

**A Study of the Section 12J Venture Capital Company Regime as a
Capital Procurement Instrument for Small Medium and Micro Enterprises**

Mini-dissertation by

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Submitted in partial fulfilment of the requirements for the degree

Master of Laws / Legum Magister

(by coursework)

in the

Faculty of Law

University of Pretoria

Pretoria

South Africa

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October 2014

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Abstract

The significance of this academic research emanates from the difficulty small, medium and micro enterprises encounter in capital procurement. These enterprises warrant attention due to the indelible contribution they make towards the South African economy, These enterprises are faced with a multitude of encumbrances inhibiting them from growth and, in some instances, causing their unsustainability. The difficulty in capital procurement is identified as one of the momentous encumbrances. Capital procurement at the early stages of an enterprise's development is imperative to the success of the enterprise. An inability to procure sufficient venture capital is cited as a predominant factor contributing to the failure of a multitude of small medium and micro enterprises.

In light of this, the South African venture capital provisions were introduced in section 12J of the Income Tax Act in order to encourage investment into small medium micro enterprises as a measure to address the capital procurement difficulty these enterprises are faced with. However, section 12J has been unsuccessful to date.

This study purports to encourage the reform of the venture capital provisions as enacted so that it achieves the purpose for which it was created. In an effort to achieve this, consideration must be had to the bureaucratic environment in which small, medium and micro enterprises exist, regulatory incentives that have been created to encourage the sustainability and development of small medium enterprises and other incentives that have been designed to render support to this sector. Furthermore, the pragmatism of the use of tax incentives to address economic ills is envisaged in order to substantiate the necessity for the venture capital provisions.

In order to effectively reform the venture capital provisions, it is imperative that the venture capital investment procedure be comprehended. This warrants the synopsis of the venture capital procedure provided for in this study. An analysis of the venture capital provisions and its shortfalls is also provided. These shortfalls primarily take the form of the restrictions imposed on the type of small, medium and micro enterprises to which investments may be directed, restriction imposed on the venture capital company and the lack of powers vested in the Commissioner to withdraw a company from venture capital company status and the penalties that may be imposed thereafter.

In an effort to reform the venture capital provisions, a brief observation of foreign jurisdictions with similar tax incentives is provided with the intention providing possible alternatives to the reformation of the current section 12J.

Chapter 1:

SMMEs and Venture Capital Necessity

1 1 Introduction

*“The stimulation of SMMEs must be seen as part of an integrated strategy to take this economy onto a higher road - one in which our economy is diversified, productivity is enhanced, investment is stimulated and entrepreneurship flourishes...”*¹

This statement made by the Department of Trade and Industry in the *National Strategy for the Development and Promotion of Small Business in South Africa* White Paper Discussion Paper (hereinafter referred to as “the White Paper”), holds true today, almost twenty years after the statement was made.² The White Paper was adopted in order to create an environment conducive to the accelerated growth of Small Medium Micro Enterprises (hereinafter referred to as “SMMEs”), a sector that had previously been suppressed by the dominance of large, capital-intensive firms.³ As a matter of fact, the disparity in the capital capacity of SMMEs is one of the issues which the White Paper sought to address.⁴ In lieu of this, several incentive schemes were created in order to assist SMMEs in the procurement of capital. These incentive schemes took the form of financial assistance,⁵ incentives and tax incentives. Section 12J of the Income Tax Act⁶ (hereinafter referred to as “section 12J”), is an incentive that was introduced to enable small business to diminish the capital

¹Department of Trade and Industry *National Strategy for the Development and Promotion of Small Business in South Africa* White Paper Discussion Paper Government Gazette 16317, Notice Number 213 of 28 March 1995 (hereinafter referred to as the *White Paper on National Strategy for the Development and Promotion of Small Business in South Africa*, 1995) Foreword.

²National Planning Commission *The National Development Plan Vision for 2030* Policy Document (hereinafter referred to as the *National Development Plan 2030*) recognises the need for further support of small business through the development of support structures, financial and otherwise, including the easing of regulatory burdens in order to promote employment. *The National Development Plan* further recognises the need for the innovative creations which the SMME sector is believed to be the source of, F Herbst *An Investigation of The Product Life Cycle Concept as an Instrument in Marketing Decision-Making for Selected Small Organisations in Africa* Phd Thesis University of Pretoria (hereinafter referred to as *An Investigation of the Product Life Cycle Component as an Instrument in Marketing Decision-Making* (2001)) (2001) thesis. Further see Department of Trade and Industry *Integrated Strategy for Small Business Development in South Africa 2004-2014* Policy Document (hereinafter referred to as the *Integrated Strategy for Small Business Development in South Africa*) available <http://www.dwaf.gov.za/WAR/documents/IntegratedSmallBusinessStrategyOct03.pdf> accessed 12 August 2013 .

³*Integrated Strategy for Small Business Development in South Africa*.

⁴*White Paper on National Strategy for the Development and Promotion of Small Business in South Africa* 1995 paragraph 2.3.

⁵The term financial assistance is not used in its ordinary form, but refers to financial grants provided by the government to eligible enterprises, in terms of the various scheme provided for by the Department of Trade and Industry as observed on the following website www.dti.gov.za.

⁶Income Tax Act 58 of 1962 (hereinafter referred to as “Act 58 of 1962”).

procurement deficiency they are faced with. Although some of these incentive schemes have been successful, section 12J has not delivered its anticipated result to date.⁷

The failure of section 12J is undesirable and requires immediate reconsideration. In order to increase investments, particularly into those made into SMMEs, policy intervention is required.⁸ Furthermore, where such policy intervention has occurred, it is important that legislation be developed in order to give effect to the policy. This is in accordance with the constitution that gives the president the power to develop and implement national policy⁹ and the recognised responsibility on cabinet to develop policy and initiate legislation based on such policy.¹⁰ Section 12J is an example of such legislation that was introduced in order to give effect to policy developed for the advancement of SMMEs.¹¹

It is important that legislation be effective and that it achieves the objectives for which it was created. The fundamental test to ascertain whether legislation is drafted in a proper manner is to determine whether the legislation implements the policy objectives in an effective manner.¹² Section 12J was introduced in order to allow SMMEs to procure capital. However, to date this section has been unsuccessful in this regard as depicted in the lack of registrations under the regime by companies that provide venture capital.¹³ Therefore it is important to amend section 12J in a manner that will enable to achieve the objectives for which it was created.

This study concerns itself with section 12J, how it advances the agenda developed in the White Paper, its content, why it has been unsuccessful to date and how it may be rectified taking into

⁷ For a further discussion regarding the failure of section 12J, refer to chapter 4 of this study. See Further L Mitchell *South Africa New legislation: Taxation Laws Amendment Act 24 of 2011 Commentary Continuation* Income Tax Reporter 51 2012 part 5 (July 2012) (hereinafter referred to as L Mitchell *South Africa New legislation: Taxation Laws Amendment Act 24 of 2011 Commentary Continuation*). J Zulman and M Preiss *Legislation and Policy Memoranda 2011 Explanatory Memorandum on the Taxation Laws Amendment Bill 2011 3 Income Tax: Business Income Tax Practice Manual* (2011) (hereinafter referred to as J Zulman and M Preiss *Legislation and Policy Memoranda 2011 Explanatory Memorandum on the Taxation Laws Amendment Bill 2011 3 Income Tax: Business*).

⁸ *World Investment Report Global Value Chains: Investment and Trade for Development* (2013) page 82.

⁹ Section 85(e) of the Constitution of the Republic of South Africa.

¹⁰ *Sidumo & another v Rustenburg Platinum Mines Ltd & others* (2008) JOL 20811 (CC) page 102. See further Department of Arts and Culture: Cheadle Thompson and Hayson Inc. Attorneys *Review of Heritage Legislation: A final Report* " page 14 Policy determinations are not legislative instruments and in order to bind provinces or the public, national policies must normally be reflected in laws or regulations".

¹¹ *White Paper on National Strategy for the Development and Promotion of Small Business in South Africa*, 1995 in particular.

¹² V Thornton *Drafting Tax Legislation* (2012 revision) page 18 available <http://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch3.pdf> accessed 12 August 2013.

¹³ L Mitchell *South Africa New legislation: Taxation Laws Amendment Act 24 of 2011 Commentary Continuation* Income Tax Reporter 51 2012 part 5 (July 2012). See further J Zulman and M Preiss *Legislation and Policy Memoranda 2011 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 3. Income Tax: Business Income Tax Practice Manual* (2011).

consideration similar sections developed in other jurisdiction. In order to successfully investigate this section, regard must be had to the circumstances in which it operates.

Section 12J was designed as a pooling mechanism for investors to channel funds into small business and junior mining operations.¹⁴ Therefore and investigation into this section encompasses a three stage analysis. Firstly, it is important to ascertain why this section is necessary. This entails the creating of a narrative which provides insight into the SMME domain. The second stage involves a synopsis of the investor that the section hopes to attract and investigations into whether tax legislation is an effective tool to this end. Lastly, an investigation into section 12J would prove itself futile if it is not aimed at providing recommendations that will rectify the section's shortfalls. Therefore the third stage encompasses an analysis of the content of section 12J and how the section may be improved. This will include identifying the apparent problems that may be ascertained on a face value analysis of the section, further, it will encompass an investigation into foreign jurisdiction which contain had similar, but, effective provisions.

1 2 Background

Notwithstanding the challenges identified in the White Paper, which continues to prevail today, the SMME sector has made a profound contribution towards the South African economy over the years. SMMES play an important role in the economic and social development of many countries, including South Africa. It is estimated that SMMEs contribute 60 per cent towards South Africa's gross domestic product.¹⁵ Further, SMMEs account for 70 per cent of private sector employment¹⁶ and have the potential to further alleviate the current 25.2 per cent unemployment rate¹⁷ and in turn, strengthen the economy. However, despite the unfathomable contribution SMMEs make to the economy, they are nevertheless confronted with a multitude of challenges. These challenges have such bearing on SMMEs, that five out of seven SMMEs are said to fail¹⁸ within their first year of establishment,¹⁹ in addition, nine out of ten SMMEs fail to exist for a period longer than ten years.²⁰

¹⁴ Minister of Finance *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2009* Bill Number: B10-2009 (hereinafter referred to as the *Explanatory Memorandum, 2009*) page 73.

¹⁵ Finweek Staff *Fragmented Approach to Assisting SME's is Inefficient* (2012) Finweek (hereinafter referred to as *Fragmented Approach to Assisting SME's is Inefficient, 2012*) available <http://finweek.com/2012/11/13/fragmented-approach-to-assisting-smes-is-inefficient/> accessed 6 January 2013.

¹⁶ *Fragmented Approach to Assisting SME's is Inefficient 2012.*

¹⁷ Statistics South Africa *Quarterly Labour Force Survey: Quarter 1 (January to March 2013)* Statistical release P0211 available http://www.statssa.gov.za/news_archive/Docs/QLFS_Press_statement_Q1_2013.pdf accessed 26 August 2013.

¹⁸ The term "fail" refers to instances where an SMME can no longer be considered as "commercially viable" P Nemaazhe *Retrospective Analysis for Failure causes in South African Small Business* Ph.d Thesis, University of

Each SMME and the circumstances around its existence are unique to it. It is therefore a difficult task to truly ascertain the prevailing reason to which the failure of SMMEs may be accredited. Ascertaining reasons why SMMEs fail is important in the endeavour to remedy the sectors failure. To this end, several studies have been conducted in an attempt to determine the factors that lead to the failure of SMMEs.²¹ The most prevalent factors identified by academics include, poor management, excessive government regulations and inadequate financing.²²

It is believed that SMMEs often do not have the necessary professional expertise required internally and this often leads to their bankruptcy.²³ Poor management may occur at various stages throughout the lifecycle of an SMME and often takes the form of a mismanagement of capital and sales, an inability to effectively manage the growth rate of the SMME resulting in issues of production and of a strategic nature and, an inability to compete effectively within their respective markets.²⁴ To an extent, the inability to comply with government regulations may be attributed to poor management. However, the costs of having to comply with these regulations poses an additional problem, which heightens the inadequate financing SMMEs are faced with. For purposes of this study, it is this lack of access to adequate financing that is of primary concern.

Despite research evidencing otherwise, a view exists that a lack of access to financing is no longer the cause for the failure of SMMEs, but a lack of skills.²⁵ However, this view is held particularly with reference to the practice of sustaining SMMEs through tender procurement.²⁶ This practice is said to deprive the SMME owner an opportunity to acquire skills through experiencing the “*start-up, early*

Pretoria (2009) (hereinafter referred to as the *Retrospective Analysis for the Failure causes in South African Small Businesses* (2009)) page 50.

¹⁹ L Peyper *Small Business Statistics “Scary”* Finweek 16 May 2013 available from <http://finweek.com/2013/05/16/small-business-statistics-scary/> (hereinafter referred to as *Small Business Statistics “Scary”* (2013)) accessed 14 July 2013.

²⁰ C Rootman & J Krüger *Adapting SMME Business Functions During Economic Turmoil* Acta (2010) Commercii 107. See also D Mahadea & M Pillay *Environmental conditions for SMME development in a South African Province* South African Journal of Economic and Management Sciences 114 (2008).

²¹ For a detailed analysis of the reasons why SMMEs fail, refer to *Retrospective Analysis for Failure causes in South African Small Business* (2009).

²² F Herbst *An Investigation of The Product Life Cycle Concept as an Instrument in Marketing Decision-Making for Selected Small Organisations in Africa* Phd Thesis University of Pretoria (hereinafter referred to as *An Investigation of the Product Life Cycle Component as an Instrument in Marketing Decision-Making* (2001)) (2001) page 109.

²³ *An Investigation of the Product Life Cycle Component as an Instrument in Marketing Decision-Making* (2001) page 109.

²⁴ *Retrospective Analysis for Failure causes in South African Small Business* (2009) page 72.

²⁵ Van Vuuren *Lack of skills failure of SMME* (hereinafter after referred to as the *Lack of skills failure of SMME*) Polity available <http://www.polity.org.za/article/lack-of-skills-the-reason-for-small-business-failure-2013-04-19> accessed 1 October 2013.

²⁶ Odendaal *Lack of skills The Reason for Small Business Failure* 2013 available www.polity.org.za accessed 17 August 2013.

*growth and rapid growth steps...*²⁷ inherent to SMMEs. Although this may hold true to some extent, it is submitted that factors contributing towards the failure of SMMEs require a collective analysis because they cannot exist in isolation. For example, an SMME owner who lacks the skills and knowledge to sustain the SMME, will in most instances lack the required skills and knowledge required for the procurement and maintenance of capital. Although the contributing factors to the failure of SMMEs do not exist in isolation, it is important to give each factor due consideration. In light of this, this study will primarily focus on the lack of access to financing and how section 12J may be used to rectify this.

Reasons for the SMME sector's lack of access to finance include, a lack of collateral in order to secure loans from financial institution,²⁸ such as banks, and a perception that an investment in a SMME, is accompanied by a risk too high for a financial institution or any investor, to bear willingly.²⁹

In an effort to remedy the SMME sector's inability to raise sufficient capital, government has placed diverse incentive schemes aimed at assisting SMMEs in procuring capital. However, these incentive schemes are not without their limitations and ineffectiveness. Albeit some of these incentives will be briefly discussed, the most important to this study is the Venture Capital Company Regime (hereinafter referred to as "the VCC regime") created by section 12J.³⁰ The VCC regime was designed in order to assist small businesses to procure capital by creating an investment incentive that would channel funds into small businesses and mining operations.³¹ The regime was modelled in accordance with the private equity model.³² However, it disregards certain elements of private equity and this shortcoming has led to its failure.³³ The nature of private equity and the elements of this model that were disregarded in the drafting of section 12J will be elaborated on in Chapter 4 of this study. As a result of its ineffective drafting, this section has not achieved the policy aims as developed in the white paper.

1 3 Problem Statement

²⁷ *Lack of skills failure of SMME.*

²⁸ Section 1 of the Financial Services Board Act, 2004 (Act No.26 of 2004) defines a financial institution as, amongst others, a bank that meets the definition contained in section 1 (1) of the Banks Act, 1990 (Act No. 94 of 1990). For purposes of this study, reference to a financial institution is only limited to those institutions recognised as banks in terms of the Financial Services Board Act, 2004.

²⁹ Task Group of the Policy Board for Financial Services and Regulation *SME's Access to Finance in South Africa* (hereinafter referred to as *SME's Access to Finance in South Africa*) page 2 available <http://www.treasury.gov.za/publications/other/Access%20to%20Finance%20in%20South%20Africa%20-%20A%20Supply-Side%20Regulatory%20Review.pdf> accessed 17 April 2012.

³⁰ Act 58 of 1962.

³¹ *Explanatory Memorandum, 2009* page 73.

³² Minister of Finance *Explanatory Memorandum on the Taxation Laws Amendment Bill 2011* (hereinafter referred to as the *Explanatory Memorandum, 2011*) Bill Number: B19-page 75.

