors that invest in an approved VCC in terms of section 12J of the Act. It focuses on all the requirements to be met by the investor, the VCC and the qualifying investee company in order for the investor to qualify for the tax relief. This review of the VCC regime includes requirements to be met and the potential tax consequences after the initial deduction in terms of section 12J(2) of the Act. This chapter addresses the secondary research objectives as identified in paragraphs 1.4.2(ii) and 1.4.2(iii) of this study.

Since the enactment of section 12J of the Act, there have been numerous subsequent amendment acts amending this section of the Act. This chapter includes an overview of these amendments, reasons for the amendments, the current requirements of the VCC regime, and a comparison of section 12J of the Act, as it was initially enacted, to the current requirements in section 12J of the Act. This chapter includes a comprehensive overview of the historical amendments of section 12J of the Act, which were enacted by National Treasury in an attempt to align the VCC regime to its objectives.

3.2 Tax benefits for individual investors and entity investors

Section 12J(2) and 12J(3) of the Act has been significantly amended since its enactment in 2009. Section 12J(2) of the Act still allows for the deduction of expenditure actually incurred for the acquisition of VCC shares. However, to align the VCC regime with its objectives, section 12J(2) of the Act was further updated to allow the deduction for expenditure actually incurred by **any** taxpayer (including foreign investors) to acquire venture capital shares in the VCC. Previously, section 12J of the Act only allowed deductions for the expenditure actually incurred for the acquisition of VCC shares by natural persons, listed companies and controlled group companies in relation to the listed company (PWC, 2012). This amendment was, therefore, a positive change to section 12J of the Act, which allowed for unlisted entities and trusts to also become potential capital

providers of VCCs, whilst benefitting from the relief provided in terms of section 12J of the Act.

For entity investors, no tax benefit was previously allowed for investments made by unlisted companies or trusts and the deduction granted to the listed entity and its group was limited to the value of 10 percent of the equity shares in the VCC (National Treasury, 2008). The potential capital providers of the VCC was limited due to the fact that the deduction for an investment in a VCC was limited to only natural persons and listed entity investors (Portfolio Committee on Finance, 2008).

Subsequent to the initial enactment of section 12J(3) of the Act, the TLAA (17 of 2009) amended this section of the Act to allow entity investors a deduction of the value of up to 40 percent of the equity shares in the VCC, in contrast with only 10 percent previously. The reason for the increase in the investment percentage limitation was to allow certain companies to be anchor investors. The objective of anchor investors is to provide some comfort to smaller investors that a larger company gives financial, material, or moral support to the SMME which would ultimately encourage smaller investments for the VCC (National Treasury, 2009).

However, in terms of section 38(1)(j) of the TLAA (24 of 2011), the entire section 12J(3) of the Act has been substituted to remove the monetary limitation for individual investors, as well as the percentage limitation for entity investors. Subsequent to this amendment, a VCC investor could get a 100 percent deduction for the investment, subject to certain anti-avoidance provisions as discussed below (PWC, 2012).

- The first anti-avoidance provision is to limit the deduction to the amount for which the taxpayer is deemed to be at risk for on the last day of the year of assessment in which the investment was made. The taxpayer will be deemed to be at risk to the extent that the taxpayer will undergo economic loss for the expenditure incurred, or for the cost of the repayment of a loan or credit (PWC, 2012).

Therefore, if the taxpayer uses its own funds and incurs expenditure to invest, it will be at risk. If the investment is made through a loan or credit facility, then the taxpayer must carry on the risk of, and take full responsibility for, this loan or credit facility to qualify for the deduction.

The taxpayer is not deemed to be at risk to the extent that the loan or credit facility has been granted directly or indirectly to the taxpayer by the VCC in which the taxpayer invested in. The taxpayer is also not deemed to be at risk if the loan or

credit facility is only repayable after a period of five years since its advancement date (National Treasury, 2011).

This anti-avoidance provision ensures that the taxpayer obtains a tax relief to the extent that it actually took on the risk of investing in these high-risk SMMs, which are generally not attractive investments.

- The second anti-avoidance provision determines that the deduction will no longer be available to the taxpayer if the investor becomes a connected person to the VCC, after the expiry of 36 months since the investment in the VCC. If this anti-avoidance provision is triggered and the VCC does not take corrective steps acceptable to the Commissioner, the VCC status, as described below, will be withdrawn with effect from the date of approval. The VCC will also have to include 125 percent of the deduction granted to investors in the taxable income of the VCC (National Treasury, 2016).

In terms of section 1 of the Act, a natural person will be a connected person in relation to the VCC if that person (together with a connected person in relation to that person) holds 20 percent or more equity shares (venture capital shares) or voting rights in the VCC. In terms of section 1 of the Act, a company will be a connected person in relation to the VCC if the company (together with a connected person in relation to that company) holds 50 percent or more equity shares (venture capital shares) or voting rights in the VCC, or 20 percent if no other person owns the majority equity shares or voting rights in the VCC.

An equity share is defined in section 1 of the Act to mean any share that participates on an uncapped basis in either the profits or capital of a company.

This anti-avoidance provision encourages investors to diversify their investment portfolio and, therefore, not to use the VCC as the investors own investment holding entity to ultimately obtain a tax benefit from investing in his/her/its own entity (SAIT, 2017).

- As per section 29(j) of the TLAA (23 of 2018), a third anti-avoidance provision was added to section 12J of the Act which determines that an investor is not allowed to hold more than 20 percent of any class of VCC shares, after the expiry of 36 months since the investment in the VCC.

Due to the connected person rule as detailed above, this anti-avoidance provision will only be applicable to entity investors. Therefore, if the entity investor holds one or more different classes of venture capital shares and holds more than 20 percent in one of these classes of venture capital shares in the VCC, then the relief in terms of section 12J of the Act will no longer be available to the investor.

The VCC status as described below will be withdrawn if corrective steps acceptable to the Commissioner are not taken by the VCC. The VCC will also have to include 125 percent of the deduction granted to investors in the taxable income of the VCC (SARS, 2018a).

- The fourth anti-avoidance provision is that the deduction will not be allowed for any investments with debt-like features. Section 38(1)(j) of the TLAA (24 of 2011) inserted the definition of venture capital share into section 12J of the Act, which states that a venture capital share is any equity share held by a taxpayer in a VCC and specifically excludes shares with debt-like features.

In terms of section 8E of the Act and section 12J of the Act, an equity share, as defined, that have debt-like features such as the issuer (the VCC) being obliged to redeem the share, the investor having the option to require the issuer (the VCC) to redeem the share or the existence of the issuer (the VCC) are likely to be terminated, are not venture capital shares as defined in section 12J of the Act.

This anti-avoidance provision also ensures that the taxpayer only obtains a tax relief to the extent that it took on the risk of investing in these high-risk SMMEs, which are generally not attractive investments to investors. There would be no risk element for the investor, if the investor is guaranteed a return of capital on its investment.

- As per section 29(i) of the TLAA (23 of 2018), the final anti-avoidance provision was added to the Act to determine that there will be no deduction allowed for shares issued to the investor in respect of services rendered to the VCC or the qualifying investee company. Such shares are, therefore, not venture capital shares as defined in section 12J of the Act.

The amendments as per the TLAA (24 of 2011) addressed the concern regarding the fact that the deduction for an investment in a VCC is limited to only natural persons and listed entities and, therefore, the amendment resulted that the capital providers of the VCC regime are no longer limited. The removal of the monetary limitations for individual investors and the removal of percentage limitations for entity investors also broadened the

scope of the VCC regime to attract more investors to the regime, therefore, aligning the regime to its objectives.

Even though the amendments as per the TLAA (24 of 2011) contained certain anti-avoidance provisions, it later came to National Treasury's attention that certain tax abusive structures have been created using the VCC regime, which was not in line with the objectives of the regime (Standing Committee on Finance, 2019a). In the 2018 budget review, it was noted that the requirements of the VCC regime would be amended to reduce the scope for tax structuring. Of particular concern to National Treasury was that investors in VCCs used different classes of shares to circumvent the connected person anti-avoidance provision of the VCC regime. Furthermore, in some instances, investors in VCCs carried on a trade with the qualifying investee companies in which the relevant VCC invested (Parker, Botha & Wischnewski, 2019).

SARS noted that through different classes of shares, investors, who control an underlying qualifying investee company, could invest capital in the underlying qualifying investee company and still enjoy the tax benefit of the VCC regime (Timm, 2018). The June 2018 Draft Taxation Laws Amendment Bill (TLAB) contained proposals that the VCC, as well as the qualifying investee company, will only be allowed to issue one class of shares (National Treasury, 2018). These proposals were excessively punitive and would have resulted in a threat to the existence of most VCCs (Ensor, 2018). The comments against this proposal will be discussed in more detail under paragraph 3.4.1 of this chapter. National Treasury acknowledged the fact that the proposed changes would not have been in line with the objectives of the VCC regime and, therefore, added more stringent investor anti-avoidance provisions to section 12J of the Act (Standing Committee on Finance, 2019a).

Over and above the provision that an investor is not allowed to be a connected person in relation to the VCC, the investor is now further not allowed to own more than 20 percent of any class of shares in that VCC, to ensure a spread of shareholders in each class of shares (Parker *et al.*, 2019).

The anti-avoidance rule which determines that there will be no deduction allowed for shares issued to the investor in respect of services rendered to the VCC or the investee company, was explicitly added to section 12J of the Act to enable VCC management to acquire shares in the VCC for carried interest purposes as, described in paragraph 3.4.1 of this chapter. These shares will not be venture capital shares as defined and would

therefore not be considered when the connected person test is applied (Parker *et al.*, 2019).

As per the latest explanatory memorandum for the July 2019 draft TLAB, National Treasury has continued to express concerns that some taxpayers are still attempting to undermine the objectives of the VCC regime. National Treasury has also indicated that in order to balance the benefit of the VCC regime with its cost to the fiscus, it was proposed that the tax deduction in respect of an investment in VCC shares should be limited to R2.5 million per annum per VCC shareholder. It was further proposed that the deduction be limited to the year of assessment in which the VCC shares were issued to the taxpayer, therefore, the investor would not be able to carry over the deduction not yet claimed, to a subsequent year of assessment (National Treasury, 2019a).

National Treasury is of the view that this amendment will not significantly impact the objectives of the VCC regime. National Treasury's view was based on its administrative data on tax expenditure, which indicated that the average expenditure per annum incurred by a new VCC shareholder to obtain VCC shares ranged between R1.3 million and R2.1 million over the past four years (National Treasury, 2019a).

Even though National Treasury argued that the average expenditure per annum is less than R2.5 million, the VCC industry argued that by implementing the R2.5 million limit the South African government will be limiting the capital investment opportunity of the VCC regime (Faulds, 2019). Furthermore, the proposed limitations applied equally to companies which generally have more capital to invest (Faulds, 2019).

Further arguments raised by the VCC industry, against the R2.5 million investment limit, was that the proposed investment limit would require VCCs to expand on its number of investors which could limit the sustainability of these VCCs and that the proposed limit could result in corporate investors to lose interest in the VCC regime as the investment benefit thereof will be inexpedient (Standing Committee on Finance, 2019b).

National Treasury noted these concerns and as per section 17 of the TLAA (34 of 2019), the R2.5 million investment limit was increased to R5 million for corporate investors.

Refer to Table 1 below for a summary of the differences in the tax benefits for individual investors and entity investors between the initial enactment and the current section 12J of the Act.

Table 1: Differences in the tax benefits for individual investors and entity investors between the initial enactment and the current section 12J of the Act.

Section 27 of the Revenue Laws Amendment Act (60 of 2008)	Section 12J of the Act (amendments up to section 17 of the TLAA (34 of 2019))	Relevant TLAA / TLAB
<i>Initial enactment</i>	<i>Current Act</i>	
Tax benefits for individual investors and entity investors		
Natural person, 100 percent deduction for expenditure incurred on an investment in a VCC, limited to R750 000 in a year of assessment and a lifetime deduction limitation of R2.25 million.	Natural person, 100 percent deduction for expenditure incurred (deemed to be at risk for) on an investment in a VCC, limited to R2.5 million per annum, provided that the investment is a pure equity investment, no more than 20 percent venture capital shares are held in one VCC (not connected person) and no more than 20 percent of any class of venture capital shares are held in the VCC.	Section 38(1)(i) (24 of 2011); section 38(1)(j) (24 of 2011); section 38(1)(k) (24 of 2011); section 29 (23 of 2018); and section 17 (34 of 2019).
No tax benefit for unlisted companies or trusts.	Deduction available to any taxpayer, therefore, refer to the 'listed company' summary below.	Section 38(1)(i) (24 of 2011)
Listed company, 100 percent deduction for expenditure incurred on and investment in VCC, limited to 10 percent of the equity shares in the VCC.	Any company, 100 percent deduction for expenditure incurred (deemed to be at risk for) on an investment in a VCC, limited to R5 million per annum, provided that the investment is a pure equity investment, no more than 50 percent (or 20 percent in certain instances) venture capital shares are held in one VCC (not connected person) and no more than 20 percent of any one class of venture capital shares are held in the VCC.	Section 38(1)(i) (24 of 2011); section 38(1)(j) (24 of 2011); section 38(1)(k) (24 of 2011); section 29 (23 of 2018); and section 17 (34 of 2019).

No deferral of the connected person test and no consequences for the VCC, if the investor is a connected person to the VCC, therefore, only penalising the investor.	Defer the connected person test to 36 months after the first date of the issue of the venture capital share, if the investor is a connected person to the VCC after such period, withdrawal of approval as a VCC with effect from the date of approval and additional penalties for the VCC. 125 percent inclusion of the deduction granted to investors in the taxable income of the VCC.	Section 38(1)(i) (24 of 2011); section 38(1)(j) (24 of 2011); section 38(1)(k) (24 of 2011); and section 32 (15 of 2016).
<i>Provision not included in the initial enactment.</i>	No deduction allowed for shares issued to the investor in respect of services rendered to the VCC.	Section 29(i) (23 of 2018)
The investment must be supported by an investment certificate.	The investment must be supported by an investment certificate.	<i>No amendment</i>

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

From the amendments above, it can be seen that National Treasury clearly wanted to align the VCC regime with its objectives. These amendments, such as removing the cap on the investment amount that could be deducted and allowing unlisted entities to participate in the VCC regime, were positive policy amendments for the VCC industry. The VCC regime did not have much effect until such amendments were made (Zuccollo, 2019). The anti-avoidance provisions also aligned the VCC regime to its objectives in order to ensure that the regime is not abused by investors and that investments are directed towards its intended purpose.

However, reintroducing an investment cap might result in a reduction in the VCC industry size, as high net worth individuals might now be discouraged to keep their investments in South Africa (Zuccollo, 2019).

3.3 Requirements to be met in order to be approved as a VCC

The VCC regime was founded upon a private equity model, and it has been established that the limiting criteria for approval as a VCC means that VCCs cannot operate in accordance with this model. The limiting criteria have also resulted in the VCC regime to be overly complicated and, therefore, resulted in the business activity of the VCC to no longer be sustainable (National Treasury, 2011).

Section 12J(5) of the Act sets out the requirements to be met by a company to obtain approval from the Commissioner to operate as a VCC. Since the enactment of section 12J of the Act, the requirements to obtain approval to operate as a VCC have been

significantly reduced (National Treasury, 2011). The current requirements of section 12J(5) of the Act are considered below.

3.3.1 Overall preliminary requirements

Currently, the overall preliminary requirements for entry as a VCC are that the company must:

- be a resident company as defined in the Act;
- all tax affairs of the company must be in order; and
- the company must be licensed in terms of section 8 of FAIS.

One new requirement has been added to the overall preliminary requirements of section 12J(5) of the Act. It determines that the main objective of the company must be to invest and manage investments in qualifying investee companies. This rule has been added to ensure that, given the fact that certain other requirements have been removed from section 12J of the Act, the investment is not misdirected to investments that provide little or no assistance to the intended target group (National Treasury, 2009).

In order to simplify the VCC regime, the following two overall preliminary requirements were removed from section 12J of the Act (National Treasury, 2011).

- Firstly, approval for VCC status is now given even if the entity is listed on a stock exchange. The initial objective of the VCC regime was to pool investments, and the fact that the VCC is listed does not prohibit it from combining investments.
- Secondly, the non-controlled group company requirement has been removed which means that a VCC can now be a controlled group company (more than 50 percent, or 20 percent, depending on the circumstances, controlled by another company). However, there are still some deduction limitations for investors.

The June 2018 TLAB contained proposals that the VCC will only be allowed to issue one class of share. Commentary against the proposal determined that specific important and globally accepted reasons exist, to conclude that, within the venture capital industry more than one class of share is required. The general partners of venture capital firms, as well as private equity firms, seek compensation for managing the performance of an investment (National Treasury, 2018).

Over and above management fees which covers the general day to day management cost of a VCC, the VCCs charge carried interest on investments in the qualifying investee companies. Carried interest is the primary source of income for VCCs and serves as their motivation to manage, develop and improve performance and efficiencies of the qualifying investee companies. If the VCC invests time in the qualifying investee companies, it will bring these qualifying investee companies into a profit-making position and maximise the value of the qualifying investee company (Chen, 2019).

Practically, how it works is that the VCC will issue two or more classes of shares. One class will be issued to the investors who contribute capital, and another class will be issued to the VCC management. The investors will receive dividends as and when the qualifying investee company returned profits. If, and only if, the qualifying investee company returns more profits than a pre-determined rate of dividends to be paid out to investors, will carried interest dividends be distributed to the VCC management (Chen, 2019).

Therefore, it was concluded that VCCs do in fact need more than one class of share to be issued, as different stakeholders, as well as the VCC management, require different rates of return (Standing Committee on Finance, 2019a).

3.3.2 No control requirement

The no control requirement in terms of section 12J(5)(c) of the Act, which determined that the VCC is not allowed to be a connected person to the qualifying investee company, has subsequently been removed from section 12J of the Act. This means that a VCC can now be a controlling group company (National Treasury, 2011). However, there are still some limitations regarding the percentage of investment in one qualifying investee company as detailed in 3.4.1 below.

