



# Tax Alert

June 2019

## Section 12J: Do your due-diligence before investing

In the current economic climate, individuals have limited disposable income to invest. Many South Africans are favouring shorter-term investments such as section 12J investments for the chance to reap higher returns. Section 12J investments are enhanced by the attendant up-front tax deduction. Given the greater uncertainty inherent in section 12J venture capital investments, they are typically considered as “higher-risk” in the market. But such investments may in fact be more uncertain than anticipated given National Treasury’s clamp down of the abuse of the section. Taxpayers are urged to obtain tax advice before investing in section 12J structures.

Access to equity finance is one of the largest challenges to economic growth for small and medium-sized businesses and junior mining companies. In order to address this, a venture capital regime (section 12J of the Income Tax Act) was implemented during 2009 to incentivise investment in such companies. The objective of section 12J was to create and maintain employment, grow the economy and ultimately the tax base. Section 12J was introduced with a sunset clause that takes effect on 30 June 2021. It is not clear at this stage whether the incentive will be extended.

### Mechanics of Section 12J

Upon investment in an approved Venture Capital Company (“VCC”), a taxpayer is entitled to claim an income tax deduction in respect of the expenditure actually incurred to subscribe for VCC shares. For example, if an investor subscribes for shares in an approved VCC for R100 000, that taxpayer will be entitled to an income tax deduction of R100 000 against his/her taxable income.

At marginal tax rates this means in effect the investor yield is computed against an investment of 55%. The deduction can be claimed upon receipt by the investor of an investor certificate from the VCC (to the extent a loan or credit was utilised by the taxpayer to finance the acquisition, certain limitations apply). The up-front tax deduction, in essence, compensates the investor for the inherent risk linked to the investment and enhances any potential returns.

However, it should be noted that where the taxpayer claims an income tax deduction in terms of section 12J, the taxpayer will be required to reduce the base cost of the VCC shares by the amount claimed. Thus, the VCC shares will carry a base cost of zero and on exit from the investment the taxpayer will be liable for capital gains tax on the full

proceeds received.

### Review of the section 12J Regime

The value of venture capital investments grew by 33% to R1.160 billion in 2017 according to the SAVCA 2018 Venture Capital Industry Survey. The popularity of these investments is clear, and understandable given the high tax burden on individuals. However, National Treasury is reviewing section 12J to prevent abuse of the section.

Section 12J was intended to facilitate investment into so-called “pooled schemes” (where the risk and return is spread amongst the underlying qualifying companies of the VCC). However, it appears that many VCC are in fact structured as “targeted schemes” (where the risk and return of an investor is linked to one or a few specific underlying qualifying companies under the VCC umbrella).

National Treasury has identified certain abusive behaviours due to the mismatch between the growth in venture capital investment compared to the 12J deductions claimed by taxpayers. These include:

- Trading between the VCC investor that has invested in a VCC and a qualifying company in which that VCC takes up shares;
- The VCC shareholder having beneficial control through shares in a VCC or voting rights/participation in the underlying qualifying company; and
- An existing business being broken up into several segments which essentially replicates the existing business where the current shareholders get the benefit of an upfront 12J deduction that they would not have otherwise been entitled to.

National Treasury has made amendments to section 12J (effective 1 January 2019) to limit these abusive structures. More amendments are expected to further limit the application of the section, which may well impact the viability of certain companies as VCCs, which would have a significant impact on the return on investment for investors.

Whilst there are many valid and reputable VCC's that have been established, whose mandates are aligned with the intention of section 12J, taxpayers are urged to obtain tax advice if they are considering making a 12J investment.

### For more information, contact:



**Alan Field**

Director: Corporate Tax

KPMG SA

T: +27 83 419 2021

E: [alan.field@kpmg.co.za](mailto:alan.field@kpmg.co.za)



**Jenna Mason**

Associate Director: Corporate Tax

KPMG SA

T: +27 63 682 1387

E: [jenna.mason@kpmg.co.za](mailto:jenna.mason@kpmg.co.za)



**Gemma Henry**

Tax Manager: Corporate Tax

KPMG SA

T: +27 79 512 9950

E: [gemma.henry@kpmg.co.za](mailto:gemma.henry@kpmg.co.za)

[Privacy](#) | [Legal](#)

[kpmg.co.za](http://kpmg.co.za)

You have received this message from KPMG in South Africa.

© 2019 KPMG Services Proprietary Limited, a South African company and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ('KPMG International'), a Swiss entity. All rights reserved.