³³ *Explanatory Memorandum, 2011* page 75.

SMMEs are considered high risk investment options and are characterised by insufficient collateral and an unsatisfactory credit record, and thus it is often difficult for SMMEs to obtain funding from financial institutions.³⁴ According to empirical data³⁵ collated on the basis of questionnaires that were responded to by 95 participants representing 102 funds, it is observed that of the total investments made into enterprises in the year 2012, only 5.76 per cent were made as venture capital investments.³⁶ This poses a challenge towards the furtherance of the SMME sector. In order to facilitate further development, it is imperative that SMMEs be provided with an alternative avenue, such as venture capital firms, to raise capital. There are a variety of funding programmes and financing schemes that are made available to SMMEs by the government, however, these schemes have had limited success to date³⁷ and this emphasises the need for venture capital firms, *albeit* it alone cannot solve all the problems SMMEs are faced with. Some of the reasons why these schemes have been unsuccessful include; a lack of awareness amongst small business owners, an uneven distribution of available funds to mainly metropolitan areas, unjustified high costs of searching for support services which are not mitigated by effective information on how and where to access support and burdensome administrative requirements of which result in user fatigue and high levels of disappointment.³⁸

The success of the use of tax provisions in directing investment into a sector may be evidenced by section 12I of the Income Tax Act (hereinafter referred to as section 12I).³⁹ Section 12I was introduced in order to procure investment into manufacturing assets in an effort to improve the productivity of the South African manufacturing sector and to encourage the skills development in an effort to improve labour productivity. Section 12I has resulted in the growth of the manufacturing sector by 55 per cent to date.⁴⁰ This sets precedence for the view that if tax legislation is correctly drafted, it has the potential to give effect to the policy objectives for which it was created. Therefore section 12J has the potential to encourage investment into SMMEs and alleviate the challenge this

³⁴ *SME's Access to Finance in South Africa* page 2.

³⁵ KPMG & SAVCA.

³⁶ Venture capital investment in this particular study refers to investments made as seed capital or into start-ups (enterprises that have been in existence for a period of one to two years) and as early stage investments p

³⁷ National Credit Regulator *Literature Review on Small and Medium Enterprises' Access to Credit and Support in South Africa* page 42 available

http://www.ncr.org.za/pdfs/Literature%20Review%20on%20SME%20Access%20to%20Credit%20in%20South%20Africa_Final%20Report_NCR_Dec%202011.pdf accessed 30 May 2012.

³⁸ A Berry *et al* Trade and Industrial Policy Strategies *The Economics of SMMEs in South Africa* (hereinafter referred to as *The Economics of SMMEs in South Africa*) <http://www.tips.org.za/files/506.pdf> accessed 30 May 2012.

³⁹ Act 58 of 1962.

⁴⁰ Department of Trade and Industry 2012/13 *Incentive Performance: Selected Projects* (hereinafter referred to as the *Incentive Performance 2012/13*) page 32 available <http://www.thedti.gov.za/publications.jsp?year=&subthemeid=> accessed on 29 September 2013.

sector faces in capital procurement. Thus the aim of this study is to determine how section 12J can be amended in order to achieve the policy objectives for which it was created. The effectiveness of tax incentives in the procurement of investment is evident throughout history. For example, in 1995 the Netherlands created a green investment policy which lowered capital tax rates on the investment in renewable energy and this initiative helped mobilise 5 billion Euros of investment capital in its first ten years.⁴¹ In 1994 the United States established tax credits and capital gains tax breaks to investors who invested in projects situated in poor neighbourhoods. These tax breaks and credits amounted to a mobilization of more than 16 billion dollars in direct investment and an addition 200 billion dollars leveraged investment. These are but a few examples of the important impact tax have on investments.

1 4 Methodology

Methodology is essential in constructing a plausible argument. The purpose of developing a methodology is to provide the consumers of the information with insight as to how the conclusions stipulated were derived.⁴² Given the nature of this study, qualitative methodology and a comparative methodology will be employed. A qualitative methodology is appropriate because it involves an inductive thematic analysis.⁴³ An inductive thematic analysis is the process where textual data is collected and interpreted and applied to the research topic in question. A comparative methodology is appropriate because it is employed as a means to a goal.⁴⁴ The goal in this instance is ascertaining how section 12J may be amended in order to give effect to the objectives for which it was created. In order to successfully satisfy this goal, a comparative study of foreign jurisdictions with similar, yet more successful provisions, is appropriate.

1 4 1 Qualitative methodology

The qualitative methodology will encompass the analysis of legislation, case law, discussion documents foreign legislation, books, journal articles and news reports. What is both an impetus and snag to this study is that there is a scarcity of academic literature addressing section 12J and thus in the analysis of section 12J, little reference will be made to academic literature criticising the section

⁴¹Eurosif1 *Netherlands* available <http://www.eurosif.org/sri-resources/sri-country-resources/netherlands> accessed 17 August 2013.

⁴² E Hofstee *Constructing a Good Dissertation* Sandton South Africa: EPE 2006 page 107.

⁴³ G Guest E Namey & M Mitchell *Collecting Qualitative Data: Qualitative Research Defining and Designing* (2013) Sage Publications (hereinafter referred to as *Collecting Qualitative Data: Qualitative Research Defining and Designing* (2013)) page 2 available at http://www.sagepub.com/upm-data/48453_ch_1.pdf accessed 12 October 2013.

⁴⁴ *Collecting Qualitative Data: Qualitative Research Defining and Designing* (2013) page 13.

and the primary basis for its criticism will be its ineffectiveness in practice, a face value analysis also taking into account legislative drafting principles and informal writings criticism the section.

1 4 2 Comparative methodology

Although this study does not contain a comparative analysis, in certain instances, reference will be made to foreign jurisdictions only to the extent that such a reference is necessary to provide a synopsis of the foreign influence depicted in the section 12J, and further, the successes and failures of provisions similar to section 12J in foreign jurisdictions.

1 5 Dissertation Overview

Chapter 2 provides a definition of SMMEs and the challenges they are faced with. The definition of an SMME is often provided with reference to multiple criteria considerations. Some of the most commonly used indicators to establish whether an enterprise qualifies as a SMME include; the number of employees, the ownership structure, the turnover, the balance sheet total, the capital base, the legal form as well as the types of activities.⁴⁵ Due to the fact that this study entails an analysis into a tax provision, the definition will be made with reference to tax legislation. An analysis into the factors contributing to the failure of SMMEs is not an analysis that can be done in isolation. Although this study concerns itself primarily with the addressing of capital procurement challenges, other contributing factors will be briefly discussed and how they have been addressed thus far.

Due to the fact that section 12J is a tax incentive, chapter 3 discusses the appropriateness of the use of tax incentives to achieve policy objectives. This chapter will briefly provide reasons in favour of and against the use of tax incentives to remedy economic ills.

Chapter 4 entails a discussion of section 12J. It provides a historical overview of how section 12J came about and why it is said that it was designed in order to achieve policy objectives. It also includes a discussion of venture capital, (the type of investment the section aims to procure), a synopsis of the section 12J provisions and the how this section has been amended to date.

Chapter 5 contains a study of the shortfalls contained in section 12J. Chapter 6 contains recommendations as deduced from the study and conclusions.

1 5 Delimitations imposed on study

⁴⁵A Jousten *SMEs and the Tax System: What Is So Different about Them* (2007) CESifo Forum 8 (2) page 14 available <http://www.cesifo-group.de/portal/pls/portal/docs/1/1191658.PDF> accessed on 01 June 2012.

Delimitations are essential to this study because the challenges faced by SMMEs are wide and diverse and in order to effectively investigate section 12J, which is aimed at addressing the SMME sector's lack of access to finance, the discussion must be limited to elements specifically related to access to finance and in particular (tax considerations directly linked to access to finance).

The primary focus of this study is an investigation into section 12J and how this section aims to assist SMMEs, in light of the existing programmes with a comparable end in mind, its shortfalls and what may be done to further improve this section. It must further be noted that this study does not concern itself with the provisions specific to junior mining companies as some of the challenges faced by this sector are innate to it and thus warrant a separate study in order to be comprehensively addressed. In addition to section 12J, this study will make reference to other challenges faced by the SMME sector, and how these challenges have been addressed.

Tax legislation on its own cannot be used to rectify all economic ills. It is important to give due consideration to the circumstances in which such an incentive will exist because the circumstances will influence the success or failure of the said legislation. Thus before an investigation into section 12J, it is important to give a brief synopsis of the circumstances in which this section will have to find effective standing. These circumstances will be made with a brief reference into what challenges the SMME sector is faced with and the measures that have been employed to date in order to address these challenges.

Chapter 2:

Definition of Small Medium-Micro Enterprises and challenges faced by this sector

2 1 Introduction

In order to place this study into context, it is imperative that a description of SMMEs be provided. There is no uniformly accepted definition of a SMME.⁴⁶ The definition will depend on the purpose of its classification.⁴⁷ It will thus vary from statute to statute depending on the purpose of its characterization in that particular statute. The United Nations Industrial Development Organization recommends that in developing the definition of a SMME, policy developers should consider both qualitative and quantitative factors.⁴⁸ Although these considerations are directed at defining SMEs, the same criterion can be applied to micro enterprises. The qualitative factors range from the nature of ownership to the nature in which the business is managed and funded. The quantitative factors include the number of employees, the value of the assets and the turnover of the business. It is therefore difficult to provide a singular unequivocal definition of an SMME.⁴⁹

The application of certain statutory provisions to this business sector is solely dependent on whether or not a particular business entity can be classified as an SMME in accordance with the definition provided in that particular statute. It is essential that statutory measures in favour of SMMEs are based on a common definition in order to improve their consistency and effectiveness.

SMMEs face a range of challenges that thwart any conceivable success. To truly understand why an alternative capital procurement procedure is required, it is imperative to familiarise oneself with the reality that SMME's are faced with. The pressures of bureaucracies imposed on the SMME sector have foiled the growth of SMMEs.⁵⁰ These bureaucracies exist internally within the enterprises and also at a governmental level in the form of excessive regulations. Over-regulation and over-control

⁴⁶J Hill *A multidimensional study of the key determinants of effective SME marketing activity: Part 1* International Journal of Entrepreneurial Behaviour & Research 2001 7 5 (2001) page 171 available <http://www.sie.edu.ac.uk/resources/SIE%20Hill%201.pdf> accessed 11 April 2012.

⁴⁷United States Agency of International Development *Booklet of Standardized Small and Medium Enterprises Definition Sustainable Achievement Of Business Expansion And Quality* (2007) page 6 available http://www.abj.org.jo/AOB_Images/633547381649218750.pdf accessed 17 July 2012.

⁴⁸A Weichenrieder for the Organisation for Economic Co-operation and Development: Centre for Tax Policy and Administration *Survey on the Taxation of Small and Medium Enterprises Draft Report On Responses To The Questionnaire* (2007) page 5 (hereinafter referred to as *Taxation of Small and Medium Enterprises Draft Report*) available <http://www.oecd.org/tax/taxpolicyanalysis/39597756.pdf> OECD accessed 12 July 2013.

⁴⁹*Taxation of Small and Medium Enterprises Draft Report.*

⁵⁰R Scase & R Goffee *The Real World of the Small Business Owner* (1980) London: Croom Helm Dobbs Ferry, NY (hereinafter referred to as *The Real World of the Small Business Owner, 1980*) page p12.

has resulted in the stifling of the business sector.⁵¹ This chapter will provide a brief synopsis of some of the regulatory and non-regulatory obstacles faced by the SMME sector. It further discusses the various ways in which an attempt has been made in order to alleviate these obstacles.

2.2 Definition of a SMME

It is irrefutable that tax legislation has a significant impact on the development of SMMEs. It not only imposes obstacles which SMMEs have to overcome, but it also attempts to facilitate the growth of SMMEs by making provision for certain tax incentives specifically designed to aid entities that qualify as such. Although this research may give attention to other legislative obstacles faced by the SMME sector, its primary focus is on the implication of tax legislation. It is for this reason that a definition of a SMME in accordance with tax legislation must be provided. As stated previously, often, the definition of a SMME will depend on the purpose of its characterisation.

For purposes of taxation, it is evident that the definition of a SMME may differ within the same tax jurisdiction. A definition of an SMME is not contained in the Income Tax Act. Instead, the sixth schedule to the Income Tax Act a definition is provided for in Regulation GNR 639.⁵² These regulations relate to the additional investment and training allowances in respect of industrial policy projects contained in section 12I of the Income Tax Act. Paragraph 1 of the Schedule⁵³ defines a small, medium or micro enterprise as a business which formally employs no more than 200 full-time employees and which has an annual turnover of no more than R50 million. For purposes of this study, the term SMME will be used with reference to this definition.

2.3 Challenges faced by SMMEs

SMMEs contend with a range of challenges that impede their potential growth. *Inter alia*, SMMEs are faced with the challenges of raising capital in order to remain liquid, tax compliance requirements:

2.3.1 Raising capital and liquidity

According to a 2001 study conducted by the Task Group of the Policy Board for Financial Services and Regulation,⁵⁴ start-up companies or small enterprise have difficulty in obtaining access to bank

⁵¹M Meyer *Bureaucracy: How it Kills your Stakeholders and Ultimately your Organisation* Management Today 23 (3) (2007) page 1.

⁵²Paragraph 1 of the Schedule to the GNR639 *Government Gazette* 33385 of 23 July 2010 (hereinafter referred to as GNR 639).

⁵³GNR 639.

⁵⁴S Smulders & M Stiglingh *Annual Tax Compliance Costs for Small Businesses: A Survey of Tax Practitioners in South Africa* (2008) *South African Journal of Economic and Management Sciences* NS 11 (3) page 354. (hereinafter referred to as *Annual Tax Compliance Costs for Small Businesses: A Survey of Tax Practitioners in South Africa, 2008*).

credit due to their non-satisfactory credit record and insufficient collateral attributed to the fact that they are start-up or small enterprises.⁵⁵ Furthermore, the failure of SMMEs can be attributed to the fact that most SMMEs lack an adequate working capital.⁵⁶

Often, SMMEs do not meet the criteria required by financial institution to obtain the required amount of debt finance for long-term growth. This is a result of a lack of appropriate collateral, excessive outstanding debt and lack of proven business skills. Usually, a prospect of credit being granted increases after a lengthy period of time has passed that has afforded the business sufficient opportunity to develop a satisfactory track record. At the earliest development stages, the finance of SMMEs is dependent on the owners and individuals close to them. The inability of SMMEs to procure bank loans is also evident in the recent statistic that depicts a lack of participation by the banking sector in the SMME sector. The South African banking industry consists of 95 recognised banking institutions,⁵⁷ however, only 13 banks provide finance to small and medium enterprises (hereinafter referred to as SME), however, there is no indication how many of these banks also extend finance to micro enterprises.⁵⁸ In determining how many banks extend finance to SMEs, the definition of a SME employed is that contained in the Schedule to the National Small Enterprises Act⁵⁹ which defines and small, medium or micro enterprise with reference to the number of employees, the gross asset value and the turnover of that enterprise.

The legislation governing commercial security is said to be complex and out-dated and does not present efficient secured finance procurement arrangements.⁶⁰ To redress this statutory deficiency would require a comprehensive reform of commercial credit laws. In order for SMMEs to acquire access to alternative capital procurement processes available to them, they require access to information which will enable them to identify potential suppliers of alternative financial services. Unfortunately, this information is not always readily available. International observers consistently conclude that the greater the number of entities that find lending to SMMEs profitable, the higher the level of competition in conventional banking services will be, and the greater the likelihood of

⁵⁵ White paper www.info.gov.za/whitepapers/1995/smallbus.htm accessed 20 April 2012.

⁵⁶ R Monk *Why Small Businesses Fail* CMA Management 74 (6) (2000) page 10.

⁵⁷ 19 registered banks, 2 mutual banks, 13 foreign banks with local branches, and 41 foreign banks with approved local representative offices The Banking Association of South Africa *SME Financial Literacy in South Africa* (hereinafter referred to as SME Financial Literacy) available <http://www.banking.org.za/index.php/our-industry/small-medium-enterprise/south-african-sme-financial-literacy/> accessed 17 September 2013.

⁵⁸ The Banking Association of South Africa *SME Financial Literacy* available <http://www.banking.org.za/index.php/our-industry/small-medium-enterprise/south-african-sme-financial-literacy/> accessed 29 September 2013.

⁵⁹ National Small Enterprises Act 102 of 1996.