3.3.3 Gross income requirement

The gross income requirement which initially determined that within 36 months from the application for approval as a VCC, a minimum of 90 percent of the gross income of the VCC must be from a financial instrument source or from services rendered to a qualifying investee company, has been amended twice in order to simplify the VCC regime.

Initially, the minimum requirement was reduced to 80 percent and the 36 month window period was removed (National Treasury, 2009).

In terms of section 38(1)(m) of the TLAA (24 of 2011), the 80 percent requirement has been completely removed, to ensure that temporary receipts of cash by the VCC does not cause the VCC regime to not reach its objectives (National Treasury, 2011).

Therefore, the VCC regime no longer includes a percentage based gross income requirement. The gross income requirement has been replaced with the requirement that, the main objective of the VCC must be to invest and manage investments in qualifying investee companies.

3.3.4 Investment portfolio requirement

Section 12J(6A) of the Act has subsequently been added to the Act, which determines that the VCC's investment portfolio must comply with the following requirements within a period of 48 months from the application for approval:

- there must be a minimum 80 percent expenditure incurred by the VCC for the acquisition of qualifying shares in qualifying investee companies that holds assets with a book value of no more than R50 million, immediately after the VCC investment; and
- a maximum of 20 percent may be invested in any one qualifying investee company.

Therefore, the requirement that there must be a minimum of R30 million expenditure incurred by the VCC for the acquisition of qualifying shares in qualifying investee companies, and that there must be a minimum 10 percent expenditure incurred by the VCC for the acquisition of qualifying shares in qualifying investee companies that holds assets with a book value of no more than R5 million immediately after the VCC investment, has been removed. Furthermore, the requirement that a maximum of 15 percent may be invested in any one qualifying investee company, has been changed slightly to increase the percentage limitation to 20 percent (National Treasury, 2011).

As per section 17 of the TLAA (34 of 2019) the 36 month period for investment has increased to 48 months.

Refer to Table 2 below for a summary of the differences in the requirements to be met in order to be approved as a VCC between the initial enactment and the current section 12J of the Act.

Table 2: Differences in the requirements to be met in order to be approved as a VCC between the initial enactment and the current section 12J of the Act.

Section 27 of the Revenue Laws Amendment Act (60 of 2008)	Section 12J of the Act (amendments up to section 17 of the TLAA (34 of 2019))	Relevant TLAA / TLAB
Initial enactment	Current Act	
Requirements to be met in order to be approved as a VCC		
Overall preliminary requirements		
Resident company	Resident company	<i>No amendment</i>
<i>Provision not included in the initial enactment.</i>	The main objective of the company must be to invest and manage investments in qualifying investee companies.	Section 25(1)(e) (17 of 2009)
Not be a controlled group company.	<i>Provision subsequently deleted from the Act.</i>	Section 38(1)(l) (24 of 2011)
All tax affairs of the company must be in order.	All tax affairs of the company must be in order.	<i>No amendment</i>
Unlisted company	<i>Provision subsequently deleted from the Act.</i>	Section 38(1)(l) (24 of 2011)
Licensed in terms of section 8 of FAIS.	Licensed in terms of section 8 of FAIS.	No amendment
No control requirement		
Not be a controlling group company (no control over qualifying investee company).	<i>Provision subsequently deleted from the Act.</i>	Section 38(1)(l) (24 of 2011)
Gross income requirement		
Within 36 months from the application to be approved as a VCC, a minimum of 90 percent of the gross income of the company must be from a financial instrument source or from services rendered to a qualifying investee company.	<i>Provision subsequently deleted from the Act.</i>	Section 25(1)(e) (17 of 2009); and section 38(1)(l) (24 of 2011)
Investment portfolio requirement		
Within 36 months from the application to be approved as a VCC, a minimum of R30 million must be invested for purposes of the acquisition of qualifying shares in qualifying investee companies.	<i>Provision subsequently deleted from the Act.</i>	Section 25(1)(e) (17 of 2009); and section 38(1)(l) (24 of 2011).
Within 36 months from the application to be approved as a VCC, a minimum of 10 percent	<i>Provision subsequently deleted from the Act.</i>	Section 25(1)(e) (17 of 2009); and section 38(1)(l)

must be invested for purposes of the acquisition of qualifying shares in qualifying investee companies that holds assets with a book value of no more than R5 million immediately after VCC investment.		(24 of 2011).
Within 36 months from the application to be approved as a VCC, a minimum of 80 percent must be invested for purposes of the acquisition of qualifying shares in qualifying investee companies that holds assets with a book value of no more than R10 million immediately after VCC investment.	Within 48 months from the application to be approved as a VCC, a minimum of 80 percent must be invested for purposes of the acquisition of qualifying shares in qualifying investee companies that holds assets with a book value of no more than R50 million immediately after VCC investment.	Section 25(1)(e) (17 of 2009); section 38(1)(l) (24 of 2011); section 29 (23 of 2018); and section 17 (34 of 2019).
A maximum of 15 percent may be invested/held in any one qualifying investee company.	A maximum of 20 percent may be invested/held in any one qualifying investee company.	Section 25(1)(e) (17 of 2009); and section 38(1)(l) (24 of 2011).
Withdrawal of approval		
If after approval the VCC does not meet the above requirements: SARS can withdraw the VCC approval from the commencement of that year and tax the VCC on 125 percent of all funds received from investors in terms of section 12J of the Act.	If after approval the VCC does not meet the above requirements: SARS can withdraw VCC approval from the commencement of that year and tax the VCC on 125 percent of all funds received from investors in terms of section 12J of the Act.	<i>No amendment</i>

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

The removal of the gross income requirement and the alleviation of the investment portfolio requirement was positive policy amendments for the VCC industry, as these requirements were deemed to be unnecessarily confining. Furthermore, allowing VCCs to be listed companies was a further positive policy amendment as VCCs are provided with easier access to capital funding.

3.4 Investee company qualification requirements (impermissible trade and qualifying company definitions)

Currently, the qualifying company definition in section 12J of the Act still determines that over and above the overall preliminary requirements for approval as a qualifying investee company, the investee company has to comply with the general trade rules as well as not carry on any impermissible trades. However, since the enactment of section 12J of the Act, the overall preliminary requirements, general trade rules and definition of impermissible trade have been amended to address various administrative and technical

concerns in terms of the investee company qualifying requirements. Investors were of the opinion that these administrative and technical concerns might have resulted in difficulty for the VCC to invest in qualifying investee companies (Cliffe Dekker Hofmeyr, 2018). Some of these concerns are discussed in more detail below.

The definitions of the qualifying investee company and impermissible trade set out the requirements to be met for an investee company to qualify as a qualifying investee company.

3.4.1 Overall preliminary requirements

The overall preliminary requirements in terms of the qualifying investee company definition, as contained in section 12J of the Act, currently requires that, the company must:

- be a resident company as defined in the Act;
- not be a controlled group company in relation to a group of companies as defined in the Act;
- have all its tax affairs in order; and
- be an unlisted company as defined in the Act.

These requirements are similar to the overall preliminary requirements for entry as a VCC as described above.

The overall preliminary requirement, which states that the investee company must not be a controlled group company in relation to a group of companies as defined in the Act, has been amended to clarify that the controlled company test only applies within the VCC-framework and, therefore, does not apply to investors investing in the company outside of the VCC regime (Cliffe Dekker Hofmeyr, 2018).

In an attempt to close various abusive schemes involving the VCC regime, an additional overall preliminary requirement (anti-avoidance rule) has been added to the qualifying investee company definition. Paragraph (g) of the definition of qualifying investee company in terms of section 12J of the Act, determines that VCC shareholders (together with connected persons in relation to the VCC shareholder) are not allowed to hold more than 50 percent of the participation rights, as defined in section 9D(1), or voting rights of the investee company. The definition of qualifying share in terms of section 12J of the Act

has also been amended to exclude hybrid equity instruments, as described in 3.2 above, from the definition of a qualifying share.

In a further attempt to close various abusive schemes involving the VCC regime, similar to the requirements to be met to be approved as a VCC, the June 2018 TLAB contained proposals that the qualifying investee company will only be allowed to issue one class of shares. Commentary from SAVCA against the proposal determined that certain important and globally accepted reasons exist to conclude that within the venture capital industry more than one class of share is required (Standing Committee on Finance, 2019a). The Standing Committee on Finance received the following commentary from the public as reasons why qualifying investee companies should be able to issue more than one class of share:

- As compensation for investing time and skills in the qualifying investee company, VCCs should be able to own shares that give it a preferred right to profit distribution from the qualifying investee companies (Standing Committee on Finance, 2019a).
- If different classes of shares are not issued to the VCCs investing in the qualifying investee company, then the original entrepreneur's shareholding in the entity will dilute as a result of the additional investment obtained from the VCCs (Standing Committee on Finance, 2019a).
- SAVCA commented that it is internationally accepted that investing requires different classes of shares at investee level, as different rounds of capital are raised and each round has different rights and pricing attached, depending on the growth of the qualifying investee company (Timm, 2018).
- There would be an administrative burden on qualifying investee companies, who had different classes of shares prior to the VCC investment, to consolidate its share capital into one class of share (SAIT, 2018).

Therefore, it was concluded that qualifying investee companies do in fact need more than one class of share to be issued, and as a consequence, this amendment has not been enacted (Standing Committee on Finance, 2019a).

3.4.2 General trade rules

Initially, the general trade rules were amended slightly to remove the requirement that, within a period of 18 months, all the investment funds received from the VCC must have

been invested in deductible expenditure incurred for purposes of any trade carried on by the investee company (National Treasury, 2009). Concerns raised by the VCC industry about the qualifying investee company definition as contained in section 12J of the Act, resulted in further significant amendments to the general trade rules (Cliffe Dekker Hofmeyr, 2018).

Firstly, VCCs were concerned with the general trade requirement, which requires that the amount of investment income included in the gross income of the qualifying investee company be limited to 20 percent of the gross income of that company. SMMEs are often structured in a group of companies, which then result in the holding SMME receiving dividends from various subsidiary SMMEs. This holding SMME will then most likely not fall within the definition of a qualifying investee company (Cliffe Dekker Hofmeyr, 2018). Furthermore, it is noted that the underlying business of these SMMEs is capital intensive and reliant on infrastructure that will only generate revenue upon completion of the infrastructure. As a consequence, these qualifying investee companies might unintentionally breach the 20 percent investment income threshold (National Treasury, 2018).

In terms of section 29(h) of the TLAA (23 of 2018), section 12J of the Act has been amended to determine that the investment income limitation will only apply after the expiry of 36 months since the VCC Investment.

In an attempt to close various abusive schemes involving the VCC regime, additional general trade rules (anti-avoidance rules) were added to the qualifying investee company definition.

- Firstly, paragraph (f)(ii) of the definition of qualifying investee company in terms of section 12J of the Act, limits the gross income of the investee company to not more than 50 percent being received from the investing VCC shareholder (or a connected person in relation to that shareholder). This trade limitation will only apply after the expiry of 36 months since the VCC investment.
- Secondly, paragraph (h) of the definition of qualifying investee company in terms of section 12J of the Act, determines that a VCC shareholder (or a connected person in relation to that shareholder) is not allowed to sell their business to the VCC and then be an investor in the VCC to whom it sold its business. The business sold by the VCC shareholder to the VCC will not fall within the ambit of the VCC regime.

3.4.3 Impermissible trade definition

A further amendment was made to the impermissible trade definition as per section 12J of the Act, to allow entities trading as a franchisee to be qualifying investee companies.

The current impermissible trade definition as per section 12J of the Act determines that the company will not be considered as a qualifying investee company if it conducts any of the impermissible trades below, as defined in section 12J of the Act:

- any trade in respect of immovable property, except for trade as a hotel or bed and breakfast;
- any financial service provider activities, specifically banking, insurance, finance provider or hire-purchase financing;
- being a provider of financial or advisory services, specifically including legal, tax advisory, stockbroking, management consulting, auditing or accounting services;
- any trade carried on in respect of gambling;
- manufacturing, buying or selling liquor, tobacco, arms or ammunition; or
- any trade conducted mainly outside of the Republic.

Refer to Table 3 below for a summary of the differences in the requirements to be met in order to be approved as a qualifying investee company between the initial enactment and the current section 12J of the Act.

Table 3: Differences in the requirements to be met in order to be approved as a qualifying investee company between the initial enactment and the current section 12J of the Act.

Section 27 of the Revenue Laws Amendment Act (60 of 2008)	Section 12J of the Act (amendments up to section 17 of the TLAA (34 of 2019))	Relevant TLAA / TLAB
Initial enactment	Current Act	
Requirements to be met in order to be approved as a 'qualifying investee company'		
Overall preliminary requirements		
Resident company	Resident company	<i>No amendment</i>
Not be a controlled group company.	Not be a controlled group company (only applies within the VCC framework).	<i>No amendment</i>
All tax affairs of the company must be in order.	All tax affairs of the company must be in order.	<i>No amendment</i>
Unlisted company	Unlisted company	<i>No amendment</i>
Trade requirements		
Within 18 months after the VCC investment, all funds received from the VCC to be incurred for purposes of trade carried on by the qualifying investee company.	<i>Provision subsequently deleted from the Act.</i>	Section 25(1)(e) (17 of 2009)
Any investment income included in the gross income of the qualifying investee company is limited to 20 percent of the gross income of that company.	Within 36 months from the VCC investment, any investment income included in the gross income of the qualifying investee company is limited to 20 percent of the gross income of that company.	Section 29 (23 of 2018)
<i>Provision not included in the initial enactment.</i>	Within 36 months from the VCC investment, gross income is limited to not more than 50 percent received from the investing VCC shareholder (or a connected person in relation to that shareholder).	Section 29 (23 of 2018)
<i>Provision not included in the initial enactment.</i>	A VCC shareholder (or a connected person in relation to that shareholder) is not allowed to sell their business to the VCC and then be an investor in the VCC to whom it sold its business.	Section 29 (23 of 2018)

'impermissible trade'		
Any trade in respect of immovable property, except for trade as a hotel or bed and breakfast.	Any trade in respect of immovable property, except for trade as a hotel or bed and breakfast.	<i>No amendment</i>
Any financial service provider activities, specifically banking, insurance, finance provider or hire-purchase financing.	Any financial service provider activities specifically, banking, insurance, finance provider or hire-purchase financing.	<i>No amendment</i>
Being a provider of financial or advisory services, specifically including legal, tax advisory, stockbroking, management consulting, auditing or accounting services.	Being a provider of financial or advisory services, specifically including legal, tax advisory, stockbroking, management consulting, auditing or accounting services.	<i>No amendment</i>
Any trade carried on in respect of gambling.	Any trade carried on in respect of gambling.	<i>No amendment</i>
Manufacturing, buying or selling liquor, tobacco, arms or ammunition.	Manufacturing, buying or selling liquor, tobacco, arms or ammunition.	<i>No amendment</i>
Trading as a franchisee.	Trading as a franchisee <i>provision subsequently deleted from the Act.</i>	Section 38 (24 of 2011)
Any trade conducted mainly outside of the Republic.	Any trade conducted mainly outside of the Republic.	<i>No amendment</i>

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

As noted above, the subsequent amendments to the investee company qualification requirements addressed various administrative and technical concerns raised by the industry through submissions to National Treasury. Allowing the qualifying investee company to issue different classes of shares and to be a controlled group company (outside of the VCC regime) will allow these qualifying investee companies to receive focused supportive management services which are fundamental for these start-up entities.

3.5 Disposal of VCC shares

Pursuant to the initial enactment of the VCC regime, a request has been made that the deduction as allowed in terms of the VCC regime should not be recouped upon the sale of the VCC shares. It has been suggested that the recoupment requirement should be removed which will result in the full proceeds received upon sale minus the base cost of the shares (which will be reduced by the initial investment tax deduction obtained) to only

be subject to CGT, at a maximum rate of 18 percent if the investor is an individual or 22.4 percent if the investor is a company (Portfolio Committee on Finance, 2008).

Following the above commentary, section 12J(9) of the Act was amended to determine that the recoupment as per section 8(4)(a) of the Act will only be triggered if the taxpayer disposes of the VCC shares within a period of five years since the acquisition thereof. Therefore, if the investment is sold after five years, the taxpayer will only be subject to CGT as explained above.

Initially the VCC regime resulted in a mere timing difference of tax payable and, therefore, the only benefit to the investor for investing in VCCs was the fact that funds saved as a result of less tax payable on the date of the investment could have been invested elsewhere until the taxpayer had to effectively repay the taxes saved, on the date of disposal of the VCC shares. Obviating the recoupment requirement, was an extremely positive amendment, due to the fact that the investor is now able to receive a permanent tax benefit on the date of the VCC investment, albeit reduced by CGT on the disposal of the investment.

3.6 Conclusion

As can be seen from the above the provisions of the VCC regime went through a number of amendments since its initial enactment. Most of the significant changes to the VCC regime occurred in 2011 and 2018.

The amendments in 2011, as was considered above, addressed the majority of the commentary against the VCC regime such as:

- Extending the incentive to all taxpayers, therefore, not limiting the potential capital providers of the VCC regime.
- The requirements to be met to be approved as a VCC has been reduced significantly, such as removing the no control requirement, removing the gross income requirement and adjusting the investment portfolio requirements to make it easier for VCCs to be approved as such, therefore, aligning the VCC regime to its objectives.
- Prior to the amendments in 2018, the requirements to be approved as a qualifying investee company have also been reduced. The general trade requirement, which required that an investee company must have carried on a trade or would have carried on a trade within 18 months after the investment from the VCC, was

removed to allow capital intensive SMMEs to be approved as qualifying investee companies. • Qualifying investee companies are now allowed to be controlled group companies. Therefore, companies outside of the VCC regime can control the qualifying investee company, allowing the controlling company to provide management support to the qualifying investee company. At first glance, this change in legislation might be counterintuitive to the objective of the VCC regime that VCCs are to provide supportive management services to the qualifying investee companies. However, this amendment allows for another company outside of the VCC regime to provide these services to the qualifying investee company, and for the VCC to only be a funds pooling mechanism. Consequently, the qualifying investee company will in effect still receive these supportive management services.