⁶⁰ *SME's Access to Finance in South Africa* page 4.

increasing the supply of finance to SMMEs.⁶¹ However these non-financial institutions experience a barrier in entering the market and are also faced with the same problems SMMEs are faced with.⁶²

2 3 1 1 Alternative Capital procurement measures

Since the 1994 democratic elections, the South African Government has concerned itself significantly with issues of economic development. In 1995, a White paper titled the White Paper on National Strategy for the Development and Promotion of Small Business in South Africa (hereinafter referred to as the White Paper) and was said to reflect Government's commitment to a sustainable SMME transformation and development.⁶³ The White Paper contained elaborate policy and strategy framework for SMME development. The strategy contained provisions encompassing pre-start-up and start-up assistance measures to growing enterprises and to assist enterprises in distress.⁶⁴ As a result of the White Paper, several assistance schemes have been developed. It is important to note that the White Paper recognised the need to establish a legal framework to give effect to the policy developed.⁶⁵

The assistance measures developed, and still in place today, take the form of support institutions⁶⁶ incubation programmes, such as the Incubation Support Programme⁶⁷ and the SEDA⁶⁸ Technology Programmes.⁶⁹ Other assistance measures take the form of support structures designed to conduct research and develop solutions for challenges inherent to a particular sector. These include the Co-operative Incentive Scheme⁷⁰ and the Technology and Human Resources for Industry Programme.⁷¹ The assistance measures also take the form of financial assistance and are designed to provide an

⁶¹ *World Investment Report Global Value Chains: Investment and Trade for Development* (2013) page 82.

⁶² *White Paper on National Strategy for the Development and Promotion of Small Business in South Africa*, 1995 Part 4.

⁶³ *White Paper on National Strategy for the Development and Promotion of Small Business in South Africa*, 1995 Foreword.

⁶⁴ http://www.dti.gov.za/sme_development/docs/strategy.pdf page 4

⁶⁵ Par 4.1, further in the Objectives and Principles.

⁶⁶ such as Small Enterprises Development Agency which was established in terms of section of the National Small Business Amendment Act, the Small Enterprise Finance Agency which was established as a result of the merger of South African Micro Apex Fund, Khula Enterprise Finance Ltd and the small business activities of IDC, the National Empowerment Fund Established by the National Empowerment Fund Act No 105 of 1998, Industrial Development Corporation, National Youth Development Agency, Land Bank, Mafisa.

⁶⁷ An incubation programme developing incubators in order to create successful enterprises, it also provides an incentive in the form of a grant subject to limitations.

⁶⁸ Small Enterprise Development Agency.

⁶⁹ 14 Incubators have been created thus far across the country and have supported 314 SMMEs and created 5358 jobs *Incentive Performance 2012/13* page 16.

⁷⁰ 1009 co-operatives have been approved under the Cooperative Incentive Scheme assistance thus far, to the aggregate value of R84.7million *Incentive Performance 2012/13* page 10.

⁷¹ Currently, there is no information available regarding the success of this programme.

alternative method of capital procurement. The financial measures include the Black Business Supplier Development Programme and the Support Programme for Industrial Innovation.⁷²

The Black Business Supplier Development Programme takes the form of a cost sharing grant offered to black-owned small enterprises and was created in order to induce faster growth for SMMEs that exhibit a potential for growth. A further objective of the programme is to facilitate the growth of SMMEs owned by previously disadvantaged persons. This programme was established in accordance with section 11 of the Broad Based Black Economic Empowerment Act (hereinafter referred to as the BBBEE Act).⁷³ Section 11 of the BBBEE Act provides for the minister to issue a strategy for broad-based black economic empowerment.

Black Business Supplier Development Programme was introduced in 2010 and provides for the partial bearing of input costs to a maximum of one million rand per enterprise. However, there are requirements imposed how the one million rand must be demarcated. The grant requires eight hundred thousand rand to be used for the acquisition of machinery and equipment, for an equal amount respectively. The remaining two hundred thousand rand is demarcated for business development and business training interventions in order to allow the enterprises to improve their corporate governance, management, marketing and productivity and modern use of technology.⁷⁴

There is little to no data depicting the effectiveness of this programme to date. As stated in Chapter one, a reason sighted for the overall failure of the incentives created by the Department of Trade and Industry includes an unawareness of their existence by the targeted beneficiaries.⁷⁵

Reasons for the lack of awareness may lie in the legislation enabling the establishment of such an incentive, *i.e.*, the BBBEE Act. In section 11, the BBBEE Act provides that the Minister of Trade and Industry may issue a strategy for broad based economic empowerment. Furthermore section 14⁷⁶ allows the Minister of Trade and Industry to make regulations in order to advance the objects of the BBBEE Act. However, despite the provision empowering the Minister of Trade and Industry to make regulations, the BBBEE Act does not require the Minister to publish the strategy by way of a notice, nor does it mandate the duty to publish any regulations made, in terms of the Act, by way of

⁷²Department of Trade and Industry *Incentives* available http://www.dti.gov.za/sme_development/sme_incentives.jsp?subthemeid=8 accessed 12 August.

⁷³Broad-Based Black Economic Empowerment Act No. 53 Of 2003.

⁷⁴The Department of Trade and Industry *Black Business Supplier Development Programme (BBSDP)* available http://www.thedti.gov.za/financial_assistance/financial_incentive.jsp?id=40&subthemeid=1 accessed 15 August 2013.

⁷⁵*The Economics of SMMEs in South Africa.*

⁷⁶Act No. 53 Of 2003.

Government Gazette publication. This is of particular importance because the Interpretation Act⁷⁷ requires regulations or orders made in terms of any legislation to be published in the *Government Gazette*.⁷⁸ This is also in line with the promotion of public participation in policy development and may be a factor contributing towards the lack of awareness of this programme.

In 1993 the ISC was restructured and renamed the Support Programme for Industrial Innovation. This programme was designed to assist small and very small enterprises in capital procurement and created three types of schemes. The first scheme is the Product Process Development Scheme. This scheme provides financial assistance to qualifying SMMEs.⁷⁹ The objective of the scheme is to promote innovation and the development of technology.⁸⁰

The other schemes created in terms of the programme are the Matching Scheme,⁸¹ which provides which awards the beneficiary financial assistance in the form of a taxable but non-repayable grant, and the Partnership Scheme⁸² which affords the beneficiary a conditionally repayable grant.

In 2011 seven million one hundred rand worth in grants was given in terms of the Product Process Development Scheme, twenty grants to the value of one million one hundred and forty thousand rand per grant were given in terms of the Matching Scheme no grants had been given under the Partnership Scheme, however, the administering of these schemes amounted to a cost nine million two hundred thousand rand (five million eight hundred thousand rand for the Product Process Development Scheme and the Matching Scheme and three million six hundred thousand rand in terms of the Partnership Scheme).⁸³ It is notable that on some occasions, these schemes may become unsuccessful (such as the Partnership Scheme); however, an administration cost in administering these schemes is incurred by government, resulting in inefficiency.

⁷⁷ Interpretation Act 33 of 1957 (hereinafter referred to as Act 33 of 1957).

⁷⁸ Section 16 of Act 33 of 1957 provides “*When any by-law, regulation, rule or order is authorized by any law to be made by the President or a Minister or by the Premier of a province or a member of the Executive Council of a province or by any local authority, public body or person, with the approval of the President or a Minister, or of the Premier of a province or a member of the Executive Council of a province, such by-law, regulation, rule or order shall, subject to the provisions relative to the force and effect thereof in any law, be published in the Gazette.*”.

⁷⁹ SMMEs with a total assets value below five million and a turnover of less than thirteen million rand, and employees below 50.

⁸⁰ Department of Trade and Industry: Support Programme for Industrial Innovation *The Product Process Development (Ppd) Scheme* available http://www.spii.co.za/ppd_intro.html accessed 16 September 2013.

⁸¹ Department of Trade and Industry: Support Programme for Industrial Innovation and Industry *Matching Scheme* available http://www.spii.co.za/matching_intro.html accessed 16 September 2013.

⁸² Department of Trade and Industry: Support Programme for Industrial Innovation and Industry *Partnership Scheme* available http://www.spii.co.za/partnership_intro.html accessed 16 September 2013.

⁸³ Department of Trade and Industry: Support Programme for Industrial Innovation *Annual Report 2010/2011* available http://www.spii.co.za/content/Annual%20Reports/SPII_Annual_Report_2011.pdf accessed 16 September 2013.

Despite government's effort to assist small business in capital procurement, government grants are not a sustainable business finance procurement measure, particularly in instances where these grants are not repayable by the beneficiary. The reasoning behind the creation of non-repayable grants may be that in granting of the loan, government enables the enterprise to grow, and in return for this the enterprise will be better positioned to make a substantial contribution towards the fiscus through the payment of taxes. However, it cannot be left to government to remedy the lack of access to finance SMMEs are currently faced with. It is put forth that government would be better served by creating incentives which encourage the procurement of capital from equity investments, which is what section 12J aims to achieve.

2 3 2 Tax Compliance Requirements

Tax compliance imposes an enormous burden on SMMEs.⁸⁴ Tax compliance cost can be defined as the cost incurred by a business entity in complying with the tax regulations imposed on it.⁸⁵ The smaller the business entity the higher the tax burden becomes.⁸⁶ This is illustrated in the results contained in a study aimed at ascertaining the financial impact of the tax compliance on SMMEs.⁸⁷ A further illustration of the burden imposed by compliance, particularly where tax complexity increases the cost of compliance, is the case of *TML Consultancy CC v Commissioner for the South African Revenue*.⁸⁸ In this case the court had to consider whether the appellant qualified as a small business corporation that fell within the ambit of the turnover tax regime.⁸⁹ The disparity in the impact tax has on an enterprise depending on its size is attributed to the capacity the enterprise has to bear the compliance costs.

Further studies indicate that tax compliance results in a costly compliance burden for SMMEs. In the year 2006, the cost of complying with a multitude of taxation provisions was estimated to amount to 25 per cent of the overall regulatory compliance cost a business had to bear.⁹⁰ This compliance cost is said to include the value of time spent by the managing body, and other persons concerned, on attempting to comprehend the applicable statutory provisions, the cost of keeping adequate records

⁸⁴ Chamberlin & Smith *Recent Findings on Tax-related burden on SMMEs in South Africa* http://www.commerce.uct.ac.za/research_units/dpru/WorkingPapers/PDF_Files/WP_06-PDF Accessed 21 August 2012.

⁸⁵ Turner, Smith & Gurd *Pitfalls in Tax Compliance Cost Research* (1998) Revenue Law Journal 8 (1) article 4.

⁸⁶ S Smulders & M Stiglingh *Annual Tax Compliance Costs for Small Businesses: A Survey of Tax Practitioners in South Africa* (2008) page 356.

⁸⁷ S Smulders & M Stiglingh *Annual Tax Compliance Costs for Small Businesses: A Survey of Tax Practitioners in South Africa* (2008) page 368.

⁸⁸ *TML Consultancy CC v Commissioner for the South African Revenue Service* (12860) [2012] ZATC 1 (hereinafter referred to as *TML Consultancy CC v Commissioner for the South African Revenue Service*).

⁸⁹ An explanation of this tax regime is contained in Chapter 3.

that allow the business to prepare and submit accurate tax returns, the cost of outsourcing the expertise of professional advisors such as consultants, lawyers and accountants and all other costs incidental thereto.⁹¹

The taxes that SMMEs have to account for include value-added tax,⁹² income tax,⁹³ skills development levy,⁹⁴ transfer duty,⁹⁵ pay-as-you-earn tax,⁹⁶ provisional tax⁹⁷ and unemployment insurance fund contributions.⁹⁸ A turnover system of taxation may be considered a tax measure employed in order to ease the tax burden on SMMEs.⁹⁹ In fact, the turn over system of taxation, is not the only tax relief measure that has been employed in order to alleviate the tax burden on SMMEs. The turnover system of taxation may apply to SMMEs if that SMME meets all the requirements of a small business corporation as provided for in section 12E(4).¹⁰⁰ It is suggested that a reduction of the effective tax burden may have a number of economic effects. It may result in a lower average tax burden that attracts foreign investment. A lower tax burden has the potential to stimulate entrepreneurship and risk taking. Companies in low tax countries are better able to be price competitive on international product markets due to a lower cost of capital.¹⁰¹ A lower tax burden also results in financial flexibility which raises investment. In light of the potential economic benefits that may result due to a less burdensome taxation environment, the reduction of the tax burden imposed on SMMEs is worth considering.

2 3 2 1 Provisions Reducing Tax Burden Imposed on SMMEs

It is imperative to note that the Income Tax Act provides for certain allowances and deductions. These deduction are contained in sections 11, 12 and 37 of the Income Tax Act and range from the wear and tear deductions to deductions for improvement costs (however subject to certain statutory requirements). These deductions do not apply exclusively to SMMEs but, regardless they contribute to the reduction of the SMME's taxable income, thus lessening the tax burden imposed. Amongst these deductions is the section 12J venture capital regime. Although information exists regarding the

⁹¹ *Tax Compliance Costs for Small Businesses: A Survey of Tax Practitioners in South Africa* (2008) page 355.

⁹² Imposed by the Value-Added Tax Act 89 of 1991.

⁹³ Imposed by Act 58 of 1962.

⁹⁴ Imposed by the Skills Development Act 9 of 1999.

⁹⁵ Imposed by the Transfer Duty Act 40 of 1949.

⁹⁶ Act 58 of 1962.

⁹⁷ Imposed by Act 58 of 1962.

⁹⁸ Imposed by the Unemployment Insurance Act 63 of 2001.

⁹⁹ Available <http://www.sars.gov.za/TaxTypes/TT/Pages/default.aspx> accessed 12 July 2013.

¹⁰⁰ Of Act 58 of 1962.

¹⁰¹ M Grandes & N Pinaud OECD Development Centre Policy Briefing No.25 *Which Policies Can Reduce The Cost Of Capital In Southern Africa?* page 13 Available <http://www.oecd.org/southafrica/33722694.pdf> accessed 13 October 2013.

success of some of these incentives exist (the success of section 12I and failures of section 12J), there is little data indicating how all of these deductions have assisted in the alleviation of the tax burden imposed on SMMEs.

Despite the existence of the above allowances and deductions, the dense nature of tax legislation and complexities innate to it, make it incomprehensible and difficult for SMME owners to administer these deduction without having to solicit external assistance from tax experts (lawyers and accountants). This does little to ease the administrative burden imposed on SMMEs where collection and compliance is concerned. However, efforts have been made to reduce the administrative burden imposed on SMMEs in the sixth schedule to the Income Tax Act¹⁰² which will be discussed further in chapter 3 of this study.

Aside from the tax burden imposed on SMMEs, there a multitude of other regulatory burdens that are imposed on SMMEs that which often impede on the growth and development of SMMEs. These regulatory burdens are too exorbitant to discuss in detail, however, a brief synopsis of the form they take will is provided below.

2 4 Non-tax related regulatory burden

SMMEs are subject to the same statutory requirements as their larger counterparts. This creates an inequity in view of the lack of resources SMMEs are often faced with. This is because larger entities are often better equipped to comply with regulatory burdens because they have ease of access to more financial and professional resources compared to SMMEs.¹⁰³ The statutory compliance requirements are regressive to the development of small medium enterprise as they place a time and monetary burden that acutely affects the liquidity of SMME's.¹⁰⁴ For purposes of this study, the statutory compliance requirements, in addition to the tax compliance requirements, will be limited to the compliance requirements imposed on SMMEs by the Companies Act,¹⁰⁵ Labour Relations Act,¹⁰⁶ Basic Conditions of Employment Act,¹⁰⁷ Compensation for Occupational Injuries and Diseases Act¹⁰⁸ and the Unemployment Insurance Contributions Act¹⁰⁹ as these are the Acts which have the most regulatory impact on SMMEs and it is thus pertinent that a brief synopsis of these statutes be

¹⁰²Sixth Schedule of Act 58 of 1962.

¹⁰³J Abor & P Quartey *Issues in SME Development in Ghana and South Africa* International Research Journal of Finance and Economics (2010) Issue 39 page 224.

¹⁰⁴ Strategic Partnerships for Business Growth in South Africa *Counting the Cost of Red Tape for Business in South Africa* <http://www.sbp.org.za/index.php?id=23> accessed 1 May 2012.

¹⁰⁵Companies Act 71 of 2008 (hereinafter referred to as Act 71 of 2008).

¹⁰⁶Labour Relations Act 66 of 1995 (hereinafter referred to as Act 66 of 1995).

¹⁰⁷Basic Conditions of Employment Act 75 of 1997 (hereinafter referred to as Act 75 of 1997).

¹⁰⁸Compensation for Occupational Injuries and Diseases Act 130 of 1993.

¹⁰⁹Unemployment Insurance Contributions Act 4 of 2002.

provided. Due to the exorbitant nature of all the statutory provisions business entities are required to comply with, this study will not cover the compliance requirements imposed in detail but will merely provide a brief synopsis of some of the burdens imposed by these statutes.

2 4 1 Company Law

The new Companies Act is aimed at providing a more flexible regime, with a less regulatory burden compared to its predecessor (the Companies Act 61 of 1973).¹¹⁰ However, albeit some of the regulatory encumbrances that were previously imposed by the old Companies Act have been relaxed, the new Companies Act still results in bureaucracies that contribute to the overall statutory compliance burden SMMEs must overcome. The provisions of the Companies Act apply to both large and small entities alike, making a few exceptions for small business entities.¹¹¹

The first regulatory burden imposed by the companies Act on SMMEs Companies and Intellectual Properties Commission (hereafter referred to as the CIPC) requires all companies and close corporations to lodge an annual financial statement along with an annual fee. An annual return is a statutory return in terms of the Companies and Close Corporations Acts and must therefore be complied with. Failure to do so results in the commission assuming that the company or close corporation has not been conducting business, or, has no intention of doing business in the near future. Non-compliance with annual returns may lead to the deregistration of the company or close corporation, which has the effect that the juristic personality is withdrawn and the company or close corporation ceases to exist under the new Companies Act.¹¹²

All companies are required to file a financial return within 30 days after its anniversary of incorporation date together with all the supplementary documents. Upon submission of these financial returns, a company is also required to pay a submission fee of 100 rand if the company has a turnover of less than one million rand, 450 rand if the company has a turnover of more than one million rand but less than ten million rand, 2000 rand if the company has a turnover between ten million and 25 million rand and 4000 rand if the company has an annual turnover of more than 25 million rand.¹¹³

¹¹⁰The BPL Team *How Does The New Companies Act Impact Small And Medium Enterprises?* (2011) <http://www.businesspartners.co.za/forum/topics/how-does-the-new-companies-act-impact-small-and-medium-enterprise> accessed 10 June 2012.

¹¹¹ PSG Corporate *SME's and the Implications of the New Companies Act* available <http://www.psgonline.co.za> accessed 3 May 2012.

¹¹² Section 82 read with section 83(1) and (3) of the Act 71 of 2008.

¹¹³ Companies and Intellectual Property Commission *Annual Return Online Guide* http://www.cipc.co.za/Help_files/HowTo_AR.pdf.

In addition to the annual fees a company is compelled to pay, the CA requires a public company and a state owned company to be audited annually.¹¹⁴ A private company may be audited if it is required to do so by a regulation enacted by the minister of finance provided that the minister believes that the auditing of such a company is in the interest of the public or if it meets the required public inter-score. Assuming that most SMMEs are private companies,¹¹⁵ on a superficial analysis, it would appear that the new CA relaxes the accountability and transparency requirement on SMMEs. However, a practical application of the CA reflects that this is not the case as is explained below.

In order to raise capital, a company can either issue shares or acquire a loan. Section 8(2) of the CA restricts the issue of shares to the public by a private company. An exception is created in terms of regulation 45(2) which provides that an issue of securities below the maximum subscription price of one million rand does not constitute a public offer. However, if a SMME would like to issue shares that exceed the maximum subscription price, it would have to register as a public company and it would then be required to comply with the same accountability and transparency requirement imposed on its larger counterparts. On the other hand, if a SMME chooses to raise capital through the acquiring of a bank loan, it would be required to be audited, in terms standard bank practices, before it is granted such loan. Not to mention that in the case of non-compliance the South African Revenue Services may require a company to be audited.¹¹⁶ Therefore although the new CA aspires to relax some of the compliance requirements, it is clear that SMMEs are still required to comply with the same regulatory burden their larger, more capacitated counterparts bear. However, in an effort to remedy this, some regulatory relief measures have been introduced in favour of SMMEs.

2 4 1 1 Provisions Reducing Company Law Burden Imposed on SMMEs

The Companies Act came into operation in 2011 and one of the features of the Companies Act is that it created less arduous obligations on SMMEs compared to that imposed on large firms.¹¹⁷ The Companies Act creates a point system which sets out the criteria for the exemption from onerous audit requirements in order to ease the regulator burden previously imposed on small business owners. The Companies Act requires an enterprise to hold less than three hundred and fifty points in order for the exemption to apply. It further allows companies with a score of less than one hundred to employ an independent review conducted by anyone who qualifies as an accounting officer.

¹¹⁴Section 30(2)(a) of the Act 71 of 2008.

¹¹⁵C Naget et al *Commercial Law* 4th edition (2011)Durban: LexisNexis page 353 (hereinafter referred to as *Commercial Law* (2012)).

¹¹⁶*South African Revenue Service (SARS) Audi*<http://www.taxconsulting.co.za/sars-audit.php>.

¹¹⁷Department of Trade and Industry *The Companies Act 71 of 2008: An explanatory Guide* (2010) page available accessed.

The scores are determined by various criteria in place. Every 1 million rand in debt financing will amount to one point, every 1 million rand turnover will also amount to one point and every member with a beneficial interest will also amount to one point. Further, a point is also awarded for every set number of employees.¹¹⁸

The easing of audit requirements imposed by company law is the only substantial provision lessening the company law regulatory burden imposed on SMMEs. However, all other provisions in the Companies Act as discussed above which apply to large firms with better capacities, apply *mutatis mutandis* to SMMEs.

2 4 2 Labour Laws

Another legislative domain that has a significant regulatory impact on SMMEs is the labour law domain. The same labour legislation that is appropriate for regulating relations between large employers and their employees, who are usually represented by large trade unions, is ineffective in the regulating of relations between small employers and their employees.¹¹⁹ A large number of cases that are adjudicated by the Commission for Conciliation, Mediation and Arbitration involve small businesses, and most of these cases are for alleged wrongful dismissals. For the purposes of this study, a brief synopsis of the legislative burden imposed by the Basic Conditions of Employment Act (Hereafter referred to as the BCEA) 75 of 1997 and the Labour Relations Act (hereafter referred to as the LRA) will be provided.

The BCEA regulates the basic working conditions that an employer is compelled to provide to its employee in firms with more than five employees. Chapter two of the BCEA sets out the working hours and wages of employees. Parties are prohibited from concluding agreements that alter the standard working hour provisions. This results in an inflexibility that impedes on the small business' efficiency. Another problematic provision of the BCEA is section 198(4) that provides that in the event that a labour broker contravenes the provisions of the BCEA, the labour broker and the employer will incur joint liability. This imposes an unjust liability on SMMEs because SMMEs are often not equipped with the capacity or the knowledge to ensure that the labour brokers they contract with comply with the requirements of the BCEA.

The Labour Relations Act regulates the relationship between the employer and its employee. Some of the most burdensome provisions of the LRA include section 10 that has an unjust consequence on SMMEs which have an elementary understanding of the law. Section 10 provides that a party who

¹¹⁸ Clause 27: *Companies Regulations*, 2011 *Government Gazette* No. 34239 GNR.351 of 26 April 2011.

¹¹⁹ *Commercial Law* (2012) page 457.

alleges that a right or protection conferred by the act has been infringed must merely prove the facts of the conduct in order for a burden of proof to be imposed on the defending party.¹²⁰ It is sufficient for the alleging party to furnish a written statement alleging the conduct for their onus in terms of the LRA to be discharged. This imposes an unjustified burden of proof on the employer who is then required to submit proof that it did not conduct itself in a manner that infringed the Act. Section 16 of the LRA requires all employers to keep adequate financial records that must be disclosed to a trade union representative in order to allow him to perform his functions. This section presents a compliance problem because the LRA does not specify the nature and extent of the information that may be required by the trade union representative in order to allow him to perform his functions. A further regulatory burden imposed by the LRA includes the right awarded to employees to partake in a partial or complete concerted refusal to work or to obstruct work for the purposes of promoting or defending a socio economic benefit. However, SMMEs are often unable to afford the cost of employee participation in most of these actions whilst larger firms are able to absorb the impact of such actions leaving SMMEs at a major disadvantage. The final regulatory burden imposed by the LRA that will be discussed for purposes of this study is the resolution of disputes process under Commission for Conciliation, Mediation and Arbitration. This process is intricate and costly. It was not designed for the purpose of resolving disputes between low-income small employers and their employees. This presents a further regulatory challenge SMMEs have to overcome.

2 4 2 1 Provisions Reducing Labour Law Burden Imposed on SMMEs

Much labour law reform is required in an effort to lessen the regulatory burden imposed on SMMEs. Recent legislative developments indicate a growing use of tax incentives to increase the employment rate. Recently, a new Employment Tax Incentive Bill was introduced and is aimed at encouraging enterprises to employ persons between the ages 19 and 29.¹²¹ However, although related to employment, this Bill does nothing to ease the intensive labour law regulations imposed on SMMEs and merely creates a tax deduction for the employer.

The importance of a properly regulated labour market cannot be ignored. Due to the imbalanced relationship between an employer and employee, if this market was left to govern itself, it is more likely that employees would be subjected to exploitation and would have very little recourse against employers. However, care must be taken not to over regulate this market to the prejudice of business development.

¹²⁰Section 10 Act 66 of 1995.

¹²¹ Department of Finance *Draft Employment Tax Incentive Bill* (2013) Policy Document available http://0-discover.sabinet.co.za.innopac.up.ac.za/all_products#results accessed 10 October 2013.

Regulatory challenges and a lack of access to finance are not the only challenges SMMEs face. SMMEs are often also at a lack of the required knowledge and skills required to sustain business practices.

2.5 Further challenges imposed on SMMEs not financial in nature

Poor management skills are recognized as one of the global disadvantages for SMMEs and contribute to the failure of these entities.¹²² A lack of management training has led to the collapse of many businesses.¹²³ SMME owners often do not possess the management skills required to administer a successful business enterprise. This lack of management skills encompasses a lack awareness and understanding of the market in which the SMME competes. More often than not, SMME owners are unfamiliar with the market factors that have an impact on the development of their enterprises. These market factors include the impact of the location of a SMME, knowledge of competitors, effective marketing strategies and an understanding of customer trends and needs. Their lack of management skills is also evident in their inability to cope with human resource issues. The labour market is highly regulated, as evident from the synopsis provided above. This results in the inability to attract and retain suitable staff, a loss of key employees, low productivity and the inadequate training and development of employees.¹²⁴

From the discussion above, it is apparent that the challenges faced by the SMME sector are significant. However, it is also apparent that Government has implemented several tactics to try and address the challenges faced by the SMME sector. These tactics work concurrently in order to create an environment conducive to the growth and development of SMMEs. In order to further illustrate the necessity of section 12J, the current incentives designed to encourage investment into SMME sector must be envisaged.

¹²² L Boone & D Kurtz *Study Guide for the Contemporary Business* (1996) page 128.

¹²³ J Okpara & D Kabongo *Strategic Management in Small Business Enterprises: Empirical Evidence from Nigeria* (2009) African Journal of Business and Economic Research 4 (1) page 23.

¹²⁴ *The Real World of the Small Business Owner* (1980) page 12.

Chapter 3:

Tax Incentives Policy Considerations

3 1 Introduction: An analysis of the Use of Tax Incentives

The lack of financial support available to SMMEs in South Africa, not only results in a very low venture establishment rate, but also contributes to South Africa's SMME failure rate which is perceived as one of the highest failure rates of SMMEs in the world.¹²⁵ In order to address the lack of sufficient capital procurement faced by the this sector, it is imperative to not only identify the hindrances that continue to persist but also, to identify measures that may be employed in order to effectively deal with these hindrances. Capital procurement methods at the disposal of SMMEs, in addition to the use of venture capital, include the obtaining of bank loans, the use of debt or equity financing, guaranteed loans, donors and funding agencies and the self-finance by the SMME owner. If SMMEs wish to obtain bank loans, they not only have to discharge the burden of proving that they have sufficient collateral,¹²⁶ but they also have to face significant premiums on the interest payable on the acquired loans.¹²⁷ It is also worth noting that banks rely primarily on collateral to mitigate the risks associated with lending money to SMMEs, and often, due to their recent establishment, SMMEs are not capable of providing sufficient collateral.¹²⁸ Similarly, when SMMEs acquire capital through debt financing,¹²⁹ although sometimes relieved from the strenuous requirement of having to provide collateral, aside from the duty to pay back the loan amount, they are also required to pay interest on debentures irrespective of their profitability or liquidity. Although this is not an obligation unique to SMMEs as all enterprises who issue debentures are required to pay interest on the debentures they issue. Another important factor that is worth considering is the impact of the use of debt financing on the SMME sector.

A positive factor in the use of debt financing is that, the returns which are generated, if the loan amounts are properly employed, have the capacity to increase the value of the firm and this outweighs the costs incurred as a result of debt financing. Furthermore, an addition advantage of debt financing is the tax savings that is created due to the tax deductibility of interest payments on loan

¹²⁵ A van A Smit & O Fatoki *Debt Financing To New Small Ventures In South Africa: The Impact Of Collateral Ethics And Legal System* African Journal Of Business Management (2012) page 1144.

¹²⁶ M Mazanai & O Fatoki *Perceptions of Start-up Small and Medium-Sized Enterprises (SMEs) on the Importance of Business Development Services* (hereinafter referred to as *Perceptions of Start-up Small Medium Enterprises* (2012)) Journal of Social Science 30 1 (2012) page 31.

Providers (BDS) on Improving Access to Finance in South Africa

¹²⁷ *SME's Access to Finance in South Africa* page 4.

¹²⁸ A van A Smit & O Fatoki *Debt Financing To New Small Ventures In South Africa: The Impact Of Collateral Ethics And Legal System* South African Journal Of Business Management 2012.

¹²⁹ Debt financing is defined as the provision of finance in the form of a debt instrument.

amounts made by the borrower.¹³⁰ However, these benefits are primarily dependent on the ability of the SMME to employ the debt financing in a manner that will ultimately grow the SMME.¹³¹ There are several factors that determine whether an SMME will generate a positive result from the use of debt financing. These factors include the profit margin of the SMME, the competitive capacity of the SMME, the market size in which the SMME operates and other micro-economic conditions.¹³² SMMEs often have to compete with well-established larger firms, in markets characterised by high levels of competition and with a limited knowledge of such competition factors. In addition to this, their high operating costs often decrease the price competitiveness of SMMEs. These factors have the potential to decrease the profit margin of the SMME. In the event that the profit margin is lower than the before-tax interest on debt, a negative impact results on the return of equity.¹³³ Thus the use of debt financing has the potential to culminate in illiquidity.¹³⁴

Equity financing¹³⁵ on the other hand, offers the ability to raise capital without the burden of having to provide collateral and bear significant interest payments. Equity financing only entitles the holder of such equity, to a dividend payable at the option of the SMME, therefore there is no obligation on the SMME to pay out a dividend at a predetermined time, unless it is agreed upon. This may also constitute a disadvantage because the investor is placed in an uncertain position regarding whether or not they will receive a return on their investment. The issue of equity also does not require collateral because it merely amounts to a personal right obtained by the equity holder against the company which entitles the holder of the share to dividends payable by the company.¹³⁶

¹³⁰F Olawale G Herbst1 & M Roberts-Lombard *An Investigation into the Impact of the Usage of Debt on the Profitability of Small and Medium Enterprises in the Buffalo City Municipality* South Africa (2010) *African Journal of Business Management* 4(4) (hereinafter referred to as *An Investigation into the Impact of the Usage of Debt on the Profitability of Small and Medium Enterprises in the Buffalo City Municipality* (2010)) page 373.

¹³¹B Kotey *Debt Financing and Other Factors Internal to the Business* *International Small Business Journal* page 15.

¹³² *An Investigation into the Impact of the Usage of Debt on the Profitability of Small and Medium Enterprises in the Buffalo City Municipality* (2010) page 376.

¹³³ *An Investigation into the Impact of the Usage of Debt on the Profitability of Small and Medium Enterprises in the Buffalo City Municipality* (2010) page 375.

¹³⁴ *An Investigation into the Impact of the Usage of Debt on the Profitability of Small and Medium Enterprises in the Buffalo City Municipality* (2010) page 376.

¹³⁵ Equity financing is not defined in the Income Tax Act 58 of 1962. However, section 1 of Act 58 of 1962 defines *equity share* as "any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution" in other words, an equity share is an ordinary share in a company.

¹³⁶ *Macaura v Northern Assurance Co Ltd* [1925] a where Lord Buckmaster "in the present case limited to a share in the profits while the company continues to carry on business and a share in the distribution of the surplus assets when it is wound up "in *Colontial Bank v. Wliinney*, 11 A.C. 420, Fry L. J., said: "In case of a corporation the individual corporations have no direct interest in the closes in possession; they have the benefit of an obligation existing between the company and themselves, a close in action".

It is observed that most investors prefer to make use of debt financing as opposed to equity.¹³⁷ As holders of debentures, the investors are, in essence, equated to creditors of the company. A benefit awarded to debenture holders is that, whether the debenture is secured against the property of the company or not, it nevertheless places the holder of the debenture in the same position as a creditor of that company, which is a far more secure position compared to that of an equity holder.¹³⁸ Furthermore, debt financing offers the investor better tax benefits which are discussed below.