- The recoupment upon the sale of the VCC investment is obviated after five years since the investment by the taxpayer. This amendment aligns the VCC regime with the objective of reducing the risk of investing in these high-risk entities by providing an upfront deduction to an investment. This amendment also ensures that the investor maintains a portion of the tax deduction, and therefore, the incentive is no longer based on a mere timing difference in tax payable.

The amendments in 2011 made the VCC regime more appealing to investors, however, the regime was subject to abusive schemes which resulted in more stringent amendments to be proposed for the regime (SAIT, 2018). The amendments proposed in the June 2018 TLAB would have caused the premature end of the VCC regime. Therefore, after a public consultation process, the amendments as per section 29 of the TLAA (23 of 2018) resulted in additional rules to circumvent abusive schemes which further aligned the VCC regime to its objectives. Fundamentally, the amendments to section 12J of the Act determined the following:

- Different classes of shares may be issued by a VCC, however, the rules force a VCC to have various investors in each class of shares.
- Shares issued to fund managers for carried interest purposes will not be regarded as VCC shares, and would therefore not be subject to the maximum investment requirement of each class of share.
- A qualifying investee company may also issue different classes of shares.
- A qualifying investee company is allowed to generate up to 50 percent gross income from an investor which qualified for the VCC deduction.

- A qualifying investee company may not carry on any trade in relation to a venture, business or undertaking or part thereof, that was acquired from an investor.

The 2018 amendments clarified some uncertainties of the VCC regime. These amendments allowed the regime to be more closely aligned with its objective of pooling funds for SMMEs and contains a reasonable framework within which these VCCs should operate. The amendments resulted in the sustainability of the VCC regime to no longer be threatened. The amendments provided clarity on the requirements of the VCC regime.

As stated in Chapter 1 the second secondary objective of this study, as listed in paragraph 1.4.2(ii) of this study, was to explore the historical development of the South African VCC regime to understand the reasoning for the enactment of the regime and therefore to determine the underlying objectives of the regime. The third secondary objective of this study, as listed in paragraph 1.4.2(iii) of this study, was to understand the current policies regarding the venture capital tax relief found in section 12J of the Act as well as to critically analyse previous research studies based on the venture capital tax relief.

This chapter has, therefore, met the second secondary objective and the third secondary objective of this study by giving an overview of the policy amendments, the reasons for the policy amendments, the current requirements of the VCC regime, as well as a comparison of section 12J of the Act as it was initially enacted with the current requirements in section 12J of the Act. This chapter further focussed on all the requirements to be met in order to qualify for the tax relief, including requirements and potential tax consequences after the initial deduction in terms of section 12J(2) of the Act.

In order to compare the VCC regime, as it is currently enacted, with the venture capital regimes available in the United Kingdom, Chapter 4 critically analyses the venture capital tax relief available to qualifying investors in the United Kingdom.

CHAPTER 4: LITERATURE REVIEW OF THE UNITED KINGDOM VENTURE CAPITAL REGIMES

4.1 Introduction

The fourth secondary objective in paragraph 1.4.2(iv) of this study is to perform a critical comparison of the venture capital tax relief measures available in South Africa with those available in the United Kingdom using the theoretical construct of the United Kingdom venture capital regimes as an underpin.

The purpose of this chapter is to critically analyse the venture capital tax relief available to qualifying investors in the United Kingdom. Similar to Chapters 2 and 3, this chapter focuses on the investment relief available to qualifying investors and the prerequisites for the investor as well as the investee company, in order for the investor to qualify for the tax relief.

The assessment of the venture tax relief offered to qualifying investors in the United Kingdom is used in Chapter 5 as a basis to compare the VCC regime of South Africa with the venture capital regimes available in the United Kingdom, and based on the shortcomings identified in the critical comparison, to make recommendations for a possibly improved or revised section 12J of the Act.

As part of understanding the United Kingdom venture capital regimes, as a basis for the comparison of the United Kingdom venture capital regimes with the South African VCC regime, the reasons for using the United Kingdom as a comparative is also discussed in this chapter.

4.2 Reasons for using the United Kingdom as a comparative

The United Kingdom has been chosen as a country to compare with South Africa for the following reasons:

- The United Kingdom is part of the commonwealth group of countries to which South Africa belongs, and elements of the South African system of taxation have been based on principles derived from United Kingdom tax legislation, most notably the residence-based tax system (Stander, 2014).
- The United Kingdom is part of the Organisation for Economic Co-operation and Development (OECD) group of countries, to which South Africa has observer status (Department of International Relations and Cooperation, 2017). The OECD works

on establishing international norms and draw on its expertise to drive innovation and inclusive growth, as well as, provide the certainty necessary to support investment and trade (OECD, 2017).

- The United Kingdom is one of the countries with the largest economies in the world (ranked fifth in the world in 2018) (World Economic Forum, 2018). Consequently, South Africa can learn from the United Kingdom's successes and failures.
- The first venture capital investment incentive, the EIS, was enacted by the United Kingdom government in 1994, which was 15 years before the South African VCC regime was enacted, which means that South Africa can leverage off of the successes and failures of this established regime (Baygan, 2003).
- The overarching objectives of both countries' venture capital regimes are aligned, i.e. to promote venture capital investments in SMMEs to grow the economy and to ultimately decrease the unemployment rate of the country.
- These EIS and VCT regimes were successful in reaching its objectives as the EIS and VCT regimes raised a total of £27.7 billion (i.e. R497 billion if an exchange rate of R18 is used) in funds since its inception. Qualifying investee companies in the United Kingdom provide on average 60 additional jobs per company and about 75 percent of investee companies undertake some form of research and development as a result of the investment obtained from the investor or the VCT.

As can be seen above, there are various reasons why the United Kingdom has been chosen as a comparative country. This is mainly due to the fact that the overarching objectives of both countries' venture capital regimes are aligned.

4.3 SMME market condition and financing constraints of SMMEs in the United Kingdom

The availability of venture capital for start-up entities has been a key policy issue for the United Kingdom government in order to promote economic development through the growth of SMMEs (Bates *et al.*, 2008).

It is ordinarily recognised that a country only requires a few high potential SMMEs to have an immense influence on the future employment and innovation within that country (Bates *et al.*, 2008). Currently, in the United Kingdom, SMMEs account for 99.3 percent of all private sector businesses, employ 60 percent of the private-sector labour force, and

contributes 47 percent to the total turnover of the private sector (Intelligent Partnership, 2017). Therefore, it can be concluded that similar to South Africa, SMMEs contribute significantly to the economy of the United Kingdom and, therefore, the development of SMMEs should be a priority of any government.

The evidence of capital limitations or credit rationing influenced governments to develop regimes whereby informal and private investors are encouraged to channel their funds to higher risk venture capital investments. It is argued that the provision of a favourable structure and environment for educated and productive risk-taking by private investors, should be an essential role of a government (Bates *et al.*, 2008). To date, most developed economies have implemented some initiatives to support early-stage venture capital investments (BVCA & NESTA, 2009).

4.4 Background to the United Kingdom venture capital regimes and the role of these regimes in the SMME market of the United Kingdom economy

The United Kingdom government has enacted liberal tax reliefs targeted at investors to increase venture capital investments (Baygan, 2003). To promote investments made by informal and private investors, the United Kingdom government introduced the EIS and the VCT tax incentives.

Both the EIS and VCT regimes are aimed at providing an incentive for investments in SMMEs. In terms of the EIS regime income tax relief is provided for the investor's direct investment in a qualifying investee company. In terms of the VCT regime income tax relief is provided for investors that require a more heterogeneous risk profile, managed by professional fund managers (Boyns, Cox, Hughes, & Spires, 2003).

The EIS and VCT regimes advance the United Kingdom economy through the provision of funding to SMMEs as well as knowledge, innovation and increased employment within SMMEs. Furthermore, it is shown that the investee companies' contribution to the fiscus in the form of taxes paid, exceeds the cost of the initial tax relief granted to investors (Intelligent Partnership, 2017). Overall, the EIS and the VCT regimes contribute to economic growth, job creation, diversification and growth (Intelligent Partnership, 2017).

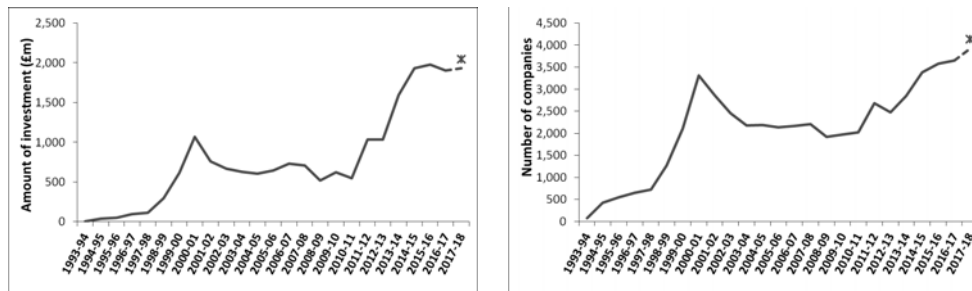
According to Her Majesty's Revenue and Customs' (HMRC) statistics, EIS's have raised almost £20 billion in investments since it was launched in 1993 (£769 million investment raised by an average of 2 150 investee companies per year, averaging £358 000 investment per investee company per year). In 2017 to 2018, 3 920 companies raised a

total of £1.9 billion of funds under the EIS regime (averaging £485 000 investment per investee company) (HMRC, 2019b). Therefore it can be concluded that the EIS regime has resulted in a year on year increase of investments in SMMEs.

In contrast, the total amount of funds raised by VCTs, since its inception in 1995, is £7.7 billion (£335 million investment raised by an average of 45 VCTs per year, averaging £7.4 million investment per VCT per year, and £3 460 per investee company, if the VCT invested all its funds in 2 150 investee companies). In the 2017 to 2018 tax year, 43 VCTs raised a total investment of £745 million (averaging £17.3 million per VCT) (HMRC, 2018).

Refer to Figures 4 and 5 below for an indication of the history of the United Kingdom EIS and VCT's ability to raise funds for investee companies (HMRC, 2019a).

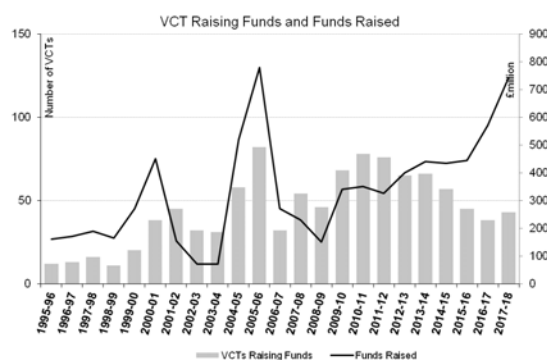
Figure 4: EIS raising funds and funds raised



(Source: HMRC, 2019b)

As can be seen in Figure 4 above, the amount of investment in terms of the EIS regime increased significantly from the 2011 tax year. The increase in EIS investments was mainly due to an increased tax relief from 20 percent to 30 percent in the 2011 to 2012 tax year. An increased investment limit also contributed to increased investments (HMRC, 2019b). The decrease in the amount of investment as from the 2015 tax year was as a result of the introduction of a risk-to-capital test which resulted in lower-risk companies to no longer qualify as qualifying investee companies (Beioley, 2019).

Figure 5: VCT raising funds and funds raised



(Source: HMRC, 2018)

The tax relief for investment in a VCT increased from 20 percent to 40 percent in the 2004 to 2005 tax years which resulted in a significant increase in the amount of investment in VCTs, as can be seen in Figure 5 above. However, the tax relief was reduced to 30 percent in the following year which resulted in a corresponding decrease in the value of funds raised by VCTs. Thereafter, an increase in the investment limit from the 2011 to 2012 tax years, contributed to an increased value of investments in VCTs, despite the decreasing trend in the number of VCTs raising funds (HMRC, 2019a).

The various tax regimes offered by a country are basic strategy instruments that may adversely or positively impact investment in that particular country. When investors make investment decisions, investors are particularly concerned with the after-tax rate of return of their investment (Clark, 2007). As evidenced in Figure 4 and Figure 5 above, the EIS and the VCT tax regimes in the United Kingdom are particular examples of how a change in a tax policy regime could impact the investments targeted by that specific regime.

From the above, it can be concluded that SMMEs are of great importance to the economy of the United Kingdom. The United Kingdom EIS and VCT regime's objectives of enhancing the growth of SMMEs to ultimately promote job creation, knowledge and innovation are in line with the objectives of the South African VCC regime. Based on the statistics presented and discussed above, it can also be seen that the United Kingdom had much success with its EIS and VCT regimes and, therefore, South Africa can leverage off the successes and failures of these established regimes.

4.5 Enterprise Investment Scheme (EIS)

The EIS regime, introduced by the United Kingdom government in 1994, is an incentive specifically targeted at encouraging investors to directly invest in higher-risk unquoted investee companies (Boyns *et al.*, 2003).

The purpose of paragraphs 4.5.1 and 4.5.2 below, is to give an overview of the United Kingdom EIS regime, in particular, the tax reliefs that are available to investors and the main qualifying conditions that apply to the investor. The investee company qualification requirements (impermissible trade and qualifying company definitions) are discussed in paragraph 4.7 of this study as these are the same for the EIS and VCT regimes.

4.5.1 Tax benefits for investors

Part 5 of the UK Tax Act contains the rules relating to the tax relief for investors investing in terms of the EIS regime. The investment in a qualifying investee company in terms of the EIS regime provides for various different forms of tax benefits. A brief summary of the tax benefits are discussed below:

- In terms of section 158 of the UK Tax Act, investors can get an income tax deduction of up to 30 percent of the consideration paid for the subscription of new shares issued by a qualifying investee company. The investment made by the investor within the EIS regime is limited to £2 million in a tax year, provided that, to qualify for the relief, any investment exceeding £1 million, should be made in knowledge-intensive companies. The maximum income tax deduction per investor for a relevant tax year, therefore, amounts to £600 000 (i.e. 30 percent of £2 million) (Meakin, 2018a).

As from April 2012, the United Kingdom government increased the rate for income tax relief under an EIS investment from 20 percent to 30 percent. The United Kingdom government further increased the annual amount that an investor can invest under the EIS regime from £500 000 to £1 million (excluding investments in knowledge-intensive companies). The United Kingdom government's objective for the increased relief was to increase the incentive for investors to invest in smaller companies, which face barriers in raising external finance, assisting these SMMEs to be established and to grow (HMRC, 2011). As can be seen in Figure 4 above, the increase in the tax relief resulted in an increase in the value of investments in terms of the EIS regime.

- In terms of section 150A(2) of the Taxation of Chargeable Gains Act (c.12 of 1992) (TCGA), upon disposal of the shares in the qualifying investee company, the investor is further allowed to disregard, for CGT purposes, any capital gains arising as a consequence of such disposal (Meakin, 2018a).

Based on research conducted by Merchant Savvy it is evident that SMMEs in the United Kingdom saw a decrease in their year on year profits from 2014 to 2016. The research also indicates that only 60 percent of SMMEs in the United Kingdom survive for three years or more. The United Kingdom SMME survival rate decreases to 44.1 percent when the SMME is five years or older. Due to the trends of declining profits and the marginal survival rate of United Kingdom SMMEs; it is unlikely that an investor will realise a capital gain upon the disposal of the shares. Investment decisions and the assessment of the efficacy of the venture capital tax regime should therefore not solely be based on the CGT relief granted (Merchant Savvy, 2018).

- In terms of sections 131 to 133 of the UK Tax Act, if the disposal of the shares in the qualifying investee company results in a capital loss for the investor, the investor can elect that, instead of setting off the capital loss against any other capital gains, the amount of the loss, less the 30 percent income tax relief previously given, can be set-off against normal taxable income of the investor in the year in which the disposal occurred (Crowdcube, 2019).

The CGT inclusion rate to be included in the individual's taxable income is 20 percent in the United Kingdom, and the highest marginal income tax rate for individuals in the United Kingdom is 45 percent (HMRC, 2019a). Consequently, the effective CGT rate in the United Kingdom is 9 percent. If the capital loss of an EIS investment is set-off against taxable income of the investor rather than against other capital gains, the investor will save a further 31.5 percent of the capital loss in taxes should the EIS investment not return any profits, and also provided that there are no other capital gains against which CGT should be levied. The loss relief will reduce the investor's exposure to 55 percent if a 100 percent loss is realised on the original investment (Emson, 2016).

- Schedule 5B to the TCGA provides further relief such as, upon disposal of any asset, where the gains realised as a consequence of the disposal of that asset, is used to invest in an EIS qualifying investee company, the investor can defer the CGT that would have been payable as a result of the disposal. However, the CGT deferral will only be available to the investor if the investment in the EIS qualifying investee company was made one year before, or three years after, the gain arose (Crowdcube, 2019). The deferred gain will become chargeable once the shares in the qualifying investee company are disposed of, and therefore this provision allows

for a mere timing difference in CGT payable on assets sold by the taxpayer (Emson, 2016).

However, in order to qualify for the tax benefits as mentioned above, the investor must hold the qualifying shares for a minimum of three years. If the qualifying shares are sold within three years, the original income tax rebate must be repaid by the taxpayer and no CGT benefits will be available to the taxpayer (Meakin, 2018a & sections 159, 209 and 256 of the UK Tax Act).

4.5.2 Requirements to be met in order to be approved as an investor

To ensure that the investor's intentions of the investment are in line with the United Kingdom government's objectives of the EIS regime, there are two anti-avoidance provisions, from the investor's perspective, within the EIS regime. The requirements, as contained in sections 163 to 165 of the UK Tax Act, to be met by the investor to ensure the investor does not abuse the EIS regime, are briefly discussed below.

- The investor's sole intention for the share purchase must be for actual commercial reasons and not for the purpose of avoiding tax (HMRC, 2016a).
- The investor is not allowed to be a connected person in relation to the qualifying investee company or control the qualifying investee company in any way i.e. not allowed to be an employee, director or partner of the qualifying investee company. The investor is further not allowed to hold, together with connected persons, more than 30 percent of the equity shares or voting rights in the qualifying investee company (HMRC, 2016a).

In summary, in terms of the EIS regime, an investor investing in a qualifying investee company could obtain a maximum of 13.5 percent saving on such investment, in the year of assessment in which the investment was made. This 13.5 percent saving is a permanent cash benefit, given the fact that the tax deduction will not be recouped and no CGT is payable upon disposal of the investment. Furthermore, if the investor realises a loss on upon disposal of the investment, a further 31.5 percent of the loss amount is shielded in terms of the capital loss relief provided in terms of this regime.

4.6 Venture Capital Trusts (VCT)

VCTs were introduced by the United Kingdom government in 1995. The VCT act as an investment vehicle for investments in SMMEs. The VCT is a listed entity on the London

Stock Exchange (LSE) of which its primary focus is to pool funds from its various investors and invest those funds in SMMs (Bestinvest, 2017).

The VCT shares are principally a retail venture capital product for private investors who wish to invest in a diversified portfolio of higher-risk trading companies managed by an investment manager. Furthermore, due to the fact that the VCT is listed on the LSE, it provides SMMs with greater opportunity to be eligible for equity investments (Bates *et al.*, 2008).

The United Kingdom government has enacted liberal tax reliefs for investors to encourage investment in VCTs. The purpose for paragraphs 4.6.1 and 4.6.2 below, is to give an overview of the United Kingdom VCT regime, in particular the tax relief that is available to investors and the main qualifying conditions that apply to the VCT. The investee company qualification requirements (impermissible trade and qualifying company definitions) are discussed in paragraph 4.7 of this study as these are the same for the EIS and VCT regimes.

4.6.1 Tax benefits for investors

Part 6 of the UK Tax Act contains the rules relating to tax relief for investors investing in the shares of a VCT. Investment in a VCT provides for various tax benefits. Unlike the EIS regime, the tax relief provided for investments in a VCT is ring-fenced to the VCT investment, which means that no deferral of CGT relief is available and capital losses are ring-fenced to capital gains. However, an investment in a VCT provides for additional dividends tax benefits. A brief summary of the tax benefits in terms of the VCT regime are discussed below.

- Similar to the EIS regime, in terms of section 263 of the UK Tax Act, investors can get an income tax deduction of up to 30 percent of the consideration paid for the subscription of new shares issued by a VCT. However, the investment made by the investor within the VCT regime is limited to £200 000 in a tax year. The maximum income tax deduction per investor for a relevant tax year, therefore, amounts to £60 000 (i.e. 30 percent of £200 00) (Jones, 2019).
- The investor will further also, be permitted to exempt any dividends received, on the portion of their investment that is within the £200 000 limit, from their taxable income and from their taxable dividends received (Jones, 2019).

- In terms of section 151A(2) of the TCGA, upon disposal of the VCT shares, the investor is also allowed to disregard any CGT arising as a consequence of such disposal (Jones, 2019).

As mentioned in 4.5.1 above, due to the trends of declining profits and the marginal survival rate of United Kingdom SMMEs; it is unlikely that an investor will realise a capital gain upon the disposal of the VCT shares. Investment decisions and the assessment of the efficacy of the venture capital tax regime should therefore not solely be based on the CGT relief granted (Merchant Savvy, 2018).

To qualify for the relief, the investor must hold these VCT shares for a minimum of five years. If the VCT shares are sold within five years, the tax rebate must be repaid. If the investor does not subscribe in new shares of the VCT but rather acquire shares from existing shareholders, then the investor will only qualify for the dividends tax and CGT relief (Jones, 2019).

In summary, in terms of the VCT regime, an investor investing in a qualifying investee company could obtain a maximum of 13.5 percent saving on such investment, in the year of assessment in which the investment was made. This 13.5 percent saving is a permanent cash benefit, given the fact that the tax deduction will not be recouped and no CGT is payable upon disposal of the investment. Furthermore, the investor can disregard any dividends received from the VCT for income tax and dividends tax purposes.

4.6.2 Requirements to be met in order to be approved as a VCT and taxation of a VCT

Venture capital investments are inherently risky and investors who invest in venture capital funds are reliant on venture capital fund managers to make investment decisions on their behalf. Due to the risky nature of these investments, governance mechanisms are invariably put into place to regulate venture capital fund managers' opportunistic behaviour (Cumming, 2003).

Therefore, a VCT must satisfy a vast amount of requirements, as detailed in section 273 of the UK Tax Act, before it can be approved as a VCT. In terms of section 259(1)(b) of the UK Tax Act, a VCT should obtain approval from HMRC before it can trade as a VCT.

Once approved as a VCT, the VCT will not be subject to income tax on any potential taxable income received, however, should the VCT provide any loan funding to qualifying investee companies, it would still be subject to income tax on interest received as a result

of the loan funding. The VCT will further not be subject to dividends tax on dividends received from qualifying investee companies. Upon disposal of the shares in qualifying investee companies, the VCT will not be subject to any CGT on any gains that arose as a result of such disposal. (Meakin, 2018b).

In order to be approved by HMRC to be a VCT, the following overall preliminary requirement for entry as a VCT has to be met:

- It is required that the ordinary shares of the VCT be listed on the LSE or admitted to trading on an EU Regulated Market. It is further required that the VCT is not a close company (SCEC, 2014).

The original motivation behind why VCTs had to be listed on the LSE was to ensure that VCTs are subject to United Kingdom tax law regulations, United Kingdom company law requirements, and United Kingdom listing requirements (AIC, 2012). However, the United Kingdom government amended the requirement to allow VCTs to also be admitted to trading on an EU Regulated Market which broadened the scope of the VCT regime (HMRC, 2010).

Over and above the preliminary requirement for approval as a VCT, the following gross income, investment portfolio and distribution requirements have to be met by the VCT:

- The gross income of the VCT must be predominantly derived from an interest in shares and or securities of qualifying investee companies (SCEC, 2014).
- The VCT is required to distribute at least 85 percent of the income received from its shares and or securities in qualifying investee companies, to its shareholders (SCEC, 2014).
- Throughout its lifecycle, the VCT's investment portfolio must comply with the following requirements:
 - A maximum of 15 percent is allowed to be invested in any one qualifying investee company (SCEC, 2014).
 - A minimum of 80 percent of the investment funds received by VCTs, should be applied towards expenditure incurred by the VCT for the acquisition of eligible shares in qualifying investee companies (Meakin, 2018b).

- The initial and subsequent investments made by the VCT must be within the permitted investment limits of the qualifying investee companies, as discussed in paragraphs 4.7.2 and 4.7.4 of this study (SCEC, 2014).
- The initial and subsequent investments made by the VCT must be made in qualifying investee companies that do not breach the permitted maximum age limit of qualifying investee companies, as discussed in paragraph 4.7.3 of this study (SCEC, 2014).

Regulating the maximum investment in any one qualifying investee company prevents extreme risk-taking by venture capital fund managers. Regulating the application of investments received by VCTs ensures that these investments are applied towards the growth of SMMEs (Cumming, 2003).

4.7 Investee company qualification requirements

The overall preliminary requirements in terms of Chapter 4 to part 6 of the UK Tax Act requires that in order for a company to qualify as a qualifying investee company it must satisfy the following requirements:

- In terms of section 286A of the UK Tax Act, the investee company must either be a United Kingdom resident company or have a United Kingdom permanent establishment, as defined in section 302A of the UK Tax Act.

Initially, the UK Tax Act required qualifying investee companies to carry out their qualifying activities wholly or mainly in the United Kingdom. This requirement has subsequently been changed to determine that the qualifying investee company should at least have a United Kingdom permanent establishment. The United Kingdom government is of the view that relaxing the limitations on qualifying investee companies would allow companies which previously did not qualify as a result of their international activity, to now qualify for investments. This amendment results in local entities to also be able to expand their business internationally (HMRC, 2010).

- The company is not allowed to be an enterprise in difficulty as defined in section 286B of the UK Tax Act. These entities are specifically excluded from the ambit of qualifying investee companies due to the fact that these entities will receive state aid for its rescue and restructuring, and are therefore already a cost to the fiscus (HMRC, 2010).

- In terms of section 295 of the UK Tax Act, the shares of the investee company are not allowed to be listed on an exchange (if the company's shares cease to be unlisted it will still be regarded as being unlisted for a period of five years).
- In terms of section 296(2) of the UK Tax Act, the investee company is not allowed to be controlled by another company together with any connected persons of that other company (i.e. the investee company must not be 51 percent held by another company).
- Should the investee company control another company, it must hold at least 51 percent in that other company in terms of the qualifying subsidiary definition in section 302 of the UK Tax Act.
- In terms of section 29A of the UK Tax Act, the investee company must have less than 250 employees employed at this company. This requirement ensures that only SMMEs as defined can benefit from the qualifying investments (Meakin, 2018b).

Over and above the preliminary requirements for approval as a qualifying investee company, the company has to comply with a variety of additional requirements to be a qualifying investee company. The key requirements are set out below.

4.7.1 The risk to capital condition

The investee company must obtain advance assurance from the HMRC in terms of section 286ZA of the UK Tax Act, that it is, in fact, an actual up-and-coming company with objectives to grow and develop, and that there is a consequential risk that this entity will suffer a capital loss in the initial stages of its operation (Meakin, 2018b).

4.7.2 Gross assets

To qualify as an investee company, the company is allowed to have a maximum of £15 million gross assets prior to the 'relevant investment' and a maximum of £16 million gross assets immediately after the 'relevant investment' (section 186 and section 297, UK Tax Act).

This requirement ensures that the EIS or VCT investments are made in true up-and-coming SMMEs, which due to their inability to obtain funding, have not been able to procure sufficient assets to grow to a medium or larger sized enterprise (Meakin, 2018b).

'Relevant investments' are defined in section 292A(3) of the UK Tax Act. 'Relevant investments' include VCT investments and investments for which an EIS, seed enterprise investment scheme or social investment tax relief compliance statement is issued, together with other investments that count as state aid.

4.7.3 Maximum age limit (initial investing period)

To qualify as a qualifying investee company, in terms of section 294A of the UK Tax Act, the age of the company may not exceed seven years from the date of the first commercial sale of its product or service offering (knowledge-intensive companies have an extended maximum age limit). After that, the company will no longer be a qualifying investee company for EIS or VCT investment purposes, unless one of the following exceptions to the basic age condition applies (Meakin, 2018b):

- Condition A (follow-on funding) is that if a 'relevant investment' was made in the qualifying investee company for a certain project or business activity, an additional investment can be made for that particular project or business activity, provided that the additional funding was foreseen in the initial project plan (HMRC, 2016b: VCM8154).
- Condition B (new project or business activity) will be applicable if a 'relevant investment' was made in the qualifying investee company for a certain project or business activity, and that qualifying investee company decides to expand its offering, i.e. a new project or business activity that is significantly different from its existing projects or business activities. The additional funding for that particular project or business activity will be excluded from the basic age condition. This exclusion will only apply if the 'relevant investment' is equal to or exceeds 50 percent of the average of the previous five consecutive years' revenue of the company (HMRC, 2016b: VCM8155).
- Condition C determines that if a 'relevant investment' was made in terms of condition B, the company can obtain follow-up funding as per condition A (HMRC, 2016b: VCM8159).

The maximum age limit is intended to ensure that investments are made in companies that are relatively new to the market and, therefore, are more susceptible to market failure. The reasoning is that older more developed companies have a track record and can, therefore, use their track record to provide more comfort to investors, and ultimately obtain more financing to grow its business (HMRC, 2016b: VCM8153). Condition B is added to

the exceptions to the basic age condition based on the fact that the qualifying investee company might not be able to leverage off of its existing track record to obtain financing for new products or business ventures (HMRC, 2016b: VCM8155).

4.7.4 Annual and lifetime investment limit

To further ensure diversification within the investor's portfolio, a qualifying investee company together with its subsidiaries are limited to receive a maximum of £5 million annual and a £12 million lifetime 'relevant investment', in terms of the United Kingdom venture capital regimes (Section 292A, UK Tax Act).

4.7.5 Qualifying trade requirement

For the investee company to qualify as a qualifying investee company, its main purpose must be to carry on a qualifying trade or actively be preparing to carry on a qualifying trade (Section 291, UK Tax Act). Generally, all trades other than impermissible trades as described below are qualifying trades, provided that they are carried out commercially with a profit-making prospect (Meakin, 2018b). At all times after the 'relevant investment' has been made, the qualifying investee company must carry on qualifying activities, which means that it must carry on a qualifying trade or be in preparation for its qualifying trade (HMRC, 2016b: VCM 55110).

All the money raised by the qualifying investee company, from the 'relevant investments' received, must be utilised for purposes of its qualifying activities, as described above, within two years from such investment (HMRC, 2016b: VCM55150).

4.7.6 Impermissible trades

The investee company will not be considered a qualifying investee company if it conducts a significant amount (more than 20 percent of its trade) of any one of the following impermissible trades as detailed in section 303 of the UK Tax Act (Meakin, 2018b):

- investment activities;
- dealing in land, commodities or futures in shares, securities or other financial instruments;
- any financial service provider activities, specifically banking, insurance, finance provider or hire-purchase financing or other financial activities;

- being a provider of financial or advisory services, specifically including legal, tax advisory, stockbroking, management consulting, auditing or accounting services;
- leasing activities;
- receiving royalties or licence fees;
- any forestry activities;
- a trade in respect of the development of property;
- farming activities;
- the operation or management of hotels or nursing homes;
- shipbuilding;
- coal and steel production; or
- energy generation activities.

The reason for excluding these impermissible trades from the EIS and VCT regimes is that the entities carrying on these specific trades are generally asset-backed and can, therefore, pledge their assets as security in a financing arrangement (Meakin, 2018b).

4.8 Conclusion

The purpose of this chapter was to critically analyse the venture capital tax reliefs available to qualifying investors in the United Kingdom. In summary, the venture capital regimes in the United Kingdom provide that an investor can get a 30 percent upfront income tax deduction based on the amount invested in terms of either the EIS or VCT regimes. Furthermore, both the EIS and VCT regimes provide additional tax reliefs. In terms of the EIS regime, CGT or capital relief is available on the disposal of the qualifying shares. The EIS regime further provides CGT deferral relief. In terms of the VCT regime, only CGT relief is available on the disposal of the qualifying shares. The VCT regime further provides dividends tax relief. In terms of both the EIS and VCT regimes, certain requirements need to be met by the qualifying investee company to ensure that investments made in terms of these regimes are in line with the objectives of the venture capital regimes.

As stated in Chapter 1, the fourth secondary objective of this study, as listed in paragraph 1.4.2(iv) of this study, was to perform a critical comparison of the venture capital tax relief measures available in South Africa with those available in the United Kingdom using the theoretical construct as an underpin, in order to make recommendations for a possibly

improved or revised section 12J of the Act, based on the shortcomings identified in the critical comparison.

This chapter has therefore partially met the fourth secondary objective of this study by giving an overview of the requirements to be met in order to qualify for the tax relief in terms of the EIS and VCT regimes, including requirements and potential income tax consequences after the initial deduction in terms of the United Kingdom venture capital regimes.

This assessment of the venture tax relief offered to qualifying investors in the United Kingdom is used in Chapter 5 as a basis to compare the VCC regime in South Africa with the venture capital regimes available in the United Kingdom, and to make recommendations for a possibly improved or revised section 12J of the Act, based on the shortcomings identified in the critical comparison.

CHAPTER 5: CRITICAL COMPARISON OF THE SOUTH AFRICAN AND THE UNITED KINGDOM VENTURE CAPITAL TAX REGIMES

5.1 Introduction

In Chapter 3, the study explored and critically analysed the tax relief available to qualifying venture capital investors who invest in approved VCCs in terms of section 12J of the Act. In Chapter 4, the study explored and critically analysed the tax reliefs available to qualifying venture capital investors in the United Kingdom. Both of these chapters focused on all of the requirements to be met by the investor, the VCC or VCT, and the qualifying investee company, for the investor to qualify for the relevant tax relief.

The objective of this chapter is to critically compare the venture capital tax relief measures available in South Africa with those available in the United Kingdom. This chapter addresses the secondary research objective, as identified in paragraph 1.4.2(iv) of this study.

The construct of the South African VCC regime is very similar to the United Kingdom EIS and VCT regimes (Zuccollo, 2019). In terms of all three regimes, investors receive significant tax incentives to invest in SMMEs. In terms of all three regimes, restrictions are imposed on investment activities of the investor, as well as on the funds controlling these investments, before the investor could qualify for the tax relief. The fact that there are similarities between the VCC regime and the EIS or VCT regimes is important as it enables one to draw upon the longer history of the EIS and VCT regimes, and make inferences about the effect of VCCs on the South African venture capital market.

5.2 Tax benefits for investors

As can be seen from the analyses performed in previous chapters of this study, in both South Africa and the United Kingdom, investors who invest in qualifying investee companies receive liberal tax reliefs for such investment, regardless of the manner in which such investment should be made. Below is a detailed comparison of the tax reliefs granted in terms of the South African and the United Kingdom venture capital tax regimes.

5.2.1 Investment types

In South Africa, investors can obtain venture capital tax relief only if investments are made in VCCs, whereas in the United Kingdom, investors have the option to either invest directly in the qualifying investee company or to invest in a VCT. Investing directly in a qualifying investee company (EIS) is generally perceived to be a riskier investment than a

VCC or VCT investment. The investment profile of a VCC or VCT is spread, and therefore, the risk is spread across various investments (Walters, 2011). Each venture capital regime provides different tax benefits to the investors; each of which will be analysed and compared below.

5.2.2 Income tax and dividends tax relief

One of the more profound differences between the VCC regime and the EIS/VCT regimes is the maximum tax relief granted to investors.