Needless to say, the innate alluring nature of debt financing to an investor, and the effects it has towards an SMME, as discussed above, petition for measures that must be developed and implemented in order to diminish the use of debt financing and to increase the use of equity financing. A measure that may be employed in order to address the use of debt financing and to encourage the use of equity invested into the SMME sector is the use of tax incentives.¹³⁹ Tax policy has a significant influence on the decisions of an investor. It influences decisions regarding the types of investments undertaken and the manner in which these investments are financed.¹⁴⁰ There is a need for an incentive that promotes the undertaking of SMME investment, and that encourages investment in the form of equity as opposed to debt.

The use of tax incentives to encourage investment is a contentious issue. However, several features of a tax system have the ability to influence the level of investment. These features include the tax rates, the tax treatment of the depreciation of an asset and the tax treatment of capital income (i.e. interest, dividend and capital gain).¹⁴¹ Despite the *prima facie* importance of tax incentives, it is still important to consider whether or not the use of tax incentives is damaging towards an economy.

3 2 Argument in support of the use of tax incentives

The effectiveness of tax incentives in procuring investment is a point of moot. It is alleged policy-makers possess an unjustified belief in that tax policy has the ability to influence investment procurement.¹⁴² This belief is said to be unjustified because there is little empirical evidence to

¹³⁷William H *Debt Financing for High-Growth Companies* available <http://entrepreneurship.org/resource-center/debt-financing-for-highgrowth-companies.aspx> accessed 17 September 2013.

¹³⁸R Beuthin & S Luiz *Basic Company Law Part 1: Companies Registered Under the Companies Act: Chapter; 20 Loans and Debentures* (2000) Durban : Butterworths page 147.

¹³⁹ Taxation is often used to address issues that are not tax in nature because tax has the ability to effectively address these non-tax related issues as depicted in the recent success of the incentives created in section 12I as discussed below.

¹⁴⁰R Stretch *A Review of the Role of Tax Incentives* February (2001) Taxgram (hereinafter referred to as *A Review of the Role of Tax Incentive*, (2001)).

¹⁴¹*A Review of the Role of Tax Incentives* (2001) page.

¹⁴²H Zee, J Stotsky and E Ley *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002) World Development Bank 30 9 (hereinafter referred to as *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002))page 1497.

substantiate the view that tax policy has the capacity to influence investment.¹⁴³ However, it submitted that to consider a lack of evidence, in support of the effectiveness of tax incentives in investment procurement, as evidence to prove the ineffectiveness of such incentives, would amount to a fallacious *argumentum ad ignorantiam*.¹⁴⁴ It must be emphasised that it is not the intention of this study to indorse the callous use of tax incentives as an antidote for all economic ills, it merely seeks to put across that tax incentives are a vital tool that may be employed in order to redress the difficulty in venture capital procurement faced by the SMME sector.

There is a scarcity in empirical evidence indicating the effectiveness of tax incentives. This fact is often stated as a mitigating factor in arguments against the use of tax incentives in an effort to influence investment procurement. However, there is existing evidence which reflects that properly structured tax incentives have the capacity to procure sectorial investment. For example, in 2008, Section 12I of the Income Tax Act was introduced. This section was introduced in order to cater for Greenfield investments (i.e. new industrial projects that utilise only new and unused manufacturing assets) as well as Brownfield investments (i.e. expansions or upgrades of existing industrial projects).¹⁴⁵ As a result of this investment incentive, the manufacturing sector has grown by 55 per cent. This incentive has allowed the government to leverage 32 billion rand in investments. It has also resulted in 3326 direct jobs and 72219 indirect jobs.¹⁴⁶ Therefore it is evident that if a tax incentive is properly structured, it has the capacity to result in a positive economic consequence. Although there are no guarantees that tax incentives will result in the desired objective nor is there a predetermined form which they should take, there are guidelines that may improve the chances of success of such incentives.¹⁴⁷

In addition to the argument of a lack of empirical evidence proving the effectiveness of tax incentives, some of the most prevalent arguments proffered against the use of tax incentives include the following postulation; tax incentives result in economic distortions,¹⁴⁸ they result in a loss of potential

¹⁴³ *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002) page 1497.

¹⁴⁴ To infer the truth of a particular viewpoint based on the lack of evidence to the contrary K Saunders *Informal Fallacies in Legal Argumentation* (1992-1993) South Carolina Law Review 44 page 361.

¹⁴⁵ Minister of Finance *Regulation made under section 12I of the Income Tax Act 58 of 1962 Government Gazette* number 33385 Notice Number 625 Regulation Number: 9336 23 July 2010.

¹⁴⁶ Department of Trade and Industry Budget Vote 36 for the Department of Trade and Industry by Minister Rob Davies (MP), at the Old Assembly Chamber, Parliament on 15 May 2013 available <http://www.thedti.gov.za/editspeeches.jsp?id=2703> accessed 17 July 2013.

¹⁴⁷ A Easson and E Zolt *Tax Incentive* World Bank Institute available (2003) (hereinafter referred to as *Tax Incentives* (2002)) <http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf> accessed 12 May 2013.

¹⁴⁸ *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002) page 1498.

revenue result in legal uncertainty.¹⁴⁹ In an effort to provide a coherent and comprehensive argument for the use of tax incentives in investment procurement, the arguments against will be briefly discussed and proven to be without merit.

3 2 1 Economic Distortions

Tax incentives are said to cause economic distortions because of the disparity in the tax treatment of incentivised investments in comparison to investments subject to “ordinary” tax consequences.¹⁵⁰ However, investment incentives by their very nature are meant to distort economic behaviour. They are designed to procure investment that would have otherwise not been procured, *sine quo non* the tax incentive.¹⁵¹ Therefore the disparity in tax treatment will only arise if the tax incentive is effective in procuring the desired investment. In other words, tax incentives only distort economic behaviour if the tax incentives created have an impact on economic behaviour. In Section 12J is an illustration of how an economic distortions can only occur if the tax incentive is effective. Section 12J has been unsuccessful thus far, as discussed in Chapter 4 of this study; therefore the existence of the incentive has not resulted in economic distortions because the section has been ineffective achieving the result for which it was created.

3 2 2 Loss of Potential Revenue

It is further argued that tax incentives are ineffective¹⁵² and result in a loss of revenue because they cause a reduction in the potential revenue that would have otherwise been acquired, had it not been for the incentive.¹⁵³ This notion may hold true in cases where incentives are needlessly created, however, as discussed earlier, an undeniable need for an alternative, more accessible capital procurement means is required for the SMME sector. Another aspect that this point of criticism fails to concede to is the fact that any loss of revenue that may occur as a result of the investment incentive may be compensated for by the growth and success of the investee SMME, which will be better positioned to contribute more to the tax base as a result of such growth. Further, if tax incentives are indeed ineffective in attracting investors, then revenue is not forgone because the tax incentive cannot

¹⁴⁹ *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002) 1498.

¹⁵⁰ *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002) page 1500.

¹⁵¹ *Tax Incentives* (2002) page 2.

¹⁵² *Tax Competition Fdi Growth* page 182.

¹⁵³ *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002) page 1501.

simultaneously be harmful and ineffective. Unless it enables investors who would have made the investment regardless of the tax incentive are able to unduly benefit from the incentive.¹⁵⁴

Loss of revenue has been directly linked with the type of tax incentive granted. Some tax incentives are said to result in more forgone revenue than others. For example, accelerated depreciation allowances are said to be very costly,¹⁵⁵ however, they are believed to be less costly than tax holidays or investment allowances because, in the case of accelerated depreciation, it is merely the timing of the payment of taxation that is affected rather than the amount of tax payable.¹⁵⁶ The type of tax incentive offered by section 12J is a favourable deduction for the amount expunged in the acquisition of qualifying interest by the investor.¹⁵⁷ Although the accelerated depreciation amounts to a loss in the fiscus in the year in which the deduction is claimed, the deducted amount is recouped when the investor disposes of the qualifying interest, before the expiration of a three year period, and thus, on face value, the incentive may seem like a deferral in the payment of taxation. However, in this regard, it is important to take note of the time value of money. The time value of money is of relevance because the postponement of tax payment has the potential to ensue in a significant interest cost to the revenue authority.¹⁵⁸ Despite the reference to time value of money in section 8EA(1) paragraph “*preference share*” of the Act, the Act does not encompass a comprehensive definition of time value of money. Thus a definition will be provided with reference to case law. In *Florence v The Government of the RSA*,¹⁵⁹ the Supreme Court of Appeal referred to the change overtime in the value of money. The court stated that the appropriate method to be employed in an effort to determine the time value of money was to adjust the value in accordance with the consumer price index.¹⁶⁰ When tax payment is deferred, the tax payer is afforded an interest savings whilst the revenue authority forfeits any possible interest accruals had the tax not been deferred.¹⁶¹

In determining whether the incentive created in terms of section 12J justifies a loss in revenue the year in which the income is deferred and a forfeiture of interest by the revenue authority, the yields of

¹⁵⁴ *Tax Competition, Fdi And Growth* page 182.

¹⁵⁵ Accelerated depreciation is a scheme that provides for the writing off of the cost of acquisition of an asset at an accelerated rate than the true economic depreciation. Such as those provided by section 12E of the Act 58 of 1962 which provide for a deduction for the depreciation of an allowance asset.

¹⁵⁶ *Tax Incentives* (2002) page 34.

¹⁵⁷ A more elaborate discussion is contained in chapter 4.

¹⁵⁸ D Shaviro *The Forgotten Henry Simons* (2013) Florida State University Law Review 41 page 39.

¹⁵⁹ *Florence v The Government of the RSA* (550/12) [2013] ZASCA page 104.

¹⁶⁰ *Farjas (Pty) Ltd v Minister of Agriculture and Land Affairs & other and another case* [2013] 1 All SA (SCA) page 381.

¹⁶¹ *The Forgotten Henry Simons* page 38.

the incentive must be weighed against the cost such an incentive imposes.¹⁶² As stated above, even though the incentive may result in foregone revenue, it can only do so if it is indeed effective in satisfying the object for which it is created. Thus if it is effective and successful, the amount of foregone revenue will be recovered by the resultant benefits of the incentive.

3 2 3 Cause for Legal Uncertainty

A further point of criticism towards the use of tax incentives in investment procurement relates to legal uncertainty.¹⁶³ It is argued that the introduction of statutory incentives in an effort to entice certain economic behaviour results a greater degree of legal uncertainty.¹⁶⁴ In order to create an environment that successfully attracts investment in any sector, there must be clarity regarding the law.¹⁶⁵ Uncertainty about laws increases the cost of investment and the efficiency with which society conducts its business.¹⁶⁶ The effect of legal uncertainty on investment remains inconclusive and frequently, results show the existence of an insignificant relationship between these two elements.¹⁶⁷ However, it is submitted that in the process of economic development requires policy reform in order create a legal regulatory framework that will allow for such development. Therefore the creation of further legal uncertainty is inescapable.

Despite the arguments that have been put forth in an effort to disprove the points of criticisms that exist regarding the use of tax incentives, it is undeniable that there is no guarantee as to the effectiveness of these incentives. However, there are guidelines that may be employed in order to improve the increase the likelihood of success. These guidelines include:

- The objectives of the tax incentive program should be clearly set out.
- The type of incentive program should be tailored in a manner that best suits the objective

¹⁶² It is worth noting that there is a right associated with the interest saving that arises from the tax deferral that is incidentally bestowed on the taxpayer. This right may be referred to as the right to use interest savings in order to generate further income for the taxpayer. Despite the possibility of ascertaining the monetary value of such a right, this right will remain untaxed and there is currently limited literature in the South African Jurisprudence in this regard. L Ngwenya 2014.

¹⁶³ *Tax Incentives For Business Investment: A Primer For Policy Makers In Development Countries* (2002) page 1501.

¹⁶⁴ A Damato *Legal Uncertainty* (2010) Faculty Working Papers: Paper 108 page 9
<http://scholarlycommons.law.northwestern.edu/facultyworkingpapers/108>.

¹⁶⁵ European Tax Policy Forum: M Zagler *Foreign Direct Investment And Corporate Income Taxation Under Legal Uncertainty* (2010) International Institute for Public Finance, Ann Arbor, Vereinigte Staaten/USA, 15(08) page 3.

¹⁶⁶ W Hirsch *Reducing Law's Uncertainty and Complexity* (1973-1974) University of California, Los Angeles Law Review 21 page 1233.

¹⁶⁷ *Foreign Direct Investment And Corporate Income Taxation Under Legal Uncertainty* page 1.

- The government should anticipate the costs and benefits by observing similar types of investments that have been employed elsewhere
- The incentive should be structured in a manner that does not create a loophole that will give rise to corruption in the granting of the incentive.
- The government should monitor and evaluate the program to determine its effectiveness.¹⁶⁸

In order to understand the necessity of further tax incentives for investment procurement, primarily equity investment, it is important to comprehend the taxation environment of the investor. The following discussion will provide a brief synopsis of how an investor is currently taxed and of the existing incentives designed to procure investment.

3 3 Tax Consequences for the Investor

There is a widespread belief in the existence of a nexus between taxation and economic growth.¹⁶⁹ It is a prevalent practice for governments around the world to use tax policy as a tool for economic policy.¹⁷⁰ As discussed above, tax systems exert a strong influence on the decisions of investors, including the type of investment taken and the manner in which such investment is financed.¹⁷¹ In order to understand why the VCC tax regime is necessary, one needs to understand why the existing tax policy is a deterrent towards SMME investment procurement and why the existing investment incentives are insufficient.

3 3 1 Comparison of Debt Financing and Equity Financing

As stated previously, debt financing is often the preferred form of investment adopted by an investor, when financing an SMME. Reason being, that in addition to the security it offers, any interest payable, to the investor, is exempt from the investor's taxable income for income tax purposes.¹⁷² Debt financing also affords the investee company a deduction for any interest paid, provided it falls within the confines of provisions regulating allowable deductions in the Act.¹⁷³ This is often perceived as an advantage of the use of debt financing because it ultimately reduces the taxable income of the

¹⁶⁸ *Tax Incentives* (2002) page 34.

¹⁶⁹ *How does the New Companies Act impact small and medium enterprises?* <http://www.businesspartners.co.za/forum/topics/how-does-the-new-companies-act-impact-small-and-medium-enterprise> accessed 10 June 2012.

¹⁷⁰ *A Review of the Role of Tax Incentives* (2001).

¹⁷¹ The Impact of Globalisation on Tax Policy and Uses of Tax Incentives, Paper presented to the Portfolio Committee on Finance by the Tax Policy Chief Directorate in the Budget Office of the National Treasury, Pretoria, October 25th 2000.

¹⁷² Section 10(h) read together with section 24J of the Act 58 of 1962.

¹⁷³ Section 11(a) and 23(g) of the Act 58 of 1962.

company which in turn reduces its tax burden. Further, the debt granted does not result in a stake of the investee enterprise, leaving the investee free to conduct its business practices according to its will. However, these advantages often do not outweigh the undesirable impacts debt financing has on the investee enterprise.¹⁷⁴

Debt financing decreases the cash flow of an enterprise because payments to settle the loan must be made regularly. Aside from the disadvantage debt financing has to the investee enterprise, it further has the effect of eroding the tax base because often the interest deductions claimed are subjected to abuse by taxpayers, in an effort to decrease their tax liability.¹⁷⁵ The abuse of allowable deductions in the form of interest on loans has had such a negative effect on the *fiscus* that measures to further limit this form of deduction, in addition to the existing anti-avoidance provisions, are currently being explored.¹⁷⁶ A draft amendment Bill, which seeks to introduce these measures, has been released in a media statement and it sets out the scenarios to which the limitations will apply.¹⁷⁷ In general, the draft legislation seeks to limit tax deductions of interest where the interest is deductible in the hands of the taxpayer paying the interest and is exempt income in the hands of the taxpayer receiving the interest.¹⁷⁸

It is not only in this regard why the encouragement of equity investment is imperative. An analysis into the current incentives created for equity investment indicates that there is a substantial shortage of effective incentives designed to encourage investment into SMMEs of all types despite the existence of the multiple incentives. Below is an indication of the existing tax incentives designed to procure investment.

3 4 Existing Tax Incentives for Equity Investment

Tax incentives for capital procurement are introduced for different reasons. In some instances, the tax incentives may be designed to counterweigh the investment disincentives inherent to that

¹⁷⁴M Negash *Corporate Tax and Capital Structures: Some Evidence and Implications Investment* (2002) page 24 Analysts Journal see further H Ronald Brown Institute for Sub-Saharan Africa: O Matarirano An Investigation into the Impact of Debt Financing on the Profitability of Small (2007) Manufacturing Firms in Bulawayo, Zimbabwe.

¹⁷⁵Department of Finance : National Treasury *Request For Public Comment For Incorporation Into Forthcoming 2013 Tax Laws Amendment Bill: Proposed Limitations Against Excessive Interest Tax Deductions* (2013) page 1 (hereinafter referred to as *Proposed Limitations Against Excessive Interest Tax Deductions* (2013)) available <http://www.sars.gov.za/Media/MediaReleases/Documents/Media%20Release%2029%20April%202013%20-%20Proposed%20limitations%20against%20excessive%20interest%20tax%20deductions.pdf> accessed 13 August 2013.