As discussed in 3.2 above, investors in VCCs can claim an income tax deduction, from his/her taxable income, equal to the amount for which the investor is deemed to be at risk for (generally 100 percent of the consideration paid for such investment). However, this deduction is limited to R2.5 million per annum for individual investors (natural persons and trusts) and R5 million per annum for corporate investors (Standing Committee on Finance, 2019b). Investors in EIS's and VCTs can claim an income tax deduction of up to 30 percent of the consideration paid for such an investment, however, the total annual investment made by the investor within the regime is limited to £1 million for an investment in a non-knowledge-intensive EIS, and £200 000 for an investment in a VCT (Meakin, 2018a & Meakin, 2018b).

The IRR of an investment is a metric used to evaluate the future profitability and growth of an investment. The IRR of an investment is homogenous for investments of different types and, as such, the IRR of an investment can be used to rank multiple investments on an even basis. If taxes (amongst other factors) did not have an impact on the return of investments, investments with the same growth rate, regardless of the amount initially invested, would then have the same IRR's. However, income tax, dividends tax and CGT (amongst other factors) directly impact the return of an investment (Goedhart, Levy & Morgan, 2016).

The IRR of an investment, including the tax relief received as a result of the type of venture capital tax regime, needs to be assessed in various scenarios to determine which venture capital tax regime is potentially more favourable for the investor. Below is an assessment of various scenarios based on the tax concessions available for an individual (natural persons or a trust). The results may differ for corporate entities due to the fact that corporates are taxed at a different income tax rate, very seldom are dividends received by corporates subject to income tax or dividends tax, and the investment limit for corporate investors is higher.

Scenario 1:

The facts assumed in scenario 1 below will be the basis on which the possible investment returns of investments in terms of the venture capital regimes are assessed in this study. As background for purposes of the IRR calculation the following facts are assumed:

- an individual investor (a natural person or a trust) has R2.5 million (VCC investment limit for individual investors, this investment limit does not exceed the EIS or VCT limits if converted to South African rand) to invest in terms of either a VCC, EIS or VCT regime;
- the investment will have an annual dividend yield of 10 percent over the investment period of five years;
- the investor will have sufficient taxable income to claim the entire R2.5 million tax deduction in the year of assessment in which the investment was made; and
- as a result of either a disposal of the venture capital shares to a third party, or a repurchase of the venture capital shares from the VCC/EIS/VCT, the investor will receive his or her initial investment value back at the end of the investment period (the consideration for the disposal of the venture capital shares will be in the amount of R2.5 million).

In summary, the tax consequences for the individual in terms of the VCC regime will be that the individual will receive a 100 percent initial tax deduction based on his or her investment value, which means that the investor could have an immediate 45 percent saving on his or her investment (based on the maximum marginal South African income tax rate). The individual will, however, be subject to 20 percent dividends tax on any dividends received from the investment. The investor's base cost in the VCC shares will reduce by the initial tax deduction claimed (base cost will reduce to zero if a 100 percent deduction was claimed). Therefore, upon disposal of the VCC shares, the investor could be subject to CGT at a rate of 18 percent of the entire proceeds received (ENSafrica, 2015).

The tax consequences for the individual in terms of the EIS regime will be that the individual will receive a 30 percent initial tax deduction on his or her investment. That means the investor will save an immediate 13.5 percent on his or her investment (based on the maximum marginal United Kingdom income tax rate of 45 percent). The investor will be subject to, at most 38.1 percent, dividends tax on any dividends received from the

investment. The investor will, however, not be subject to any CGT on any capital gains realised upon disposal of the investment (Meakin, 2018a).

The tax consequences for the individual in terms of the VCT regime will be that the individual will receive a 30 percent initial tax deduction on his or her investment. That means the investor will save an immediate 13.5 percent on his or her investment. The investor will not be subject to dividends tax and will further not be subject to CGT on any capital gains realised upon disposal of the investment (Meakin, 2018b).

The scenarios assessed below are based on the fact that a non-South African resident could invest in a South African VCC regime and receive the tax benefit, as section 12J(2) of the Act refers to any taxpayer, which is defined in the Act as any person chargeable with any tax leviable in terms of the Act. It is further based on the fact that a South African resident can invest in the United Kingdom regimes, as the EIS/VCT regimes provide non-United Kingdom residents relief against their United Kingdom taxable income (Hann, 2010).

Figure 6: IRR of an R2.5 million investment in terms of the VCC, VCT and EIS regimes

	VCC	EIS	VCT
Amount invested:	R2 500 000	R2 500 000	R2 500 000
After-tax dividend amount per year for 5 years:	R200 000	R154 750	R250 000
After-CGT investment disposal proceeds:	R2 050 000	R2 500 000	R2 500 000
IRR:	9.55%	6.38%	9.34%

Therefore, in its simplest form it can be assumed that, due to the fact that the EIS and VCT initial tax relief is limited to 30 percent of the consideration paid for such investment and that the VCC regime will allow for a 100 percent upfront income tax deduction equal to the consideration paid for such investment, the IRR of an EIS and VCT investment appears to be lower than the IRR of an investment in a VCC.

Currently, the highest dividends tax rate in the United Kingdom is 38.1 percent (HMRC, 2016c) and in South Africa, the dividends tax rate is 20 percent (SARS, 2018a). From the calculations presented in Figure 6 above, it can be perceived that an investment in terms of the EIS regime, which does not provide a dividends tax exemption, has a lower IRR than an investment in terms of the VCC regime. This could be due to the fact that the dividends tax rate of the United Kingdom exceeds the dividends tax rate of South Africa, combined with the fact that the VCC regime allows for an increased upfront tax deduction.

Stated differently, a reduced dividends tax rate, combined with an increased upfront tax deduction, leads to the calculation of the IRR of an investment in a VCC to be higher than an investment in terms of the EIS regime.

It can also be deduced from the calculations presented in Figure 6 above, that the dividends tax relief provided in terms of the VCT regime did not result in an IRR exceeding that of an investment in terms of the VCC regime. This might be as a result of the 70 percent differential in the upfront deduction in terms of the VCC regime, not being exceeded by the dividend tax relief provided over the investment period.

Furthermore, it can be presumed from the calculations presented in Figure 6 above, that the dividends tax relief provided in terms of the VCT regime, resulted in the IRR of an investment in terms of the VCT regime exceeding the IRR of an investment in terms of the EIS regime.

In this scenario, it is concluded that the 100 percent upfront tax deduction in terms of the VCC regime results in a more attractive investment for investors, compared to the EIS and VCT regimes. However, consideration should also be given to the dividends tax relief provided in terms of the VCT regime. Such relief could significantly improve the investor's return on investment.

Scenario 2:

Figure 7: IRR of an R3.6 million investment in terms of the VCC, VCT and EIS regimes

	VCC	EIS	VCT
Amount invested:	R3 600 000	R3 600 000	R3 600 000
After-tax dividend amount per year for 5 years:	R288 000	R222 840	R360 000
After-CGT investment disposal proceeds:	R3 150 000	R3 600 000	R3 600 000
IRR:	8.52%	6.38%	9.34%

In scenario 2, the same background facts as in scenario 1 are considered. However, this scenario assumes that the investor has R3.6 million (VCT £200 000 investment limit multiplied by an average exchange rate of R18) to invest. Based on the calculations presented in Figure 7 above, it can be accepted that the IRR of an EIS and VCT investment will remain the same as in scenario 1, due to the fact that the EIS and VCT investments' tax deduction is not limited in this scenario. However, the IRR of an investment in a VCC will reduce to below that of a VCT investment, which is conceived to

be as a result of the combined effect of the limitation to the initial tax deduction, no dividends tax relief, and the adverse CGT consequences upon disposal of such investment.

In this scenario, it can therefore also be concluded that the upfront 100 percent tax deduction in terms of the VCC regime, results in a more attractive investment for investors. However, adding a limitation to the initial tax deduction could result in the IRR of the investment to decrease, if the investor wants to invest more than R2.5 million per annum in VCC shares. Conversely, the limitation to the initial tax deduction limits the reduction in the base cost of the VCC shares and, therefore, results in a decrease of the future CGT effect on disposal of the investment. Which in turn increases the IRR of the investment. However, due to the fact that the income tax rate exceeds the effective CGT rate, and due to the time value of money principles, overall the IRR will arguably decrease as a result of the upfront income tax deduction limitation.

Scenario 3:

Figure 8: IRR of an R18 million investment in terms of the VCC, VCT and EIS regimes

	VCC	EIS	VCT
Amount invested:	R18 000 000	R18 000 000	R18 000 000
After-tax dividend amount per year for 5 years:	R1 440 000	R1 114 200	R1 800 000
After-CGT investment disposal proceeds:	R17 550 000	R18 000 000	R18 000 000
IRR:	6.55%	6.38%	8.00%

The same background facts as in scenario 1 are considered in scenario 3. However, this scenario assumes that the investor has R18 million (EIS £1 million investment limit multiplied by an average exchange rate of R18) to invest. From the calculations presented in Figure 8 above, it can be surmised that the IRR of an EIS investment will remain the same in scenario 1, 2 and 3 due to the fact that in these scenarios, the EIS regime does not trigger a limitation on the investor's allowable income tax deduction. As evident in the scenario's considered above, an investment in terms of the VCT regime, even though the income tax deduction in terms of the VCT regime is limited, appears to have a higher IRR than an investment in terms of the EIS regime. This result is presumably due to the dividends tax relief granted in terms of the VCT regime.

In this scenario, it can therefore also be inferred that the limitation to the initial tax deduction, decreases the IRR of such investment. It may further be concluded that a dividends tax relief could have a compounded effect to increase the IRR of an investment.

As discussed in 3.2 above, based on administrative data on tax expenditure, the average expenditure per annum incurred by a new VCC shareholder to obtain VCC shares ranged between R1.3 million and R2.1 million over the past four years (National Treasury, 2019a). Given the fact that it is supposed that a South African investor will generally not invest more than R2.5 million per annum in VCC shares, it is more likely that scenario 1 above would be the basis on which a comparison between the South African and the United Kingdom regimes should be made. Therefore, it can be concluded, based on the calculations presented in scenario 1, that if no capital gain or loss is realised upon sale of the VCC shares, and if only R2.5 million is invested, an investment in terms of the VCC regime could result in a slightly higher IRR of the investment compared to that of the VCT and EIS regimes.

However, the VCC industry is in its growth phase and, therefore, the statistics presented by the government should not necessarily be taken at face value. These investments may increase in the future after more potential investors are made aware of the VCC regime. It is also a reality of the venture capital industry that a small number of investors contribute towards a large portion of the total VCC assets under management, and there is a high volume of investors who invest less capital in these VCCs. The industry averages are, therefore, skewed (Zuccollo, 2019). The conclusion that scenario 1 above would more likely than not be the basis on which a comparison between the South African and United Kingdom regimes should be made, is based on historical data and does not necessarily reflect the future industry norm.

5.2.3 The capital gain or capital loss relief

As mentioned above, the VCC regime does not provide for any capital gain or capital loss relief. Accordingly, the investor will be taxed at a 22.4 percent (companies), or 18 percent (individuals), effective CGT rate on any capital gains realised as a result of the disposal of VCC investments. The capital gains realised on a VCC investment will most likely be the entire proceeds received upon disposal of the investment as the initial tax deduction, on the consideration paid for the VCC shares, will result in a reduction of the base cost of the VCC shares (ENSAfrica, 2015).

Generally, capital losses derived as a result of the disposal of an asset may only be applied towards reducing any capital gains derived as a result of the disposal of another asset. South African tax law does not allow for capital losses to be set-off against the income of a revenue nature. Consequently, a VCC investor that incurred a capital loss upon disposal of a VCC investment, will not be able to set off that capital loss against its income of a revenue nature. The VCC investor will only be able to utilise the capital loss if it realised a capital gain as a result of another asset's disposal. It should further be reiterated that due to the reduction in the base cost of the VCC shares, the investor will almost always realise a capital gain upon disposal of his or her VCC shares (ENSafrica, 2015).

The VCT, as well as the EIS regimes, allows the investor to disregard any CGT arising as a consequence of the disposal of the shares in the qualifying investee company (Meakin, 2018). The EIS regime further allows for a loss relief, which determines that the investor can set-off any capital loss derived from the disposal of shares in a qualifying investee company, from its income of a revenue nature (Crowdcube, 2019).

Scenario 4:

In scenario 4, the same background facts as in scenario 1 are considered. However, this scenario assumes that as a result of either a disposal of the venture capital shares to a third party, or a repurchase of the shares from the VCC/VCT or the qualifying investee company, the investor will receive more than his or her initial investment value back at the end of the investment period (the consideration for the disposal of the venture capital shares will be in the amount of R3 million). Therefore, if a profit on disposal of the investment in the amount of R500 000 is incorporated into the calculation, the IRR results before and after CGT would be as per Figure 9.1 and Figure 9.2 below. Figure 9.3 further illustrates the impact of CGT on the IRR of an investment that did not return any dividends during the investment period (all results of scenario 4 are collectively referred to as Figure 9).

Figure 9: The impact of a profit realised on the sale of a VCC investment versus a profit realised on the sale of VCT and EIS investments

Figure 9.1: Before-tax profit realised on the sale of the investment

	VCC	EIS	VCT
Amount invested:	R2 500 000	R2 500 000	R2 500 000
After-tax dividend amount per year for 5 years:	R200 000	R154 750	R250 000
Before-CGT investment disposal proceeds:	R3 000 000	R3 000 000	R3 000 000
IRR:	13.15%	8.58%	11.40%

Figure 9.2: After-tax profit realised on the sale of the investment

	VCC	EIS	VCT
Amount invested:	R2 500 000	R2 500 000	R2 500 000
After-tax dividend amount per year for 5 years:	R200 000	R154 750	R250 000
After-CGT investment disposal proceeds:	R2 460 000	R3 000 000	R3 000 000
IRR:	11.20%	8.58%	11.40%

Figure 9.3: After-tax profit realised on the sale of an investment which did not return any dividends during the investment period

	VCC	EIS	VCT
Amount invested:	R2 500 000	R2 500 000	R2 500 000
After-tax dividend amount per year for 5 years:	Rnil	Rnil	Rnil
After-CGT investment disposal proceeds:	R2 460 000	R3 000 000	R3 000 000
IRR:	5.54%	4.28%	4.28%

Based on the results as illustrated in Figure 9.1 above and the results in scenario 1 above, it is evident that a before-tax profit realised on the disposal of VCC/EIS/VCT shares increased the IRR of all these investment options. However, based on the results as illustrated in Figure 9.2 above, as soon as the investor's return on investment is more than what was initially invested, the IRR of a VCC investment is below that of a VCT investment. It can, therefore, be argued that the combined effect of dividends tax, CGT, and the fact that the investor's base cost in its VCC investment reduces to zero, results in the IRR of a VCC investment to be below that of a VCT investment.

In this scenario, as illustrated in Figure 9 above, the IRR of an investment in terms of the VCC regime will nevertheless exceed the IRR of an investment in terms of the EIS regime, due to the fact that the EIS and VCC regimes do not provide for any dividends tax relief and the dividends tax rate of the United Kingdom exceeds that of South Africa.

However, as illustrated in Figure 9.3 above, if the investment does not return any dividends over the investment period, the IRR of an investment in terms of the VCC

regime might exceed that of the EIS and VCT regimes, due to the 70 percent differential in the upfront deduction in terms of the VCC regime versus that of the EIS and VCT regimes.

In this scenario, it can be concluded that in the scenario of an investment that returns more than what was initially invested by the investor (either by means of dividends received or proceeds on disposal of the investment exceeding the initial amount invested), the cumulative effect of the dividends tax relief combined with a CGT relief provided in terms of the VCT regime, resulted in a more attractive investment for an investor than an investment with an increased upfront tax deduction. However, the CGT relief on its own (without dividends tax relief) does not necessarily result in a more attractive venture capital regime than what is already enacted in South Africa.

Scenario 5:

In scenario 5, the same background facts as in scenario 1 are considered. However, this scenario assumes that as a result of either a disposal of the venture capital shares to a third party or a repurchase of the shares from the VCC/VCT or qualifying investee company, the investor will receive less than his or her initial investment value back at the end of the investment period (the consideration for the disposal of the venture capital share will be in the amount of R2 million). Therefore, if a loss on disposal of the investment in the amount of R500 000 is incorporated into the calculation, the IRR results before and after CGT would be as per Figure 10.1 and Figure 10.2 below (all results of scenario 5 are collectively referred to as Figure 10).

Figure 10: The impact of a loss realised on the sale of a VCC investment versus a loss realised on the sale of VCT and EIS investments

Figure 10.1: Before-tax profit realised on the sale of the investment

	VCC	EIS	VCT
Amount invested:	R2 500 000	R2 500 000	R2 500 000
After-tax dividend amount per year for 5 years:	R200 000	R154 750	R250 000
Before-CGT investment disposal proceeds:	R2 000 000	R2 000 000	R2 000 000
IRR:	9.34%	3.82%	6.96%

Figure 10.2: After-tax profit realised on the sale of the investment

	VCC	EIS	VCT
Amount invested:	R2 500 000	R2 500 000	R2 500 000
After-tax dividend amount per year for 5 years:	R200 000	R154 750	R250 000
After-CGT investment disposal proceeds:	R1 640 000	R2 157 000	R2 000 000
IRR:	7.71%	4.67%	6.96%

Due to the increased risk of investments in terms of the EIS regime, the EIS investor is provided with a loss relief should this risky investment fail (Emson, 2016).

Based on the results in Figure 10.1 above and the results in scenario 1 above, it is evident that a before-tax loss on disposal decreased the IRR of all these investment options. From the calculations presented in Figure 10 above it can be deduced that the IRR of a VCC investment exceeds the IRR of a VCT and an EIS investment in this scenario, regardless of the fact that the EIS regime provides for capital loss relief. However, based on the scenarios considered in this study, it can be surmised that if the EIS regime also provided for dividends tax relief combined with the capital loss relief, the IRR of the EIS regime would be more than that of the VCC and VCT regimes.

It can, therefore, be concluded that the CGT and capital loss relief provided does not necessarily contribute towards a more favourable regime than what is already enacted in South Africa. However, it is evident that if a dividends tax relief is combined with the CGT or capital loss relief, it could result in an increase of an investment's IRR.

5.2.4 Other investment decision considerations

Other than the IRR calculations presented above, there are various other factors that should be considered and compared before it can be concluded whether there are any possible shortcomings identified in the tax relief provided to investors in terms of the VCC regime. In particular, the following should be considered:

- The VCT is required to distribute at least 85 percent of its income from its shares in qualifying investee companies, to its shareholders. Therefore, investors are ensured of dividends if the fund receives dividends from its qualifying investee companies (SCEC, 2014). The requirements to be met in order to be approved as a VCC as considered in paragraph 3.3 of this study, does not include such requirement and, therefore, it can be assumed that the VCC is entitled to withhold investment returns from its shareholders.
- Once approved as a VCT, the VCT will not be subject to income tax or dividends tax on dividends received from qualifying investee companies. Upon disposal of the shares in investee companies, the VCT will further not be subject to any CGT on any gains that arose as a result of such disposal (Meakin, 2018b). A VCC could be subject to income tax or dividends tax on dividends received from qualifying investee companies. However, it is assumed that in most instances, the dividends received by the VCC will be exempt from income tax in terms of section 10(1)(k) of the Act and from dividends tax in terms of section 64F of the Act (SARS, 2018b). Furthermore, upon disposal of the shares in its investee companies, the VCC will be

subject to CGT at an effective rate of 22.4 percent on any capital gains realised and, therefore, the CGT paid will reduce the amount that the VCC can distribute as dividends to its shareholders (ENSafrica, 2014).

From the scenarios considered above, it can be concluded that a 100 percent upfront tax deduction on the expenditure incurred for the acquisition of VCC shares is most definitely favourable for investors. However, it appears that the attractiveness of the VCC regime is suppressed by policies such as a limitation to the income tax deduction, no dividends tax relief, and a reduction in the base cost of the investment paired with no CGT relief for investors. Furthermore, investor's returns are affected due to the fact that the VCC itself is not exempt from tax.

5.3 Anti-avoidance provisions of the South African and United Kingdom venture capital regimes

Both the South African and United Kingdom venture capital regimes have various anti-avoidance provisions from an investor's and qualifying investee company's perspective, which prevent investors from obtaining any unintended tax benefits. These anti-avoidance provisions are discussed in detail in Chapter 3 and 4 above. These provisions are compared below.

5.3.1 Minimum holding requirement

In order to qualify for the tax benefits in terms of the venture capital regime in either South Africa or the United Kingdom, the investor is required to hold the VCC or VCT shares for a minimum of five years (HMRC, 2016a and National Treasury, 2011).

Initially, section 8(4)(a) of the Act determined that the initial tax deduction received will be recouped if the VCC shares are subsequently disposed of, regardless of the disposal date. However, section 12J of the Act has been amended to determine that after a five-year investment lock-up period, the investor will only be taxed, at the effective CGT rate, on any capital gains realised upon the sale of the VCC shares (however the base cost of the VCC shares will be reduced) (ENSafrica, 2015).

Therefore, due to the fact that the recoupment provision has been removed from the VCC regime, provided that the investment lock-up period is adhered to, it can be concluded that the National Treasury attempted to align the VCC regime with the United Kingdom venture capital regimes, to enhance the efficacy of the VCC regime and align it to its objectives (Portfolio Committee on Finance, 2008). However, this amendment to section 12J of the

Act did not result in the ultimate tax benefit of the VCC regime to be entirely aligned with the ultimate tax benefit of the EIS or VCT regimes, given the fact that the VCC investor will, nevertheless, be subject to CGT on any capital gains realised as a result of the disposal of the VCC shares.

The minimum holding requirement is reduced to three years in terms of the EIS regime (HMRC, 2016a). Having a shorter investment lock-up period is arguably efficiency-enhancing, as investors who have invested in a VCC/VCT or qualifying investee company that is performing poorly, can more freely reallocate their funds to other investments (Cumming, 2003).

However, the investment lock-up period does provide some liquidity and market stability to the VCC or VCT itself. The qualifying investee company will also benefit from an investment lock-up period due to the fact that its value would not decrease as a result of continuous share sales, which may give the impression of a lack of confidence in its prospects (CFI, 2017). However, if the objectives of the VCC regime are to encourage equity funders to invest in SMMEs and to promote the establishment and growth of SMMEs, it is unclear why the investment lock-up period is imposed on the taxpayer and not on the VCC itself. Imposing a lock-up period on the investment in the VCC provides comfort to the VCC itself and not necessarily to the qualifying investee company. There is currently no minimum holding period for the VCC's investment in the qualifying investee company.

5.3.2 No control requirement

The governments of both South Africa and the United Kingdom implemented certain no control requirements in their venture capital regimes to ensure that the qualifying investor's investment portfolio is diversified and to ultimately ensure that the investor does not receive any unintended tax benefits. It was found that these no control requirements are similar for all three venture capital regimes and are, therefore, compared below.

In terms of the VCC regime, a qualifying investor is not allowed to be a connected person to the VCC (National Treasury, 2016). A qualifying investor is further not allowed to hold more than 20 percent of any class of VCC shares (Taxation Laws Amendment Act, 23 of 2018). Moreover, the VCC is limited to a maximum of 20 percent investment in any one qualifying investee company, and the qualifying investee company is not allowed to be a controlled group company (National Treasury, 2011).

The EIS regime prohibits the investor from being a connected person to the qualifying investee company (HMRC, 2016a). Furthermore, the qualifying investee company is not allowed to be a controlled group company. In terms of the VCT regime, similar to the EIS regime, the qualifying investee company is not allowed to be a controlled group company (section 296(2) UK Tax Act).

Therefore, it can be concluded that the VCC regime disallows control at various levels. The qualifying investor is not allowed to control the VCC and the VCC is not allowed to control the qualifying investee company. In terms of the EIS and VCT regimes, control is only prohibited at the qualifying investee company level.

One of the objectives of the VCC regime is to create a structure whereby investors could pool their funds in the VCC, which would then channel those funds to investments in qualifying investee companies (National Treasury, 2011). Therefore, prohibiting the qualifying investor from controlling the VCC aligns the VCC regime with its objective of pooling funds from various investors. However, it is unclear how such a requirement will further enhance investments made in SMMEs, as the no control requirement of the qualifying investee company, already provides for diversification of the VCC's investments.

5.3.3 The element of risk requirements

One of the objectives of the venture capital regimes is to reduce the risk of investing in these high-risk entities by providing an upfront income tax deduction to an investment which would have generally been capital in nature and, therefore, not have qualified for an income tax deduction in terms of section 12J of the Act (SAICA, 2012). Specific anti-avoidance provisions were implemented in terms of these venture capital regimes to ensure that there is a real element of risk of investing in the qualifying investee company and to ensure that the investor does not receive any unintended tax benefits. The element of risk requirements of the VCC regime and of the EIS/VCT regimes will be compared below.

The requirements of the EIS regime broadly state that the investor should not purchase shares in a qualifying investee company for the purpose of avoiding tax (HMRC, 2016a).

The EIS/VCT regimes further determine that for the investor to qualify for the tax relief, the qualifying investee company must have obtained advance assurance from the HMRC that

there is an element of risk involved in investing in the qualifying investee company (Meakin, 2018b).

In terms of the VCC regime, the element of risk requirements are more specific and not as broadly stated as the requirements of the EIS/VCT regimes. These requirements are as follows:

- As considered in paragraph 5.2 of this study, an investor will only receive a tax deduction for the investment in a VCC equal to the amount for which the investor is deemed to be at risk for. Therefore, no deduction is allowed in terms of the VCC regime, if the investment is made through a loan or credit facility which has been granted to the taxpayer directly or indirectly by the VCC in which the taxpayer invests in, or if the loan or credit facility is only repayable after a period of five years since its advancement date (PWC, 2012).
- The definitions of venture capital share and qualifying share in terms of section 12J of the Act has been amended in 2019 to exclude shares with any debt-like features, such as hybrid equity shares, as defined in section 8E of the Act (Taxation Laws Amendment Act, 24 of 2011). This exclusion ensures that investors only receive relief for investments where there is an actual risk that the investor would not receive any return on the investment.
- There will be no deduction allowed for shares issued to the investor in respect of services rendered to the VCC or the qualifying investee company (Taxation Laws Amendment Act, 23 of 2018).

It is evident from the element of risk requirements of the VCC regime, that the South African government attempted to ensure that the tax relief is only provided to an investor if the investor acquired pure equity shares, which by nature of the performance of SMMEs, could result in the investor losing its invested capital. These investment types are generally not favoured by investors, and therefore the tax deduction is intended to reduce the risk of investing in these high-risk entities. However, to further align the VCC regime with its objectives, the South African government should consider adding a requirement that the qualifying investee company should obtain advance assurance from SARS that there is an element of risk involved in investing in the qualifying investee company, thereby avoiding abuse of the VCC regime.

5.4 Requirements to be met in order to be approved as a VCC versus requirements to be met in order to be approved as a VCT

Both the VCC and VCT regimes have specific requirements in place that have to be met before the respective Commissioners can approve an entity as a VCC or VCT. The qualifying investor will not receive any tax benefits for an investment in a VCC or VCT that has not been approved by the respective Commissioner or HMRC. The requirements for approval as a VCC or VCT as outlined in detail in paragraph 3.3 and paragraph 4.6.2 of this study will be compared below.

The overall preliminary requirements for entry as a VCC are that the company must be a South African resident company, licensed in terms of section 8 of FAIS, and all tax affairs of the company must be in order (National Treasury, 2011).

Initially, a VCT could only be approved as such if it was listed on the LSE. The United Kingdom government amended the preliminary requirement to allow a VCT to be approved as such if it was listed on the LSE or if it was admitted to trading on an EU Regulated Market, as it was found that the United Kingdom listing requirements were too rigorous (HMRC, 2010). Therefore, the VCT regime has only one preliminary requirement for entry as a VCT, which is that the entity must be listed on the LSE or admitted to trading on an EU Regulated Market (SCEC, 2014).

Shortly after the VCT listing requirement was amended, the South African government amended the preliminary requirements to allow a VCC to be approved as such, whether it was listed on a stock exchange, or not. The South African government took the same view as the United Kingdom government, which is that the fact that a VCC or VCT is listed, or not listed, does not prohibit it from pooling investments for SMMEs (National Treasury, 2011).

The gross income of the VCT must be predominantly derived from an interest in shares of qualifying investee companies (SCEC, 2014). A similar requirement was included in the VCC regime which determined that 90 percent of the gross income of the VCC must be from a financial instrument source (National Treasury, 2009). The South African government removed this requirement and replaced it with the requirement that the main objective of the VCC must be to invest and manage investments in qualifying investee companies (National Treasury, 2011). The South African government considered that adding a limitation to the type of gross income received by the VCC, is overly limiting, and the overall preliminary requirements along with the investment portfolio requirements are

sufficient to ensure that funds are applied towards its intended purpose (National Treasury, 2011).

The VCT regime allows for a maximum of 15 percent to be invested in any one qualifying investee company (SCEC, 2014). Similarly, the VCC regime only allowed for a maximum of 15 percent to be invested in any one qualifying investee company. This limitation has, however, been increased to 20 percent to slightly ease the no control requirement of the VCC (National Treasury, 2011).

Both the VCC and VCT regimes have a requirement that a minimum of 80 percent of investments received by the VCC or VCT should be applied towards expenditure incurred for the acquisition of eligible shares in qualifying investee companies. In terms of section 12J(6A) of the Act, 80 percent of the VCC's investment funds received, must be applied towards investments in qualifying investee companies that hold assets with a book value of no more than R50 million, immediately after the VCC investment. In terms of section 186 of the UK Tax Act, 80 percent of the VCT's investment funds received must be applied towards investments in qualifying investee companies that hold gross assets with a book value of no more than £15 million, prior to the relevant investment and no more than £16 million, immediately after the relevant investment. Therefore, if converted to South African rand, the VCT can invest in entities whose gross asset value is five times that of a South African entity. However, this requirement is based on the definition of an SMME in the respective countries.

In the United Kingdom (within the European Commission) an SMME is defined as a business that has fewer than 250 employees and either revenue of up to €50 million or gross assets up to €43 million (38 times that of a South African SMME) (Hall, 2018). Therefore, limiting the gross assets of the qualifying investee company to £16 million immediately after the relevant investment ensures that the investment made by the VCT does not result in the qualifying investee company no longer being classified as an SMME. It could further be seen, based on the qualifying investee company gross assets limitation and the gross assets limitation per the SMME definition, that the United Kingdom was conservative in its limitation of qualifying investee company investments. Consequently, the qualifying investee company should have had an actual inability to obtain funding due to it not being able to pledge its assets as security for its funding. The qualifying investee company should ultimately be required to utilise the funds invested to grow into a larger enterprise (Meakin, 2018b).

In South Africa, an SMME is defined as a business that has fewer than 200 full-time employees, turnover of up to R50 million, and total gross asset value of up to R18 million (the Schedule, Small Business Act). It is therefore unclear why the VCC regime allows for investments in companies that hold assets with a book value of up to R50 million if one of the objectives of the regime is to encourage equity funders to invest in SMMEs. An SMME as defined is only allowed to have a total gross asset value of up to R18 million. National Treasury's reasoning for the increase in the gross asset limitation from R10 million to R50 million in 2014, was that the VCC has seen limited uptake and therefore changes were made to enhance the attractiveness of the VCC regime (National Treasury, 2014).

From the above, it can be concluded that neither the VCC nor the VCT needs to be listed on a stock exchange for approval as a VCC or VCT. It can further be affirmed that both the VCC and VCT regimes place restrictions on the allocation of the funds received from its investors. In an attempt to make the VCC regime more attractive for potential investors, the restrictions in terms of the VCC regime, which used to be similar to the VCT restrictions, have been alleviated. The VCC is no longer required to ensure that a certain percentage of its income is from a financial instrument source and its qualifying investee company investment limits have been significantly reduced to the point where the VCC's investment could result in the qualifying investee company no longer being an SMME as defined.

5.5 Investee company qualification requirements

The VCC, EIS and VCT regimes have certain qualification requirements that have to be met by the SMME before the company can qualify as a qualifying investee company. As mentioned in paragraph 5.4 above, the qualifying investor will not receive any tax benefits for an investment in a VCC or VCT that does not have at least 80 percent of its funds received from its investors, invested in qualifying investee companies. The investee company qualification requirements of the South African and United Kingdom venture capital regimes are discussed in detail in paragraph 3.4 and paragraph 4.7 of this study. These requirements are compared below.

In general, section 12J(1) of the Act determines that the overall preliminary requirements to qualify as a qualifying investee company are that the company must be an unlisted South African resident company, all tax affairs of the company must be in order, and the company is not allowed to be a controlled group company. Chapter 4 to part 6 of the UK Tax Act determines that the overall preliminary requirements to be a qualifying investee company are that the company must either be an unlisted United Kingdom resident

company or have a United Kingdom permanent establishment, the company is not allowed to be an enterprise in difficulty, the investee company is not permitted to be controlled by another company, and the investee company must have less than 250 employees.

The South African venture capital regime provides that the qualifying investee company has three years since the initial investment by the VCC to ensure that it carries on a general trade with a profit-making prospect. Similarly, the United Kingdom regimes provide that the qualifying investee company has up to two years to use its money raised from the relevant investments for the purposes of its qualifying activities (HMRC, 2016b: VCM55150). The requirements of both the South African and the United Kingdom venture capital regimes define certain business activities as impermissible trades due to the fact that such trades generally result in the SMMEs business being asset-backed. The SMME can provide such assets as security for loan funding. Impermissible trades as defined in both the South African and the United Kingdom venture capital regimes are virtually the same.

From the above, it can be concluded that the qualifying investee company requirements in terms of the United Kingdom regimes are similar to that of the VCC regime. However, in terms of the United Kingdom regimes, there are some additional requirements to be met for a company to qualify as a qualifying investee company. These additional requirements and its relevance in South Africa are assessed below:

- The South African VCC regime further does not allow a company with a South African permanent establishment to qualify as a qualifying investee company.

In terms of article 7(1) of the OECD's Model Tax Convention, a contracting state will only have taxing rights in respect of the business profits of a foreign enterprise that is a resident of another contracting state if the enterprise has a permanent establishment in that state to which such profits are attributable. In terms of article 5(1) and (2) of the OECD's Model Tax Convention, the term permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on and includes especially; a branch; an office; a factory; a workshop and a mine (ENSAfrica, 2016).

Therefore, in terms of certain double tax agreements, a non-resident company with a permanent establishment in South Africa, might be subject to income tax in South Africa (ENSAfrica, 2016).

Furthermore, even though not required to do so, a foreign company with a permanent establishment in South Africa is likely to employ South African residents and, therefore, contribute towards decreasing unemployment in South Africa (Integrate immigration, 2015).

- The South African VCC regime does not have a requirement that a VCC is not allowed to invest in an enterprise in difficulty.

This requirement is specifically included in the United Kingdom EIS and VCT regimes as an SMME in the United Kingdom which satisfies the requirements of an enterprise in difficulty as defined in article 107 of the treaty provisions on state aid, can receive rescue and restructuring aid of up to €10 million from the United Kingdom government (BIS, 2011). South African companies in difficulty do not receive such state aid from the South African government and, therefore, venture capital funding or private equity funding will be the primary source of support for these companies (Deeb, 2016).

- In terms of the United Kingdom VCT and EIS regimes, it is required that qualifying investee companies have less than 250 employees. This requirement ensures that only SMMEs as defined can benefit from the qualifying investments (Meakin, 2018b). In South Africa, an SMME as defined should have less than 200 full-time employees and therefore, specifically stating that VCCs are only permitted to invest in companies with less than 200 full-time employees could align the VCC regime with its objective of promoting investment in SMMEs. However, such a requirement could also potentially limit the objective of the VCC regime to ultimately address the unemployment rate in South Africa.
- In terms of the EIS and VCT regimes, a qualifying investee company has a maximum age limit of seven years from the date of the first commercial sale of its product or service offering (Meakin, 2018b). The maximum age limit is intended to ensure that investments are made in companies that are relatively new to the market, more susceptible to market failure, and do not have a track record to provide more comfort to investors (HMRC, 2016b: VCM8153).