¹⁷⁶*Proposed Limitations Against Excessive Interest Tax Deductions* (2013)page 1.

¹⁷⁷*Proposed Limitations Against Excessive Interest Tax Deductions* (2013) page 1.

¹⁷⁸*Proposed Limitations Against Excessive Interest Tax Deductions* (2013) page 2.

jurisdiction.¹⁷⁹ Another reason for the introduction of tax based incentives for investment relates to the intention to offset other disadvantages that an investor may face in a particular jurisdiction such as lack of infrastructure, bureaucratic complexities and weak administration. As discussed above, the SMME sector faces an extensive amount of statutory compliance requirements, amongst other hurdles. These statutory requirements may be considered investment disincentives for investors. South Africa is a developing nation and although its infrastructure may be considered incomparable to any other on the African continent, its infrastructure may be considered less than desirable to a potential investor when compared to other developing nations such as Singapore, New Zealand and China for instance. According to a study conducted by the World Bank,¹⁸⁰ South Africa ranks number 43, in the ease of doing business ranking, when compared to 189 countries. The ease of doing business ranking is based on what is termed the distance to frontier score.¹⁸¹ The distance to frontier score is determined by taking, into account, factors such as:

- The procedures, amount of time, money and capital required in order to start a business;
- The procedures, amount of time and money required when obtaining construction permits and electricity;
- The procedures, amount of time and money required in order to register a property
- The rights and bureaucracies pertaining to the acquisition of credit;
- The protection afforded, in terms of regulation, to minority investors;
- The compliance cost associated with tax compliance;
- The cost and bureaucracies associated with cross-border trading; and
- The contractual rights and insolvency procedures recognised in each country.¹⁸²

¹⁷⁹ V Thuroyni Chapter 3: *Drafting Tax Legislation* V Thuroyni (ed.) *Tax Law Design and Drafting* (1994) (Volume 1) page 3 (hereinafter referred to as *Tax Law Design And Drafting: V Thuroyni Drafting Tax Legislation*) International Monetary Fund: Washington DC.

¹⁸⁰ World Bank Group: International Bank for Reconstruction and Development *Doing Business (2015) Going Beyond Efficiency: Comparing Business Regulations for domestic firms in 189 Economies* (2014) 12 (hereinafter referred to as *Doing Business (2015) Going Beyond Efficiency: Comparing Business Regulations for domestic firms in 189 Economies, 2014*) page vii available www.worldbank.org accessed 12 September 2014.

¹⁸¹ *Doing Business (2015) Going Beyond Efficiency: Comparing Business Regulations for domestic firms in 189 Economies* (2014) page 5.

¹⁸² *Doing Business (2015) Going Beyond Efficiency: Comparing Business Regulations for domestic firms in 189 Economies* (2014) page 218.

The study does not take into account the cost implications that inadequate infrastructure may have on doing business, however, it does take cognisance of the availability or lack thereof where such information is relevant in ascertaining the distance to frontier score.

Although tax incentives may be designed to attract investment, legislatures are warned to avoid creating complexity and uncertainty in tax legislation in an attempt to lure investment, as this has the potential to result in the opposite effect.¹⁸³ The tax incentives designed for investment may take the form investment allowances and credits, tax holidays and low tax rates.

3 5 Tax incentives not directed at equity investment

3 5 1 Small business corporations

Section 12E creates a special dispensation for the taxation of entities recognised as small business corporations.¹⁸⁴ This dispensation encompasses a reduced tax rate at which the small business corporation must account for tax. For Income Tax purposes, a small business corporation is classified as a business that has a turnover of less than fourteen million rand, the entity must either be a company or a close corporation, the shareholders or members of the company or close corporation must all be natural persons, the shareholders or members of the company or close corporation must not hold an interest in any other company.¹⁸⁵ Interpretation Note No 9 (issue 5) serves to provide guidance as to the application of the provisions of section 12E with reference to the requirements of a qualifying small business corporation. Section 12E was enacted in order to encourage new ventures and employment creation.¹⁸⁶

The turnover system of taxation is available to SMMEs if that SMME qualifies as a small business corporation as defined in section 12E. The small business corporation is taxed at a reduced rate of taxation. For purposes of income tax, if an SMME has a turnover of less than sixty-seven thousand one hundred and eleven rand, the SMME will be taxed at a rate of zero per cent, however, if the SMME's taxable income exceed sixty-seven thousand one hundred and eleven, but is below three hundred and fifty thousand rand, the SMME will be taxed at seven per cent of the amount above thirty six thousand, five hundred and fifty six rand and if the SMME has taxable income of above three

¹⁸³ *Tax Law Design And Drafting: V Thuronyi Drafting Tax Legislation*) page 2.

¹⁸⁴ *Section 12E and the Requirements for a Qualifying Small Business Corporation*
Taxgram (2004) August.

¹⁸⁵ Section 12(E)(4) of Act 58 of 1962.

¹⁸⁶ TML Consultancy CC v Commissioner for the South African Revenue Service page 12 *also refer to* Interpretation Note No 9 (issue 5) page 5.

hundred and fifty thousand rand, the SMME will be liable for income tax at the normal rate of twenty eight per cent,¹⁸⁷ unless the SMME is registered on a turnover system of taxation.

Furthermore small business corporations which carry on the trade of manufacturing are allowed to deduct the full cost of expenditure incurred for the acquisition of machinery in the year of assessment in which the asset was brought into use by the taxpayer. They are also permitted to claim an accelerated depreciation for any machinery plant at fifty per cent of the cost price in the year that asset was brought into use, thirty per cent in the succeeding year and twenty per cent in the second succeeding year.¹⁸⁸

3 5 2 Reducing the administrative burden imposed on SMMEs; a synopsis the Sixth Schedule of the Income Tax Act

The turnover tax system came into operation in 2009 and it is regulated by section 48 of the Income Tax Act and the sixth schedule to the Income Tax Act. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill¹⁸⁹ the turnover tax system was introduced in order to decrease the compliance and administrative burden imposed by tax legislation on micro enterprises. Micro enterprises are defined as businesses with a turnover of up to one million rand per annum. When a business is registered for turnover tax, the business is then exempted from ordinary income tax, capital gains tax, dividend withholding tax and value added tax. The micro business however remain liable for payroll taxes such, *id est*, Unemployment Insurance Fund Contributions and Pay-As-You-Earn.

3 6 Tax disincentives

Not only should consideration be given to the creation of tax incentives for business-angel investments¹⁹⁰ but the existing disincentives should also be removed in order to increase South Africa's attractiveness as an investment jurisdiction. This should be done in order to correct the

¹⁸⁷Income tax tables for small businesses and turnover tax rates for the 2012/2013 and 2013/2014 years available <http://www.sars.gov.za/AllDocs/OpsDocs/Tables/IT-GEN-01-TBL03%20-%20Tax%20Rates%20for%20Companies%20and%20Small%20Businesses%20for%202013%20and%202014%20-%20External%20Table.pdf> accessed 17 September 2013.

¹⁸⁸Interpretation Note No.9 (issue 5) 14 October 2009 further, see *Small Business Corporations and Micro Businesses; Income Tax And Capital Gains Tax*.

¹⁸⁹Minister of Finance (National Treasury) *Explanatory Memorandum on the Revenue Laws Amendment Bill* (2008) page 55 .

¹⁹⁰The term "Business Angel Investor" refers to those individuals who back new entrepreneurial ventures with promising business plans. They are the largest source of real risk capital in the country and the least understood. In fact, outside the major financial centres, they are often the only source of risk capital for the entrepreneur available <http://www.investorsnetwork.co.za/blog/viewpost/47> accessed 14 March 2012.

market failure in the provision of equity to SMMEs. There are a number of tax and regulatory disincentives for the provision of such funding in South Africa, which should be removed.¹⁹¹

Priority should be given to the removal of obstacles and disincentive provisions. These disincentives are said to take the form excessive provisions relating to debt financing which discourage the establishment of financial services providers focused on the SMME sector. It is argued that an equally important consideration needs to be had to the disincentives inherent to the fiscal policy.¹⁹²

¹⁹¹*SME's Access to Finance in South Africa.*

¹⁹²*Tax Incentives* (2002) page 2.

Chapter 4:

The Venture Capital Company regime under the Income Tax Act

4 1 Policy Derivative of Section 12J

The White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 encompasses a multitude of tax reform propositions aimed at creating an environment conducive to the growth and development of SMMEs.¹⁹³ These measures included a lowered corporate tax rate for small enterprises,¹⁹⁴ a depreciation allowance,¹⁹⁵ exemptions from import duties or rebates from import duties on manufacturing inputs,¹⁹⁶ tax incentives to do away with a [then] perceived gender bias towards SMME's owned by women¹⁹⁷ and the normalisation of SMME taxes in arrears¹⁹⁸ a non-compliance once-off amnesty,¹⁹⁹ tax incentives for the granting of loans by the banking sector, training institutions and higher write offs for expenses incurred in the compliance with tax regulation.²⁰⁰ The tax reform measures were specifically targeted at; easing the tax burden imposed on SMMEs, encouraging large business enterprise support, encouraging the granting of loans by financial institutions and the inclusion of the SMME sector in the industrial-development incentives granted under the Regional Industrial Development Programme (which is governed by the Regional Industrial Development Programme Act 187 of 1993 and is aimed at economic growth through the provision of financial incentives).²⁰¹ For purposes of this study the most significant pronouncement made in the White Paper on National Strategy for the Development and Promotion of Small Business in South Africa 1995, was the recognition that a further investigation was required in

¹⁹³White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 par 4.12.

¹⁹⁴White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 4.12.1.

¹⁹⁵ A multitude of depreciation allowances have been introduced, not only to facilitate SMMEs but for other entities.

¹⁹⁶White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 4.12.3.

¹⁹⁷White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 4.12.7.

¹⁹⁸White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 4.12.8.

¹⁹⁹White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 4.12.6.

²⁰⁰White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 4.12.5.

²⁰¹J Drewes and D Bos *The Regional Industrial Development Programme an Evaluation* South African Journal of Economics 63(2) pages 137–148. Furthermore, see White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 4.12.10.

an effort to establish an appropriate tax incentive, similar to the United Kingdom's Business Expansion Scheme in order to encourage investments into SMMEs.²⁰²

In 2005, the Integrated Strategy on the Promotion of Entrepreneurship and Small Enterprises: Unlocking the Potential of South African Entrepreneurs²⁰³ (hereinafter referred to as the Strategy on Integrated Small Enterprise Development, 2005) was developed in a further attempt to facilitate and foster the growth and development of SMMEs. The Strategy on Integrated Small Enterprise Development established three areas of strategic action in an effort to achieve its purpose. These areas of strategic action included, amongst others, an increase in the supply of financial and non-financial support to the SMME sector.²⁰⁴ The most profound pronouncement made in the Integrated Small Enterprise Development, 2005, similar to that in the White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995, is a commitment to further investigate tax incentives to encourage investment into SMMEs by entrepreneurs, family members and friends.²⁰⁵

In light of the Government's agenda to assist the procurement of capital by SMMEs, as depicted in the White Paper and the Strategy on Integrated Small Enterprise Development, 2005, section 12J, the venture capital company tax regime, was introduced into the Income Tax Act, in 2008, by the Revenue Laws Amendment Act.²⁰⁶ This is evidenced by statement made in the White paper requiring the establishment of an incentive similar to the BES.

²⁰² White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 par 4.12.12 expressly states that a further investigation must be conducted in an effort to incept an incentive similar to the business expansion scheme for the investment into small businesses. The BES was introduced in 1983 and was a tax-based incentive created with the objective of encouraging private investment into small business entities. This investment scheme was created to fill the equity gap (the lack of equity financing made available to certain business entities) in private equity that existed in the United Kingdom at the time. The BES created This scheme was then replaced by the Enterprise Investment Scheme in 1993 which provided tax reliefs for investments that were made directly into unquoted companies. The EIS provided for income tax relief on the subscription of shares and Capital Gains Tax (hereinafter referred to as CGT) exemptions. In 1995 the Venture Capital Trust Scheme (hereinafter referred to as the VCT) was created in order to provide tax reliefs to individuals investing in VCTs. The VCTs were tax incentivised collective investment vehicles created for the indirect investment into both unquoted and listed companies. In 2000, the Corporate Venture Scheme was introduced as part of an initiative to promote corporate venturing schemes. It is apparent that due to its historical development, the UK serves as an ideal jurisdiction for a comparative study on venture capital.

²⁰³ Department of Trade and Industry *Integrated Strategy on the Promotion of Entrepreneurship and Small Enterprises: Unlocking the Potential of South African Entrepreneurs* (2005). Pretoria (hereinafter referred to as the Strategy on Integrated Small Enterprise Development, 2005).

²⁰⁴ *Strategy on Integrated Small Enterprise Development*, 2005 page 4.

²⁰⁵ *Strategy on Integrated Small Enterprise Development*, 2005 Page 30.

²⁰⁶ Revenue Laws Amendment Act 60 of 2008 (hereinafter referred to as Act 60 of 2008).

Furthermore, the existence of section 12J is founded on the necessity to create tax incentives that encourage investments by an entrepreneur family and friends into start-up businesses as recognised by the Government in the Strategy on Integrated Small Enterprise Development, 2005.²⁰⁷

Section 12J came into operation on the 1st of July 2009²⁰⁸ and was introduced in order to assist small medium-sized enterprises and junior mining exploration companies to obtain access to equity finance.²⁰⁹ The legislature recognized the disparity between debt financing, which allowed for amounts invested in a company to be deducted from a taxpayer's tax liability, and equity financing, which does not encompass any similar benefit. It also recognized that lack of access to equity finance was the primary of the crippling growth SMMEs experience.²¹⁰ Section 12J encompasses a tax incentive for investors who invest in small medium enterprises and junior mining exploration companies through Venture Capital Companies. In order to comprehend the operations of section 12J and the shortfalls contributing to its failure, a comprehensive description of venture capital and the venture capital process is provided below.

4.2 Venture Capital Defined

Private equity may be defined as equity capital provided to unlisted firms with the object of encouraging growth of the financed company and is characterised by long term investments.²¹¹ Venture capital is defined as capital co-invested with the entrepreneur for the purposes of providing capital and an insight into the early stages of business. Venture capital is often regarded as a subset of private equity.²¹² The Income Tax Act does not provide a definition of venture capital and therefore, in order to provide a coherent definition of venture capital, it is necessary to refer to external sources. The Oxford Dictionary defines venture as "a risky undertaking", Webster's Dictionary defines venture capital as "a very high risk investment", and Collins English Dictionary defines venture capital as

²⁰⁷ *Strategy on Integrated Small Enterprise Development*, 2005 page 31. This is also affirmed in the *Unlocking Potential in an Enterprising Nation: The Integrated Small Business Development Strategy in South Africa 2004-2014* where it is stated that tax and other incentives must be envisaged in order to encourage economic support towards small enterprises see page 26 available http://intertest.dwaf.gov.za/WAR/WAR_WEBSITE_DOCS/Edition_6/FINAL_DOCUMENTS/Extra_reading/Integrated_Small_Business_Strategy.pdf accessed 17 March 2013.

²⁰⁸ Section 27 (2) Act 60 of 2008.

²⁰⁹ Department of Finance (National Treasury) *Explanatory Memorandum on the Revenue Laws Amendment Bill 2008* (hereinafter referred to as the *Explanatory Memorandum on the Revenue Laws Amendment Bill 2008*) *Government Gazette* Number: 31267 Notice Number: 781 Gazette Date: 2008-07-22.

²¹⁰ *Explanatory Memorandum on the Revenue Laws Amendment Bill 2008* page 67.

²¹¹ I Missankov R van Dyk A van Biljon M Hayes & W van der Veen *Is Private Equity A Suitable Investment For South African Pension Funds?* (2006) page 10 presented at the Convention of the Actuarial Society of South Africa October 2006.

²¹² D Klalowski *The Venture Capital Investment Process* (2012) New York, NY : Palgrave Macmillan (hereinafter referred to as *The Venture Capital Investment Process*, 2010) page 12.