Based on research conducted by the Department of Small Business Development it is evident that only 37 percent of SMMEs in South Africa survive for three years or more and only 9 percent of SMMEs survive up to ten years (Mashimbye, 2018). Therefore, adding a maximum age limitation to a qualifying investee company could

ensure that investors are protected from investments made by venture capital fund managers which have exorbitant failure rates (Cumming, 2003). However, it should be considered whether merely assisting SMMEs for the first few years of its operation would result in the venture capital regime meeting its objectives and whether the regime itself could cause these statistics to improve.

5.6 Conclusion

The objective of this chapter was to critically compare the venture capital relief measures available in South Africa with those available in the United Kingdom and thereby successfully addressing the secondary research objective as identified in paragraph 1.4.2(iv) of this study.

Based on the similarities in the venture capital regimes as considered above, it is clear that the drafting of the South African VCC regime was significantly influenced by the United Kingdom venture capital policies. As concluded in Chapter 4, the United Kingdom had much success in its venture capital regimes. Despite the similarities, there are nevertheless significant differences between the various venture capital regimes that are important to recognise in a comparative analysis of these regimes. The critical analysis performed and shortcomings identified from the comparison are used in Chapter 6 of this study as a basis for the conclusion on the effectiveness of the VCC regime in meeting its objectives and as a basis for making recommendations for a possibly improved or revised section 12J of the Act.

CHAPTER 6: SUMMARY AND CONCLUSION

6.1 Introduction

Chapters 1 and 2 of this study highlighted the importance of SMMEs for the future economic growth and development of South Africa and its contribution to a decreased unemployment rate, innovation, competition and international growth in South Africa. It was however noted that one of the main challenges faced by the South African SMME sector, is access to equity finance (National Treasury, 2008).

Therefore, in an attempt to promote the growth of SMMEs, a tax concession in terms of section 12J of the Act was implemented as a mechanism through which the South African government has aimed to encourage equity investments in SMMEs (Manuel, 2008). Encouraging equity investments in SMMEs have been portrayed as one of the best strategies for achieving the national development goals (Kabongo & Okpara, 2009).

This study assessed the importance of SMMEs in the United Kingdom, and it was determined that similar to South Africa, SMMEs contribute significantly to the economy of the United Kingdom. The United Kingdom government has enacted liberal tax relief regimes targeted at investors to increase venture capital investments in the United Kingdom (Baygan, 2003). The EIS and VCT regimes advance the United Kingdom economy through the provision of funding to SMMEs as well as knowledge, innovation, and increased employment within these SMMEs.

The research method used in this study was a literature review of previous research performed with regard to the South African and United Kingdom venture capital regimes. The research included a critical analysis in which the South African VCC regime was compared to the United Kingdom venture capital regimes. A comparative analysis was performed to identify possible shortcomings in the South African VCC regime in light of the importance of SMMEs in the South African economy. The shortcomings identified, can be used to make recommendations for the possible improvement of the VCC regime, as currently enacted in section 12J of the Act. Specifically with regard to its eligibility criteria and the tax relief provided. The comparative analysis was conducted using each country's respective venture capital tax legislation, the information supplied by each country's relevant tax authority, and previous research conducted on these respective regimes.

The purpose of Chapter 6 is to reflect on the research findings and conclusions reached in the preceding Chapters 1 to 5. The research performed in these chapters has uncovered several shortcomings to the South African VCC regime. This chapter provides a summary

of key findings of the research, suggests recommendations to address the identified shortcomings, identifies future areas of research concerning the South African VCC regime, and provides an overall conclusion to the research.

6.2 Research objectives

The objectives behind this study are contained in Chapter 1 (see paragraph 1.4 of this study) and are divided between the main objective and several secondary objectives, which assisted to ultimately achieve the study's main objective. In broad terms, the main objective of this study was to critically compare the VCC regime in its current form, along with the sunset clause, to its underlying objectives, in order to reach a conclusion on whether the South African VCC regime achieves its underlying objectives and if the VCC regime, in its current form, can achieve these objectives in the future.

The primary objective was successfully achieved by addressing the secondary objectives. The secondary objectives of this study, details of where the objectives have been achieved, and conclusions reached, are as follows:

- To critically analyse previous research studies and the literature relating to the importance of SMMEs in the South African economy. This research objective was addressed in Chapters 1 and 2 of this study, where it was concluded that SMMEs are of great importance to the economy of any country and, therefore, the government should encourage the establishment and growth of SMMEs as a tool to address unemployment and inequality.
- To explore the historical development of the South African VCC regime, to understand the reasoning for the enactment of the regime and to ultimately determine the underlying objectives of the regime. This research objective was addressed in Chapters 2 and 3 of this study. It was concluded that due to the acceptance of the importance of SMMEs to bring about economic growth and the fact that equity investments in SMMEs would possibly achieve the required economic growth, the government of South Africa introduced a tax incentive to encourage venture capital equity investments in SMMEs. However, it was further concluded that the requirements of the VCC regime, as initially enacted, needed to be amended in order to align the regime with its objectives. The underlying objectives of the VCC regime and an assessment of the historical ability of the regime to meet its objectives, are considered and concluded on in paragraph 6.3.2 below.

- To understand the current policies regarding the venture capital tax relief found within section 12J of the Act as well as critically analyse previous research studies based on the VCC regime. This research objective was addressed in Chapter 3 of this study. It was concluded that the requirements of the VCC regime went through a myriad of policy amendments, to address various commentary against the regime, to make the regime more appealing to investors, to clarify uncertainties in respect of the regime, to circumvent abusive schemes, and to ultimately align the regime to its initial objectives. The amendments to section 12J of the Act, which aimed to align the VCC regime to its objectives and an evaluation thereof, are considered in paragraph 6.3.4 below.
- To perform a critical comparison of the venture capital tax relief measures available in South Africa with those available in the United Kingdom using the theoretical construct as an underpin, and to make recommendations for a possibly improved or revised section 12J of the Act based on the shortcomings identified in the critical comparison. This research objective was addressed in Chapters 4 and 5 of this study, where it was concluded that the VCC regime has been enacted in South Africa as a result of the United Kingdom's great success with its established venture capital regimes and that the VCC regime is modelled after the United Kingdom's EIS and VCT regimes. It was further concluded that despite the similarities, there are significant differences between the South African and the United Kingdom venture capital tax regimes that are important to recognise in a comparative analysis of these regimes. The shortcomings of the VCC regime and recommendations for a possibly improved or revised section 12J of the Act will be discussed in paragraphs 6.4 and 6.5 below.

6.3 Summary of research findings

To reflect on the research findings and conclusions reached in the preceding Chapters 1 to 5, the summarised results of the study are discussed below. This summary specifically focuses on an overview of section 12J of the Act, the objectives of the VCC regime, and includes an assessment of the historical ability of the regime to meet its objectives.

6.3.1 Summarised overview of section 12J of the Act

A VCC is defined in section 12J of the Act as: *"a company that has been approved by the Commissioner in terms of subsection (5) and in respect of which such approval has not been withdrawn in terms of subsection (3A), (3B), (6) or (6A)."* One of the key qualifying

criteria for approval as a VCC is that its main objective should be the management of investments in qualifying investee companies (National Treasury, 2009). Broadly stated, a qualifying investee company is a South African resident unlisted company, of which the book value of its assets is no more than R50 million immediately after VCC investment, and which does not carry on any impermissible trades (Mazansky, 2019).

Section 12J(2) of the Act entitles an investor to deduct the expenditure actually incurred in subscribing for VCC shares from its taxable income. Consequently, an R100 investment in VCC shares should in theory only cost an individual investor R55, as the investor receives a 45 percent tax break on his or her investment, based on the maximum marginal South African income tax rate (Mazansky, 2019). Company investors only receive a 28 percent tax break on their investments in VCC shares.

The deduction allowed in the hands of investors in terms of section 12J(2) of the Act should, as a general rule, be recouped or recovered in terms of section 8(4)(a) of the Act. However, section 12J(9) of the Act obviates the recovery or recoupment if the investment was retained for a period exceeding five years. Consequently, the taxpayer should not be subject to normal income tax upon disposal of the VCC shares.

The investor's base cost in the VCC shares will, however, reduce by the initial tax deduction claimed (base cost will reduce to zero if a 100 percent deduction was claimed). Therefore, upon disposal of the VCC shares, the investor could be subject to CGT.

The extent to which the tax efficiency of the deduction applies, depends on what taxes the investor is aiming to alleviate. If an individual investor wants to shelter capital gains from its taxable income, only 40 percent of the capital gains amount needs to be invested in a VCC to alleviate the tax burden of CGT. If the investor is sheltering normal taxable income, 100 percent of the taxable income amount needs to be invested in a VCC to alleviate the tax burden of income tax (Mazansky, 2019).

6.3.2 Objectives of section 12J of the Act

From the review of the South African VCC regime, it can be concluded that the main objectives for the enactment of the VCC regime were as follows:

- To encourage equity funders to invest in SMMEs (National Treasury, 2016).
- To encourage the establishment and growth of SMMEs as a tool to address unemployment and inequality (National Treasury, 2017).

- To create a structure whereby investors could pool their funds in the VCC, which would then channel those funds to investments in qualifying investee companies (National Treasury, 2011).
- To have the VCC provide supportive management services to the qualifying investee companies (National Treasury, 2011).
- To reduce the risk of investing in these high-risk entities by providing an upfront income tax deduction on an investment which would generally have been capital in nature and, therefore, not have qualified for a deduction in terms of section 12J of the Act. The upfront deduction will consequently increase the IRR of the investment (SAICA, 2012).

6.3.3 Assessment of the historical ability of the VCC regime to meet its objectives

Since the enactment of the VCC regime, some highlights of the venture capital industry, and its contribution to the growth of SMMEs in South Africa included the following:

- Currently, the VCC industry has R8.3 billion in assets under management (capital raised from VCC shareholders). Approximately R4 billion of the VCC assets under management have been raised in 2019 (Zuccollo, 2019).
- The reported value of VCC investments in qualifying investee companies during 2009, was just over R300 million, and this has significantly increased to R1.5 billion during 2018 (SAVCA, 2010 & SAVCA, 2019).
- The reported number of new VCC investments in 2009, was about 37, and this has significantly increased to 181 new VCC investments in 2018 (SAVCA, 2010 & SAVCA, 2019).
- At the end of 2018, the venture capital asset class had R5.37 billion invested in 665 deals. These numbers have doubled since the first SAVCA survey in 2010. In 2010, the venture capital asset class had R2.64 billion invested in 251 deals (SAVCA, 2010 & SAVCA, 2019)
- The average expenditure per annum, incurred by a new VCC shareholder to obtain VCC shares, ranged between R1.3 million and R2.1 million per investor over the past four years (National Treasury, 2019a).

- Based on the initial results of the VCC industry survey which is currently being undertaken by PWC (an audit and advisory firm), as instructed by the section 12J association, the VCC regime had created 27,000 permanent jobs since its enactment (Zuccollo, 2019).

Based on the statistics discussed above, it can therefore, be estimated that the average initial cost to the fiscus for each job created by the VCC regime is R138 000. This result is obtained by determining the initial tax foregone by the fiscus, that is a maximum of 45 percent of the R8.3 billion assets under management, divided by 27,000, which is the estimated number of jobs created by the VCC regime. Furthermore, if the average investment per VCC shareholder is R1.7 million, it is understood that each investor's investment created five jobs through the VCC regime. If the natural person, for which a job has been created through the VCC regime, pays an average of R35 253 in tax per annum (based on the lowest marginal taxable income rate), it could take the fiscus four years to recover the initial tax forgone, after which the individual will continue to pay income taxes on his or her salary earned. In addition, the fiscal cost of the VCC regime is partially offset through taxes that could potentially be paid within the five-year investment lock-up period. These taxes include the tax on income earned by the VCC, tax and VAT on income earned by the underlying SMMEs, and dividends tax on distributions made by the VCC to the qualifying investor. Furthermore, there will be CGT consequences when an investor disposes of the VCC shares, as well as when the VCC disposes of the shares in the SMME.

From the outset, it appears that the VCC regime costs the fiscus a considerable amount of money. However, the CGT on the disposal of the VCC shares could reduce the cost per job to R27 700. This is due to the fact that the effective return to the fiscus on any capital gains on disposal of the investment in the qualifying investee company and on disposal of the VCC shares could be 36 percent if the VCC and VCC investor's CGT costs are combined (National Treasury, 2019b). This is in line with the cost of R27 000 per job of the Employment Creation Facilitation Fund created by National Treasury in 2011, which aimed to create 150 000 permanent jobs (Standing Committee of Appropriations, 2019). Given the fact that the rate of tax for companies is less than an individual's rate and given the fact that the effective CGT rate for companies is higher than an individual's rate, the cost per job will be less if companies are investing in these VCCs. Therefore, it can be concluded that the actual cost to the fiscus is much lower than the initial up-front deduction.

As was seen above, the South African government introduced the VCC regime to increase investment in SMMEs, to ultimately decrease unemployment and increase economic growth. However, since the VCC regime had not been there for very long, the impact of the VCC regime in the South African economy has not been entirely realised. From the statistics presented above, it can be inferred that the number of VCC investments recorded over the years from 2008 to 2018 only increased once amendments to the VCC regime were made i.e. around 2014, which is 36 months after significant amendments to section 12J of the Act were made (refer to Figure 3 above). By the end of 2011, there were less than five VCCs registered with SARS which indicated that the financial benefits were too small and the qualifying requirements unnecessarily prohibitive and complex (PWC, 2012).

It was acknowledged by National Treasury that initially, the VCC regime did not prevail in its objectives. Effectively, the VCC regime only started meeting its objectives in the last five years of the regime. The venture capital industry is in its growth phase and, therefore, the benefit as intended might only be realised at a later stage of the economic cycle. Furthermore, due to the sunset clause in the VCC regime, South Africa might never see the benefits of the regime materialise.

6.3.4 Evaluation of the amendments to section 12J of the Act in an attempt to align the VCC regime with its objectives

The amendments to section 12J of the Act, which aimed to align the VCC regime to its objectives, are considered below. These amendments aimed to increase the benefit of the investment and to alleviate the criteria for approval as a VCC and qualifying investee company.

The investor's investment limits have been increased, subject to certain anti-avoidance rules, which increased the potential tax benefit for investors and, therefore, aimed to make the VCC regime more appealing to investors (PWC, 2012).

The recoupment requirement upon the sale of the VCC shares has been removed from section 12J of the Act, provided that the VCC shares were held by the taxpayer for five years or more. This amendment eventuated that the VCC regime is more than a mere timing difference in tax payable (Portfolio Committee on Finance, 2008).

Based on the calculations presented in scenario 1 of Chapter 5 of this study, it was found that, due to the time value of money principles, an increased tax saving in the year of

assessment in which the investment is made, is most likely to result in an increased IRR of the investment.

If the initial tax deduction is recouped it will result in the tax benefit to be temporary. Therefore, previously, the only benefit to the investor for investing in VCCs was the fact that funds saved as a result of less tax payable on the date of the investment could have been invested elsewhere until the date of disposal of the VCC shares. Following the amendments, the taxpayer is now able to receive a permanent tax benefit on the date of the VCC investment, albeit reduced by CGT upon disposal of the investment.

These two amendments discussed above, arguably aligned the VCC regime to its objective of increasing the IRR of the investment and, therefore, ultimately reducing the risk of the investment. Given that these amendments aimed to make the VCC regime more appealing to investors, it inherently aimed to align the regime to its objective of encouraging equity investments in VCCs.

The VCC regime was extended to all taxpayers and, therefore, unlisted companies and trusts are included as qualifying investors. The purpose of this amendment was to avoid a possible limitation of the potential capital providers of the VCC regime (PWC, 2012). Since this amendment broadened the scope of the VCC regime, it can be deduced that it intended to align the regime to its objective of encouraging equity investments in VCCs.

One of the initial objectives of the VCC regime was to create a structure whereby investors could pool their funds in the VCC and the reality remains that whether or not the VCC is listed, does not prohibit it from merging investments. Therefore, this amendment was made in an attempt to more closely align the VCC regime to its objectives.

The gross income requirement of the VCC has been simplified, by replacing the requirement that a minimum of 90 percent of the gross income of the VCC must be from a financial instrument source or from services rendered to qualifying investee companies, with the requirement that the main objective of the VCC must be, to invest and manage investments in qualifying investee companies.

The VCC is compelled to create a structure whereby investors could pool their funds in the VCC, which would then channel those funds to investments in qualifying investee companies. Therefore, extending the ambit of the nature of income received by the VCC, and ensuring that the main objective of the VCC must be to invest and manage investments in qualifying investee companies, are efforts that purport to align the VCC

regime with its objectives. This amendment ensures that temporary receipts of cash by the VCC does not prevent the regime from reaching its objectives (National Treasury, 2011).

It was noted that the investment portfolio requirements to be met in order to be approved as a VCC, might have been unnecessarily confining. Given the capital intensive nature of start-up entities, SMMEs generally require more than R10 million to be invested. The gross asset limitation of qualifying investee companies was increased from R10 million to R50 million in 2014. A South African SMME as defined is only allowed to have a total gross asset value of up to R18 million. It is therefore unclear why the VCC regime allows for investments in companies that hold assets with a book value of up to R50 million if one of the objectives of the regime is to encourage equity funders to invest in SMMEs. National Treasury's reasoning for the increase was that the VCC has seen limited uptake and, therefore, changes were made to make the VCC regime more attractive for investors and consequently align the regime with its objectives (National Treasury, 2014).

Concern has been raised over the fact that qualifying investee companies are not allowed to be controlled group companies. An objective of the VCC regime is for the VCC to provide supportive management services to the qualifying investee companies. Disallowing control was considered to be counter-intuitive to the objectives of the VCC regime because start-up businesses' valuations are low and these businesses will initially require support from an established entity to get their business up and running. Therefore, section 12J of the Act has been amended to clarify that the test of control does not apply outside of the VCC framework. From the outset, it appears that this amendment is counterintuitive to the objective of the VCC regime as the VCC is not encouraged to provide supportive management services to the qualifying investee company. However, due to this amendment, nothing prevents the qualifying investee company from obtaining these supporting management services from an anchor entity which will have more time and resources available to assist the SMME. Therefore, it can be surmised that this amendment provided the SMME with an opportunity for growth.

In addition, prohibiting the qualifying investor from controlling the VCC aligns the VCC regime with its objective of pooling funds from various investors. However, it is unclear how such a requirement will further enhance investments made in SMMEs as the no control requirement of the qualifying investee company already provides for the diversification of the VCC's investments.

From the amendments above, it can be seen that National Treasury clearly wanted to align the VCC regime with its objectives. These amendments were positive policy amendments for the VCC industry and from the statistics discussed above, it is clear that the VCC regime did not have much effect until these amendments were made.

6.4 The shortcomings identified with regard to section 12J of the Act, if compared to the United Kingdom EIS/VCT regimes.

Before getting entangled in the hype of an investment, which is partially funded by income tax that would have otherwise been paid to SARS, the investor should consider certain intricacies and limitations associated with the VCC regime, which could suppress the attractiveness of this regime (Butchart, 2019).

Chapter 5 critically compared the venture capital tax relief measures available in South Africa with those available in the United Kingdom. It can be concluded that the construct and objectives of the South African VCC regime are very similar to the United Kingdom EIS and VCT regimes (Zuccollo, 2019). In both South Africa and the United Kingdom, investors who invest in qualifying investee companies, regardless of the manner in which such investment should be made, receive liberal tax reliefs for such investments. As mentioned above, despite the similarities, there are significant differences between the South African and the United Kingdom venture capital regimes that are important to recognise in a comparative analysis of these regimes.

There are various factors, which could ultimately deteriorate the efficacy of the VCC regime, which should be considered by the investor, before making an investment decision. From the theory discussed in Chapter 3, and the critical comparison of the venture capital tax relief measures available in South Africa with those available in the United Kingdom, as per Chapter 5 of this study, it can be concluded that the main factors that could influence a potential VCC investor's investment decision, are as follows:

6.4.1 VCC regime aimed at high-net-worth individuals or corporates

Most VCCs require a minimum investment amount and, therefore, to fully benefit from the VCC regime, the investor is envisaged to be someone who is taxed at the maximum marginal South African income tax rate. The investor should have sufficient taxable income to claim the entire investment as a tax deduction in the year of assessment in which the VCC shares are acquired, after considering other tax concessions such as investments in retirement funds and tax-free investments (Butchart, 2019). Furthermore,

in terms of the VCC regime, the taxpayer cannot carry over, the tax deduction not yet claimed as a result of insufficient taxable income in the year of assessment in which the investment was made, to a subsequent year of assessment. This gives rise to a possible shortcoming in the VCC regime, such that the regime is aimed at high-net-worth individuals or at corporate investors, and therefore, low-income individuals do not necessarily obtain the full benefit of the regime.

6.4.2 Tax benefits for investors

One of the more profound differences between the VCC regime and the EIS/VCT regimes is the maximum tax relief granted to investors.

The tax deduction in terms of the VCC regime is limited to the amount in respect of which the taxpayer is at risk for (i.e. generally 100 percent of the consideration paid for such investment). A taxpayer is deemed to be at risk to the extent that the incurring of expenditure, or the repayment of any loan or credit used to finance the expenditure incurred to subscribe for VCC shares, would result in economic loss to the taxpayer (National Treasury, 2019a). However, this deduction is limited to R2.5 million per annum for individual investors (natural persons and trusts) and R5 million per annum for corporate investors (Standing Committee on Finance, 2019b). The limitation to the upfront tax deduction could result in investors no longer being able to claim, as a tax deduction, the full amount of the investment. Consequently, the upfront tax benefit is limited to R1.125 million for individual investors and R1.4 million for corporate investors (Howell, 2019).

In terms of the VCC regime, the investor will further be liable for dividends tax on any dividends received from the VCC, and CGT on capital gains realised upon disposal of the VCC shares (Mazansky, 2019). It is further noted that, in most instances, the entire proceeds received by the investor upon disposal of the VCC shares would be subject to CGT, due to the reduction in the base cost of the VCC shares, which could reduce the IRR of the investment (Portfolio Committee on Finance, 2008).

Investors in EIS's or VCTs can claim an income tax deduction of up to 30 percent of the consideration paid for such investment, however, the total annual investment made by the investor within these regimes is limited to £1 million for an investment in a non-knowledge-intensive EIS, and £200 000 for an investment in a VCT (Meakin, 2018a & Meakin, 2018b).

Due to the time value of money principles, a 100 percent upfront tax deduction in terms of the VCC regime results in a more attractive investment for investors when compared to the EIS or VCT regimes. However, adding a limitation to the initial tax deduction could result in the IRR of the VCC investment to decrease if the investor wants to invest more than the proposed limit per annum.

The EIS, as well as the VCT regimes, allows the investor to disregard any CGT arising as a consequence of the disposal of the shares in the VCT or qualifying investee company (Meakin, 2018a & Meakin 2018b).

The EIS regime further allows for a loss relief which determines that the investor can set-off any capital loss derived from the disposal of EIS shares, from its income of a revenue nature (Crowdcube, 2019).

It is concluded in Chapter 5 of this study that, if the investment does not return any dividends over the investment period, and if the investor does not invest more than the proposed limit per annum, the IRR of an investment in terms of the VCC regime might exceed that of the EIS and VCT regimes, regardless of the CGT relief provided. This result is due to the 70 percent differential in the upfront deduction in terms of the VCC regime versus that of the EIS and VCT regimes.

An investor in the VCT regime will not be subject to any dividends tax on distributions made by the VCT. It is concluded in Chapter 5 of this study that, if the investor does not invest more than the proposed limit per annum, the IRR of an investment in terms of the VCC regime might exceed that of the EIS and VCT regimes, regardless of the dividends tax relief provided. Again, this result is due to the 70 percent differential in the upfront deduction in terms of the VCC regime versus that of the EIS and VCT regimes.

It can, therefore, be concluded that the CGT, capital loss relief and dividends tax relief provided for in terms of the EIS and VCT regimes does not necessarily contribute towards a more favourable regime than what is already enacted in South Africa. It is further noted that a limitation to the initial deduction in terms of the VCC regime could result in a decrease of the IRR of a VCC investment. However, it is evident that if a dividends tax relief is combined with a CGT or capital loss relief, it could result in an increase of the IRR of a VCC investment, even if the initial tax deduction is limited. Therefore, a possible shortcoming of the VCC regime is that a high upfront tax benefit is provided to taxpayers to increase the uptake of the VCC regime, but no tax benefit is provided during and upon

disposal of the investment. This results in a high upfront cost to the fiscus, the associated benefits of which will only be apparent in a later stage of the VCC life cycle.

6.4.3 VCC structure and tax liability possibly affecting the returns of its investors.

In South Africa, investors can only obtain a venture capital tax relief if investments are made in VCCs, whereas in the United Kingdom, investors have the option to either invest directly in the qualifying investee company or to invest in a VCT. In terms of the VCC regime, the investor relies on the VCC manager to manage the investment, and the VCC manager is ultimately responsible for the returns on the investment (Lessem, 2018).

It is found that some VCCs focus on the promotion of a tax benefit granted to investors rather than focusing on the underlying investment portfolio, the investment strategy supporting the VCC's investment portfolio, and how the strategy will deliver long-term financial growth to the economy (Lessem, 2018).

In terms of the United Kingdom VCT regime, once approved as a VCT, the VCT will not be subject to income tax or dividends tax on dividends received from qualifying investee companies. The VCT will further not be subject to any CGT if any capital gains are realised upon disposal of the shares in the qualifying investee companies. (Meakin, 2018b). The VCC will be subject to CGT at an effective rate of 22.4 percent on any capital gains realised (ENSAfrica, 2014). Therefore, a potential shortcoming of the VCC regime is that the CGT paid by the VCC itself will reduce the amount that can be distributed as dividends to the VCC shareholders, which could result in a decrease of the IRR of the shareholder's VCC investment (ENSAfrica, 2014).

If the VCC does not continue to meet to the requirements to be approved as a VCC or if any investor holds more than 20 percent of any class of VCC shares, SARS can withdraw the status of the VCC and tax the VCC at 125 percent on all funds received from its investors. Therefore, an investor's return is at risk if the VCC does not adhere to its requirements of, *inter alia*, ensuring that there is an adequate spread of investment in and by the VCC and that the VCC invests in the appropriate qualifying investee companies within the prerequisite timeframe (Mazansky, 2019). This provision results in a possible shortcoming of the VCC regime, such that the investor's returns are affected if the VCC does not adhere to its requirements.

The investor in the VCC has a five-year investment lock-up period, while there is currently no investment lock-up period for the VCC. Therefore, the VCC can alter its investment portfolio at any time during the qualifying investee's investment lock-up period. If the objectives of the VCC regime are to encourage equity funders to invest in SMMEs and to promote the establishment and growth of SMMEs, a possible shortcoming to the VCC regime is that an investment lock-up period is imposed on the investor but not on the VCC itself.

The VCC has 48 months, from the qualifying investor's investment, to invest the funds received in qualifying investee companies. Furthermore, there is no requirement for the VCC to distribute its investment returns to its investors. This could result in a possible shortcoming of the VCC regime. Firstly, the qualifying investor's funds could be held in a fund for up to four years, with no real establishment and growth of SMMEs. Secondly, the investor's investment returns could be affected if the VCC does not invest the funds it received in qualifying investee companies, or does not distribute investment returns to the investor.

Given the fact that the VCC regime is in its growth phase, it might be difficult to reduce the period of which the VCC is entitled to hold funds. The VCC has to ultimately accumulate sufficient funds to ensure that the appropriate amount of funds could be invested in the SMME to enable the SMME to grow. Furthermore, if the investment amount per qualifying investor is limited, it might be more difficult for VCCs to accumulate sufficient funds to ensure that the appropriate amount of funds is invested in the SMME and that there is a sufficient spread of investments in the VCC's investment portfolio. However, if the VCC is an established fund and has a certain amount of assets under management not invested there is shortcoming that a qualifying investor's funds could be unduly held up in this fund.

Therefore, the overall shortcomings to the VCC structure are firstly, that the qualifying investor does not have the option to invest directly in an SMME whilst still obtaining a tax benefit for the investment, secondly, that all VCCs regardless of their age and size have four years to invest funds received in a qualifying investee company, and lastly that the conduit or trust principle does not apply to the VCC itself, resulting in possible decreased returns for the investor, which could deteriorate the efficacy of the VCC regime.

6.4.4 Qualifying investee companies' limitations

A possible shortcoming to the VCC regime is that it does not allow a company with a South African permanent establishment to qualify as a qualifying investee company. In

terms of certain double tax agreements, a non-resident company with a permanent establishment in South Africa might be subject to income tax in South Africa (ENSafrica, 2016). A South African permanent establishment could also contribute to a reduced unemployment rate in South Africa (Integrate immigration, 2015).

6.5 Recommendations for the possible improvement of the VCC regime

Based on the outcomes of the literature review conducted in this study, and with the aim of reaching the objectives identified in Chapter 1 (see paragraph 1.4 of this study), it is evident that specific amendments could be made to section 12J of the Act to possibly improve the current VCC regime. Based on the shortcomings identified above, recommendations for the possible enhancement of the VCC regime are discussed below. These recommendations aim to improve the policy design of the VCC regime, to ultimately promote the growth of South African SMMEs.

- As indicated in Chapter 3 of this study, section 12J of the Act went through a myriad of amendments since its enactment. It is concluded, in 6.3.3 above, that the VCC regime is in its growth phase and the VCC regime has only started to achieve its objectives in the last five years of the regime. Therefore, it is recommended that the sunset clause of the VCC regime is extended, to allow the benefits of the VCC regime to fully materialise.
- It is recommended that the taxpayer should be able to carry over, to a subsequent year of assessment, the tax deduction not yet claimed as a result of insufficient taxable income in the year of assessment in which the investment was made. This suggested amendment would ensure that the investor is entitled to the full tax benefit in terms of the VCC regime, and therefore, aligns the regime with its objective of reducing the risk of the investment in SMMEs by increasing the IRR of the investment.
- Based on the latest amendment to the limitation to the initial tax deduction, it is evident that National Treasury is concerned with the initial cash outflow of the VCC regime. It is therefore recommended that the upfront deduction should be limited to a percentage of the amount of the investment and that further relief in the form of dividends tax and CGT should be provided, instead of posing a monetary limit to the initial upfront tax deduction. Should it not be conducive to provide further relief in the form of dividends tax and CGT, it is proposed that:

- provision is made for an anchor investor who could obtain the full tax benefit of an investment equal to 20% of a certain class of VCC shares, and to limit the remaining investor's tax benefits; or
- an accelerated tax allowance is provided, over three years, for amounts invested above the initial investment limit (Standing Committee on Finance, 2019a).
- It is recommended that similar to the United Kingdom EIS regime, the taxpayer should have the option to either invest directly in the qualifying investee company or to invest in the qualifying investee company through a VCC.
- It is recommended that the period of which VCCs could retain funds received by its shareholders, should be reduced if the VCC reaches a certain age and has an excess amount of uninvested assets under management.
- One of the objectives of the VCC regime is to create a structure whereby investors could pool their funds in the VCC. Therefore, it is recommended that the VCC should be taxed based on a conduit or trust principle. The VCC should not be taxed on investment income that will be taxed in the investor's hands. The VCC should also not be taxed on capital gains as a result of the disposal of shares in qualifying investee companies, if the investor is taxed on the capital gains as a result of the disposal of the VCC shares. The VCC should effectively only be taxed on any investment returns retained by it exceeding a certain period. However, this suggestion is based on the fact that no dividends tax or CGT relief is provided to the qualifying investor.
- The investor's returns are affected if the VCC does not adhere to its requirements. The penalty imposed on VCCs, which is ultimately a cost to the VCC investor, is against the objective of the regime of reducing the risk of the investment in SMMEs. It is, therefore, recommended that each investment decision of the VCC should be approved by a majority vote from the VCC investors and VCC management, to ensure that the VCC investors and VCC management are mutually responsible for ensuring that the VCC adheres to its requirements.
- To further ensure that the investor's returns are not affected by the decisions from the VCC, the VCC should be required to distribute a percentage of the investment

returns from its investments in the qualifying investee companies, to its shareholders.

- Consideration should be given to adding a requirement that the qualifying investee company should obtain advance assurance from SARS that there is an element of risk involved in investing in the qualifying investee company, thereby avoiding abuse of the VCC regime.
- To promote the establishment and growth of SMMEs, it is recommended that VCCs be required to retain its investment in the qualifying investee company for a certain period and a South African permanent establishment should be included in the ambit of qualifying investee companies.

6.6 Limitations of the study and recommendations for future research

This study focused on the amendments to section 12J of the Act to align the VCC regime with its objectives and further focused on a comparison between the South African and the United Kingdom venture capital regimes.

It was not the objective of this study to provide a detailed analysis of how the VCC regime has directly impacted the South African economy. It was further not the objective of the study to provide a detailed analysis of how the United Kingdom venture capital regimes have directly impacted the United Kingdom economy.

Further research could also be conducted based on other countries' venture capital tax relief measures to enable researchers to make recommendations to National Treasury regarding the current venture capital tax relief measures or other possible relief measures which could be implemented to stimulate growth in the South African SMME market.

Before the VCC regime's sunset date is reached, further research is required regarding the direct impact of the VCC regime on the South African economy or similar regimes in other countries' economies. The proven success or failure of a venture capital regime could be considered by National Treasury in its future policy decisions.

As mentioned in Chapter 3, section 12J was amended so that the initial tax deduction for the taxpayer be limited to R2.5 million for individual investors and R5 million for corporate investors. The limitation amendment has faced criticism by established VCCs and the venture capital association as it is argued that the limitation would require VCCs to expand on its number of investors which could limit the sustainability of these VCCs.

Furthermore, the limit could result in corporate investors losing interest in the VCC regime as the investment benefit thereof will be inexpedient (Standing Committee on Finance, 2019b). Future research can be conducted on the actual impact of such limitations on the VCC industry.

6.7 Concluding remarks

With effect from the 1st of July 2009, in terms of section 12J of the Act investors (any taxpayer) can claim an upfront income tax deduction in respect of the expenditure incurred in exchange for the acquisition of VCC shares. The overall objective of the VCC regime was to encourage the establishment and growth of SMMEs.

The VCC regime is, however, often criticised for being tax-inefficient (SAIT, 2017). Therefore, this study focused on addressing the research question: Does the current South African VCC regime achieve its underlying objectives and can the regime, in its current form, achieve these objectives in the future?

As currently written, the VCC regime would expire on the 30th of June 2021. From the research conducted in this study, it is evident that the VCC regime only started meeting its objectives during the last five years of the regime, post significant amendments to section 12J of the Act. It is therefore recommended that the sunset clause of the VCC regime be revised based on the fact that to date the VCC industry did not have policy certainty and the economic impact of the VCC regime has not yet been fully assessed.

Even though amendments were made to align the VCC regime to its objectives, several shortcomings in the South African VCC regime are noted when compared to the United Kingdom venture capital regimes. This is especially true with regard to the tax relief provided to VCC investors. In light of the shortcomings identified, the study included various recommendations to improve the current section 12J of the Act.

It can, therefore, be concluded that if National Treasury considers extending the sunset clause of the VCC regime, some improvements should be incorporated in the current section 12J of the Act, in order to enable the VCC regime to fully achieve its objectives and make a lasting impact on the South African economy.

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