“capital for investment which may easily be lost in risky projects, but also can provide high returns”. The Organisation for Economic Co-operation and Development defines venture capital as capital, in the form of money and expertise, provided by firms who invest with management in young companies that are not listed on a stock exchange with the aim of acquiring high returns from the investment.²¹³ In order to comprehensively define venture capital in a manner that depicts its true characteristics, it is important to distinguish between industry terms that are used interchangeably, such as venture capital and private equity.²¹⁴

Venture capital can be divided into four stages of investment. The first stage is known as the early stage and is characterized by an investment into the start-up phases of a business. This form of venture capital is associated with a high risk but also a possible high return as well. The second stage of venture capital is usually an investment made into companies which have developed to a significant extent and have acquired recurring revenues over a period of time. This second stage of venture capital is associated with a medium risk yet a possible high reward for the investor. The third stage of venture capital would involve companies moving from a national to an international domain and is associated with the prospects of a high reward even though the risk is low. The fourth stage of venture capital is essentially not venture capital because it amounts to an investment into a company that has established a good and steady cash flow and a worthy balance sheet. This form of investment serves as an ideal vehicle for leveraged buy-outs and is usually characterized by low or medium rewards for the investor coupled with a low risk undertaking.²¹⁵

In order to understand how venture capital works, the definitions must be put into context. Therefore it is important to provide such definitions with reference with reference to the investing process, starting from the investors psychological convictions, to external factors influencing the venture capital process.

4 3 Synopsis of the Venture Capital Investment Process

Venture capitalists do not rely on formal and structured investment processes; however, some companies have dissembled the investment process down to a near science. Initial attempts to describe the venture capital investment process were made by academics in the 1990's where they established a five stage model of venture capital investment which was generally descriptive and

²¹³ Organisation for Economic Co-operation and Development *Venture Capital and Innovation* page 5 available <http://www.oecd.org/sti/inno/2102064.pdf> accessed 1 May 2013.

²¹⁴ D Klonowski *The Venture Capital Investment Process* (2012) page 3.

²¹⁵ R Thompson *Real Venture Capital* third edition (2007) RHT Management: London “Venture capital tends, in many people’s minds, to be associated with early stage investments which is too narrow a definition, since it is often possible to get very high returns from later-stage investments with a lot of growth”.

simplistic and broadly highlighted the key venture capital activities at each stage. A second attempt was later embarked upon which considered the internal workings of venture capital firms and the complexities of the internal decision making process.²¹⁶ For the purposes of this discussion, the Klonowski model developed in by Professor Darek Klonowski²¹⁷ will be discussed because this model provides a comprehensive view of the venture capital investment process. The Klonowski model encompasses a number of distinctive features. The model identifies the various approval processes employed in an effort to recognise the appropriate investee company. It further outlines the level of internal documentation required throughout the venture capital investment process.

According to the Klonowski model, the first part of the venture capital process involves the deal generation stage.²¹⁸ This entails the accessing of information required to draw the venture capital firm to a potential investee company. This information is procured through various means, including consultation with various professionals or through a process of self-generation which is described as an initiative taken by the venture capital firm to identify suitable investment candidates and the direct marketing by the venture capital firm.²¹⁹ Simply put, this is the stage where a venture capital investor identifies a prospective investee company.

The next part of the venture capital process involves the initial screening of candidates through the evaluation of business proposals. This screening of process encompasses the analysis of the proposed business pursuits in an effort to ascertain their viability. If the proposed business idea is considered feasible, according to the venture capital firm's internal requirements, a pre-approval is then granted before the next due diligence phase and internal approval is conducted. According to this model, less than five per cent of the received business proposals result the successful investment

²¹⁶*The Venture Capital Investment Process*, 2012 page 26.

²¹⁷Darek Klonowski is a Professor of Business Administration at Brandon University and has over fifteen years of experience in the private equity industry. He is Managing Director of Copernicus Capital Management (currently Abris Capital), a venture capital fund affiliated with Boston-based Advent International. He previously worked for Enterprise Investors, the largest and most successful venture capital fund in the Central East European region. Dr Klonowski has also advised multiple clients on asset allocation strategies in Eastern Europe, including the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC) of which South Africa has been a member since 1957. Further, Professor Darek Klonowski has studied and written extensively on the venture capital investment process and has developed a model for venture capital in emerging markets. It cannot be ascertained the exact moment when the model was developed, however, earlier works containing the model include D Klonowski *The Venture Capital Investment Process in Emerging Markets Evidence from Central and Eastern Europe* International Journal of Emerging Markets 2 (4) (2007) page 361 (hereinafter referred to as *The Venture Capital Investment Process in Emerging Markets Evidence from Central and Eastern Europe*, 2007) available <http://us.macmillan.com/author/darekklonowski> accessed 17 September 2013.

²¹⁸*The Venture Capital Investment Process*, 2010 page 26.

²¹⁹*The Venture Capital Investment Process*, 2010 page 26.

attainment by the prospective investee companies. In light of this, it is plausible that five out of seven businesses established fail within their first year of establishment.²²⁰

The third part of the process involves the conducting of a second due diligence and internal feedback.²²¹ The second due diligence phase entails an investigation into the prospective firm's financial history, the firm's constitution and so forth. If the venture capital firm finds the investee firm's history satisfactory, the next step is then a deal completion which involves the entering into an agreement whereby the venture capital firm undertakes to invest money into the investee company for a return or economic benefit. Throughout the existence of the financial relationship between the venture capital firm and the investee firm, the venture capital firm takes an active involvement in the investee company by monitoring the investee company and providing all the necessary guidance required.²²² This is an imperative part of the venture capital investment process because investee companies often require substantial assistance and guidance from more experienced and knowledgeable parties.²²³ The necessity for a continued involvement of the investor firm in the investee firm is also depicted in the lack of skills and managerial expertise identified in the White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995.²²⁴

The last step in the Klonowski model is an exit or divestment strategy and is considered the most important part of the venture capital process.²²⁵ A venture capitalist's initial objective is to place the investee company in a position where the investee company is able to make a return profit on all its initial investments. Once this has been achieved, the relationship between the venture capital firm and the investee firm is then terminated through an exit strategy. This exit strategy usually takes the form of an initial public offering or the sale to an investor, however, it is important to take cognisance of the fact that an initial public offering is the preferred form of divestment because it is said to preserve the investee and investor firm in addition to providing the investee firm with continued access to capital.²²⁶ Although the Klonowski model is comprehensive and vastly recognised as a legitimate model for venture capital investment, it is notable that South Africa's venture capital investment

²²⁰ *Small Business Statistics "Scary"* (2013).

²²¹ *The Venture Capital Investment Process*, 2010 page 27.

²²² *The Venture Capital Investment Process*, 2010 page 27.

²²³ *The Venture Capital Investment Process in Emerging Markets Evidence from Central and Eastern Europe* International Journal of Emerging Markets, 2007 page 365.

²²⁴ White Paper on National Strategy for the Development and Promotion of Small Business in South Africa, 1995 paragraph 2.3.1.

²²⁵ *The Venture Capital Investment Process in Emerging Markets Evidence from Central and Eastern Europe*, 2007 page 365.

²²⁶ *The Venture Capital Investment Process in Emerging Markets Evidence from Central and Eastern Europe* (2007) page 365.

process does not abide strictly to the stages set out in the Klonowski model. For purposes of this study, it is important to identify a venture capital investment process unique to South Africa. However, this poses a challenge as there is a considerable lack of literature depicting the South African venture capital investment process. In 2013, a paper depicting the challenges faced by the private equity sector in Africa was published in consultation with the South African Venture Capital Association (hereinafter referred to as SAVCA). It is with reference to this paper that a brief synopsis of the private equity investment process is provided below.

SAVCA is a non-profit company which was incorporated on the 8th of November 2000. The main objective of SAVCA is to provide a platform for the development of venture capital investment in South Africa and other countries or territories.²²⁷ Members of SAVCA are defined as persons (natural or juristic persons) who are recognised as venture capitalists or private equity investors. Members are required to provide management and support to investee firms, amongst others, and more importantly, abide by any resolutions adopted by SAVCA.

In the paper prepared in consultation with SAVCA, one can depict that similarly to the Klonowski investment model, private equity investment in Africa exists in two phases. The investment strategy phase and the investment execution phase. The investment strategy phase entails the development of a fund strategy and a fundraising stage.²²⁸ The first phase is simply the raising of funds that takes place prior the investment of these funds as private equity. Particularly of interest to this study is the second phase which is characterised by four stages. The first stage is referred to as the deal sourcing stage, similar to the Klonowski deal generating stage, which entails the identifying of potential investee firms. The second stage is the deal execution stage. This is an undertaking by the investor invest in identified firm.²²⁹ The third stage is the post-deal holding stage, where the investee actively engages in the investor firm in an effort to enhance the investee firm's capacity and by providing technical and expert assistance.²³⁰ The final stage is the exiting stage, where the investor disposes of its shares by way of; trade or strategic sales, and initial public offering, a group sale, a secondary sale or by selling its interest back to management or the founder of the investee firm.²³¹ These phases of private equity can be applied *mutatis mutandis* to the venture capital investment process, especially taking into account the fact that section 12J is formulated in accordance with the private equity model.

²²⁷Memorandum of Incorporation of the South African Venture Capital available at Association <http://www.savca.co.za/downloads/Memo3.pdf> accessed 1 September 2013.

²²⁸*The Venture Capital Investment Process in Emerging Markets Evidence from Central and Eastern Europe* (2007) page 365.

²²⁹*The Venture Capital Investment Process in Emerging Markets Evidence from Central and Eastern Europe* (2007) page 365.

²³⁰*The Venture Capital Investment Process*, 2010 page 24.

²³¹*The Venture Capital Investment Process*, 2010 page 24.

Both the Klonowski model and the South African private equity model are designed to allow investors to have an active involvement in the activities of the investee company and also to allow for a divestiture by way of a public offering. This is interesting to note due to the implications the current section 12J has on this factor, as discussed below.

4 4 The Role of Venture Capital Companies in the SMME Sector

Profitability, survival and growth of SMMEs, is often impaired by the financing difficulties faced by this sector. These difficulties in obtaining funding exist due to the fact that banks are highly risk averse in the provision of venture capital to SMMEs because of the risk perception that often accompany SMMEs.²³² Venture Capital Companies greatly improve access to venture capital for SMMEs.²³³ This access to capital created by Venture Capital Companies results in an economic and socio-economic benefit.²³⁴ As noted above, SMMEs are considered an essential tool for the redress of unemployment and accelerated economic growth, thus the acquiring of sufficient capital through Venture Capital Companies heightens their prospects of success which then results in job creation and an improved economy.²³⁵

A survey conducted by the Development Bank of Southern Africa and SAVCA indicates that the impact of venture capital in the South African economy is far reaching and has proven to be instrumental in the achievement of government objectives, particularly where employment, exports and competitiveness are concerned.²³⁶ This survey provides an analysis of the impact venture capital has had to SMMEs between the periods 2005 to 2009 in comparison to business entities listed on the Johannesburg Stock Exchange.²³⁷ According to the survey, private equity funded companies have contributed 9 per cent to employment, 5 per cent of which is employment of formal sector employees. Companies backed by private equity are said to have attained an average turnover of 20 per cent and a pre-tax deduction profit growth of 16 per cent. The growth in exports of private equity funded entities

²³² *SME's Access to Finance in South Africa* age 2 available

<http://www.treasury.gov.za/publications/other/Access%20to%20Finance%20in%20South%20Africa%20-%20A%20Supply-Side%20Regulatory%20Review.pdf> accessed 17 April 2012.

²³³ OECD Policy Brief *Small and Medium-sized Enterprises: Local Strength, Global Reach* page 4 available from <http://www.oecd.org/dataoecd/3/30/1918307.pdf> accessed 15 May 2012 .

²³⁴ F S Memba W R Gakure & K Karanja *Venture Capital: Its Impact on Growth of Small and Medium Enterprises in Kenya* <http://vc4africa.biz/wp-content/uploads/2012/04/VC-Kenya-Report.pdf> accessed 12 May 2012.

²³⁵ S Mallach *Epilogue: A South African Perspective* (1997) *Berkeley Journal of International Law* 15(1) page 104.

²³⁶ Southern African Venture Capital and Private Equity Association and Development Bank of Southern Africa *The Economic Impact of Venture Capital and Private Equity in South Africa* (2009) available from <http://www.savca.co.za/downloads/SAVCA-DBSA2009ecoImpactStudy.pdf> accessed 12 March 2013 (hereinafter referred to as the Economic Impact of Venture Capital (2009)).

²³⁷ Economic Impact of Venture Capital (2009) page 14.

has increased to 31 per cent per annum on average and the research and development growth has increased to 7 per cent.²³⁸

It is evident that venture capital investments facilitate the development of SMME's significantly. The creation of a tax system that encourages venture capital growth can only enhance the existing advantages that private equity bestows on the SMME sector. Notably, tax is not the only element considered by an investor when choosing to make a particular investment; however, it is argued that the tax system of a particular jurisdiction can have an immense influence on the investment desirability of that particular jurisdiction. This is because excessive taxation has the effect of dampening down incentives and may affect a country's economic functioning adversely. Conversely, where the tax revenue to GDP ratio is low, *id est*, where the tax rate is too low, the government is unable to raise sufficient revenue required for its expenditure on infrastructure, basic health, education and services.²³⁹

The impact that Venture Capital Companies have on SMMEs, necessitates a study of the Venture Capital Company regime established by section 12J established with the intention in encouraging venture capital investments into SMMEs. This is because since its establishment in 2008, the Venture Capital Company regime has been relatively unsuccessful in achieving the objectives, as depicted in the White Paper, the National Strategy and the Memorandum on the Objects for which it was created.²⁴⁰

4 5 Synopsis of section 12J

Subsequent its introduction, the section has been amended substantially by the Revenue Laws Amendment Act 24 of 2011 (hereinafter referred to as the Revenue Laws Amendment Act 2011). This amendment occurred as a result of the section's inability to attain the objective for which it was created, *id est*, the procurement of capital by SMMEs.²⁴¹ The perception that the investment benefits offered to the investor under section 12J²⁴² are too insignificant contributes to the section's failure. Furthermore, the restriction imposed on the investee companies were not aligned with the private

²³⁸ Economic Impact of Venture Capital (2009) page 1.

²³⁹ World Bank Group: International Bank for Reconstruction and Development *Doing Business (2015) Going Beyond Efficiency: Comparing Business Regulations for domestic firms in 189 Economies* (2014) 12 page vii available www.worldbank.org accessed 12 September 2014.

²⁴⁰ L Mitchell *South Africa New legislation: Taxation Laws Amendment Act 24 of 2011 Commentary Continuation* Income Tax Reporter 51 2012 part 5 (July 2012). See further J Zulman & M Preiss *Legislation and Policy Memoranda 2011 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 3. Income Tax: Business Income Tax Practice Manual* (2011).

²⁴¹ Department of Finance (National Treasury) *Explanatory Memorandum on the Revenue Laws Amendment Bill 2008* Government Gazette Number: 31267 Notice Number: 781 Gazette Date: 2008-07-22.

²⁴² Every reference to sections from this point forth is made with reference to the Income Tax Act 58 of 1962 unless it is otherwise stipulated.

equity model upon which the regime was founded and have rendered the regime far too complex, resulting in the unsustainability of the venture capital company regime.

4 6 Incentives created in section 12J for investors who invest through venture capital companies and the requirements and limitations imposed

In order for individual or company investors to be eligible for the benefits created in terms of section 12J, the investors are required to invest through a VCC that qualifies as such in terms of the Income Tax Act. The synopsis of section 12J can be divided into 4 sections. The first being the requirements imposed on the VCC, the requirements imposed upon the investors and the benefits which it affords them, the anti-avoidance provisions contained and the requirements imposed on the qualifying company

Section 12J(5) stipulates the requirements that must be met before a VCC can be afforded such status in terms of section 12J. A company will acquire VCC status if the Commissioner approves it as such. The commissioner will only approve it as such if the Commissioner is satisfied that the company is a resident company; with the sole business of investing in qualifying companies; the tax affairs of the company are in order and the company is licensed in terms of section 7 of the Financial Advisory and Intermediary Services Act²⁴³ (hereinafter referred to as FAISA). These requirements and their shortfalls are further expounded upon in Chapter 5 below.

Section 12J is designed to provide tax benefits to investors who invest through the investment vehicle. It does not afford any tax benefits to the VCC itself. Section 12J(3)(a) provides that a taxpayer who invests in the shares of a VCC qualifies for a deduction equivalent to one hundred per cent of the amount invested in the VCC. However, such deduction must then be recouped upon the alienation of the shares in the VCC. The deduction is subject to a recoupment in terms of section 8(4) in the event that the individual disposes of the VCC shares before the expiration of a three year period. It is worth noting that the term “taxpayer” is defined in section 1 as any person chargeable with any tax leviable in the Income Tax Act. Therefore, section 12J is open to both resident and foreign investors.

Section 12J also contains anti-avoidance provisions in order to prevent the possible abuse of the section. Section 3A prohibits deductions where the investment results in the investors becoming a connected person. The second anti-avoidance provision provides that where a taxpayer, incurs an

²⁴³ Act 32 of 2002.

expenditure in the form of a loan, in order to invest in a venture capital company, that loan is tax deductible only to the extent where the taxpayer bears risk, as a result of this financial assistance for the purchase of VCC shares may not be granted by the VCC. The last anti-avoidance provision is the requiring of shares to be in the form of pure equity.

Section 12J(1) requires a VCC to make an investment only in “qualifying shares”. Qualifying shares are defined as equity shares held by a venture capital company which are issued by a “qualifying company” and do not include hybrid equity instruments as defined in section 8E(1) or constitute a third-party backed share as defined in section 8EA(1). Hybrid equity instruments are defined as shares that obligate the issuer of that share to redeem the shares or where the share is redeemable at the option of the holder and where such redemption is made subject to time condition. Furthermore, a hybrid equity instrument is defined as any share that is terminated within a period of three years.²⁴⁴ Third-party backed shares are defined as preference shares, where the rights enforceable under those share, are enforced by the holder of that share, who also receives or to whom the benefits in terms of those shares accrues to, and not the person entitled thereto.²⁴⁵

The VCC may not hold more than twenty per cent of its gross assets in any one of the investee.²⁴⁶ This requirement is inserted in order to ensure the diversity of the VCC’s holding. The VCC is also required to play a passive role (angel investor) in the investee company and may not act as the controlling owner of the business. A company will constitute a qualifying company if the company is a resident, it is not a controlled company in a group of companies, its tax affairs are in order, it has complied with the relevant tax law provisions, and company it must not carry an impermissible trade.²⁴⁷

4 7 Amendments to section 12J

Since its introduction in 2008, section 12J has been amended twice. First by the Taxation Laws Amendment Act, 2009²⁴⁸ (hereinafter referred to as the Amendment Act of 2009) and then by the

²⁴⁴Section 8E(1) of Act 58 of 1962.

²⁴⁵Section 8EA(1) of Act 58 of 1962.

²⁴⁶Section 12 (6A)(c).

²⁴⁷ Section 12J(1) of Act 58 of 1962 defines Impermissible trade as: Dealing or renting of immoveable property, except trade as a hotel keeper (including bed and breakfast establishments); Financial service activities such as banking, insurance, money-lending and hire-purchase financing; trade carried on in respect of gambling, liquor, tobacco, arms and ammunition.

²⁴⁸ Taxation Laws Amnedment Act 17 of 2009.

Taxation Laws Amendment Act, 2011²⁴⁹ (hereinafter referred to as the Amendment Act of 2011). The amendments lead to the monitoring requirement that had initially been imposed requiring a determination of whether the funds received by the qualifying company were spent in accordance with the stipulated expenditure allocation. A further review of the incentive revealed other smaller anomalies. These anomalies lead to the revision of South African Revenue Services' approval process for the VCC incentive, *id est*, prior the amendment SARS was required to provide upfront approval of the form, structure and other aspects of the VCC. The prohibition against non-qualifying company income was also relaxed. Under the amended provision twenty per cent of the gross income of the company can be derived from investment income (dividends, royalties, rental from immovable property, annuities and proceeds from investment or trading in financial instruments, marketable securities or immovable property) other than dividends from qualifying shares and proceeds from investment in qualifying shares as opposed to the ten per cent that had previously been imposed. The section also required approval of the expenditures of the VCC. Instead of the pre-approval, a provision was inserted allowing the Commissioner to withdraw a company's VCC status. The provisions applicable to qualifying investee companies contained certain requirements that were triggered on the expiry of eighteen month deferral period which were subsequently removed. These provisions required the investee company to prove that it had engaged in business activity within the eighteen month period. The current provisions simply require the investee company not to be engaged in impermissible trade. The investee company was required to have spent the sums received from the VCC within an eighteen (or thirty six) month period. Furthermore the limitation on the amount of deduction the taxpayer investor is entitled to under section 12J were also relaxed.

²⁴⁹ Taxation Laws Amendment Act 24 of 2011.

Chapter 5:

Shortcomings of the VCC regime

5 1 Introduction

Taxation is a multidisciplinary practice, therefore is important to take cognisance of the fact that an analysis from a legal perspective is insufficient to provide an adequate recommendation on a particular issue. Instead, care should be taken to explore the issues at hand from an economic perspective²⁵⁰ in addition to the legal contribution this paper seeks to provide. The purpose of this chapter is to provide a discussion of the shortfalls of section 12J taking into account the purpose for which it was incepted, the reality of venture capitalism in the South African market and the SMMEs to which it applies.

As aforementioned in Chapter 1 of this study, the primary motivation for the introduction of section 12J was the desire to attract investments directed at SMMEs. However, section 12J only caters provides for the investment into VCCs which are then required to invest in a qualifying company in order for the investee to qualify for the tax benefit granted under the section. As is evident in the synopsis provided in the preceding chapters regarding the failure of this section, the objectives for the inception of section 12J have not been given effect to. A discussion regarding the shortfalls of section 12J that have contributed to its failure will follow.²⁵¹

5 2 1 Requirements imposed on the VCC

Section 12J(5)(a) requires a VCC to be a resident company before it may be approved as such for the purposes of qualifying for the benefits afforded to investors by virtue of section 12J. Section 1 paragraph (b) of the definition “resident” provides a definition of the term “resident”. A company is said to be “resident” if it has been incorporated, established or formed or has its place of effective

²⁵⁰ R Gordon & V Thuronyi Chapter 1: *Tax Legislative Process* (1994) in Thuronyi (ed.) *Tax Law Design and Drafting* (Volume 1) International Monetary Fund: Washington DC (hereinafter referred to as *Tax Legislative Process* V Thuronyi *Tax Law Design and Drafting* Volume 1) page 4.

²⁵¹ The Davis Tax Commission has released a report relating to tax considerations relevant to SMMEs. In its report, the commission acknowledges that the requirements imposed on section 12J are far too complicated and inflexible, furthermore, it identifies three fundamental problems with the regime. These issues relate to the asset value of the target company being understated, a failure to take cognisance of the financial crisis and its impact, the legal costs associated with such investments, the inability of most SMMEs to meet investor expectations, the high risk the investment poses. The commission has suggested that the South African Revenue Services, National Treasury and the Department of Trade and Industry work together in an effort to provide an appropriate relief measure for SMMEs. Refer to the Davis Tax Committee *Small And Medium Enterprises: Taxation Considerations*, Interim Report, July 2014 available <http://www.taxcom.org.za> accessed 20 August 2014.

management²⁵² in the Republic of South Africa. Furthermore, the section provides that where a company is a foreign investment entity, in determining whether the entity is a resident, certain activity must be disregarded. Such activity includes activity that constitutes the provision of financial services as defined in section 1 of the FAISA and any service incidental to the provision of the financial service.²⁵³

The purpose of determining a company's residence is ascertaining the tax liability of that company.²⁵⁴ The South African tax system imposes tax liability on a residence basis²⁵⁵ and thus, if a company is resident in South Africa, it will be liable for tax on its worldwide income. However, section 12J has no bearing on the VCCs tax liability due to the fact that the benefits derived from investing through a qualifying VCC are afforded only to the investor and not the VCC itself.²⁵⁶ This has the effect of disqualifying investors who choose to invest through a foreign VCC from the endowments of section 12J. In order to determine whether this amounts to a notable disadvantage in the VCC regime, regard must be had to the tax treatment of investors who chose to invest through foreign VCCs. The Act does not afford any deductions for the acquisition of venture capital shares in a foreign VCC. Therefore the requirement section 12J(5)(a) imposes serves as a hindrance to the achievement of the objectives for which section 12J was created.²⁵⁷

An additional requirement that requires consideration is contained in section 12J(5)(b) which requires the sole objective of the VCC to be the management of investments into qualifying companies. The term "sole objective" has not been defined in the ITA. The term "sole objective" may be defined with reference to the case *AB Trust v the Commissioner for the South African Revenue Service*.²⁵⁸ In this case, the court had to determine whether the appellant met the requirements of a public benefit organisation in order to be considered as such in accordance with section 30(3) read with the Ninth Schedule to the Act. On behalf of the Commissioner it was submitted that the term "sole objective" had to be interpreted in accordance with two approaches. The first being a subjective qualitative test and the other being an objective qualitative test. The subjective qualitative test entails a determination

²⁵² For a further definition of what constitutes a juristic person's place of effective management please refer to Interpretation Note 6 *Place of Effective Management* 26 March 2002.

²⁵³ Section 1 under paragraph "resident" (b).

²⁵⁴ R Stretch *Residence Basis of Taxation* (2000) October Taxgram.

²⁵⁵ As introduced by Act 59 of 2000.

²⁵⁶ As discussed in Chapter 4 of this study.

²⁵⁷ Furthermore, it is worth noting possible contradiction in the Income Tax Act if section 12J were to be extended to foreign VCCs. Section 12J(5)(b) creates ambiguity within the Act. Section 12J(5)(b) requires the sole objective of the VCC to be the management of investments into qualifying companies, however, as stated above, section 1 of the definition of *resident* requires the provision on financial services to be disregarded in determining a company's residence.

²⁵⁸ *AB Trust v the Commissioner for the South African Revenue Service* (2014) ITC 12466 (hereinafter referred to as *AB Trust v the Commissioner for the South African Revenue Service*) page 1.

of the subjective purposes of those who founded the public benefit organisation.²⁵⁹ The court stated that the problem with a subjective test is flawed due to the fact that the founders of the organisation and those who subsequently control it would not have perpetuated its existence but for the fact that it was carrying on public benefit activities.²⁶⁰ The case fails to elaborate on what the objective qualitative approach entails. The court did not make a determination on the interpretation of the term “sole objective” and focused its attention on determining whether the activities of the appellant were benevolent in nature and whether an undue benefit would have been derived by affording it the status of a public benefit organisation.

On a grammatical interpretation the section has the implication that the only object of the VCC must be the management of investments into qualifying companies. Furthermore, section 126A (b) requires at least 80 per cent of the VCC expenditure to have been derived from the purchasing of qualifying interests into qualifying companies. This is of relevance because, as discussed above, SAVCA serves as a reliable source for information regarding the venture capital industry in South Africa. SAVCA has a comprehensive list of all its members who engage in the provision of private equity. However an observation of SAVCA's membership indicates that these private equity firms do not have the sole objective of managing investments into qualifying companies. Furthermore, a survey conducted by SAVCA in partnership with Price Waterhouse Coopers²⁶¹ indicates that the majority of investments made by participating firms²⁶² were made as later stage investments.

5 2 2 Requirements on the type of share

In addition to the limitations imposed on the VCC, section 12J(1) under the paragraph “qualifying share” imposes further restrictions on the type of share that may be acquired. In terms of this subparagraph (c) of the definition of “qualifying share” a qualifying share must not constitute a third party backed share as defined in section 8EA(1). This has the effect of requiring all investments made by VCCs into the qualifying companies to be in the form of ordinary shares thus ruling out the possibility of investments through shares that have attached to it any preferential rights such as a dividend distribution or redemption at the option of the investee company. Failure to recognise the fact that a number of VCC often prefer to invest in SMMEs in the form of preference shares, due to the

²⁵⁹ *AB Trust v the Commissioner for the South African Revenue Service* page 16.

²⁶⁰ *AB Trust v the Commissioner for the South African Revenue Service* page 17.

²⁶¹ SAVCA & KPMG *Private Equity Survey* (2014) (hereinafter referred to as *Private Equity Survey*) available www.savca.co.za/.../2014/.../KPMG-SAVCA-Private-equity-survey-2014 accessed May 2014.

²⁶² *Private Equity Survey* The survey was conducted through the issue of questionnaires. The collated data was further supplemented by additional information sources including but not limited to discussions and international reports. The survey is regarded as a representation of at least 90% of the South African Private Equity industry by funds under management.

high risk associated with investing in such entities,²⁶³ results in the objects of section 12J being defeated. Consideration should be had to extending the application to preference shares taking care to impose the necessary restriction to prevent the abuse of the section and the dominant bargaining position of the VCC.

Furthermore, the section 12J(1) under the definition of “qualifying share” requires the share to be issued to that company by a qualifying company. In other words the benefits contained in section 12J are non-transferrable. This section neglects to take into consideration the possibility of transfer of shares through mergers and acquisition and thus has the result of making section 12J undesirable to VCCs who envisage possible expansion in this manner in future and also disqualifies SMMEs who may want to expand in this manner in future. In addition to this, this creates uncertainty for the taxpayer because, as discussed above, SMMEs are believed to be high risk in nature, thus the investor is at risk of forfeiting the benefit derived in terms of section 12J in the case of the liquidation of the SMME or VCC. Thus section 12J should be amended in order to provide for such transferability. In response to this, a proposed amendment in the Budget Speech includes the relaxing of section 12J in order to allow the transferability of tax benefits when investors dispose of their holdings.²⁶⁴

5 2 3 Requirements imposed on the qualifying company

Section 12J(f) requires the sum of the investment income derived by the qualifying company to not exceed an amount equal to 20 per cent of the gross income of that company for that year. Investment income is defined in section 12E(4)(c)(i) as any income in the form, including but not limited to royalties. In order to understand why this is of relevance it must be understood in context of the technology sector. A royalty is defined in section 49A of the Income Tax Act as any amount that is received or accrues in respect of the use or right of use of or permission to use any intellectual property or the imparting or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information. If for example, a small company that specialises in information technology were to develop an operating system similar to Windows, Android, Symbian etcetera, such a company would be prohibited from receiving license fees for the use of its intellectual property. This provision has the effect of deterring investments in the technology sector and therefore the section should be revised to allow for the receipt of investment income of this nature in certain instances.

²⁶³ Bowman Gilfillan: C Cogut W Curbow S Thacher & Bartlett LLP *Private Equity* (2014) Getting the Deal Through: Law Business Research available www.bowman.co.za/.../Getting-the-Deal-Through-Private-Equity-2014.pdf accessed 17 May 2014 page 282.

²⁶⁴ Minister of Finance: National Treasury *Budget Speech 26 February 2014* (2014) (hereinafter referred to as *the Budget Speech*) page 18 available <http://www.treasury.gov.za/documents/national%20budget/2014/speech/speech.pdf> accessed 17 March.

Furthermore, section 12J fails to take into consideration the fact that there are enterprises that are of such a nature that their profitability is delayed and therefore may consist of solely investment income for a period of a year. In order to illustrate this, the farming industry serves as a useful example. A small business that engages in farming activity, for produce that takes a long period to yield may fall outside the ambit of section 12J because it not meet the requirements for the definition of “qualifying company”. Thus section 12J(f) of the definition of “qualifying company” has the effect of precluding certain business activity from its operation.

It should further be noted that the deduction afforded to investors should not be subject to recoupment.²⁶⁵ Furthermore, a capital gains tax exclusion in the event where the shares are sold after the minimum three year period should be considered

5 2 4 Shortcomings identifies as per consultation with the Venture Capital Industry

Public consultation with the private sector is an important process in the development of effective tax legislation. It is impossible for Government to adequately draft legislation without being fully aware of the challenges and functioning of the sector which it seeks to which its legislation will be directed.²⁶⁶ In light of this, it is important to note the concerns raised by the private sector regarding the provisions of section 12J. In public consultation with taxpayers regarding section 12J, interested parties sought to have the deduction made absolute, instead of it being subjected to a recoupment upon the disposal of the qualifying interest. In an effort to address this, Government alluded to a proposed amendment by the in the 2014 Budget Speech²⁶⁷ which included the making permanent of deductions permitted under section 12J provided the investments are held for a certain period of time. It should be noted that the necessary restrictions should be imposed when deductions are made permanent in order to prevent the occurrence of avoidance transactions.²⁶⁸

The private sector further took issue with section 12J(5)(g) which requires an intermediary investment vehicle to be licensed in terms of the FAISA.²⁶⁹ The private sector submitted that the nature of a venture capital investment often occurs through of trust and not the intermediary company model envisaged by section 12J. In addition to this, concerns were raised regarding the reconciliation of the relationship of an investment advisor to the intermediary investment vehicle in legislative terms. In

²⁶⁵ The proposed amendment in the National Budget seek to achieve this.

²⁶⁶ *Tax Legislative Process V Thuronyi Tax Law Design and Drafting* Volume 1 page 8.

²⁶⁷ *the Budget Speech* page 18.

²⁶⁸ Standing Committee on Finance (SCOF): *Report-Back Hearings Draft Taxation Laws Amendments Bills, 2011 Draft Response Document National Treasury and SARS Presented to SCOF 2011* available <http://www.treasury.gov.za/public%20comments/070911%20NT%20TLAB%20Latest%20Response%20Doc.pdf> accessed 12 June 2013.

²⁶⁹ Financial Advisory and Intermediary Services Act 37 of 2002 (hereinafter referred to as Act 37 of 2002).

light of this, comprehending the nature of an intermediary service is of importance. The court has provided some clarity regarding the scope of activity that would fall under the intermediary services which require licensing in terms of FAISA. A financial services provider is defined as a person who furnishes advice, and or renders any intermediary service or renders an intermediary service.²⁷⁰ Of relevance to section 12J is the definition of an intermediary service. Section 1 of FAISA encompasses a definition of what constitutes an intermediary service and it is defined as an act carried out by a party on behalf of another party, where such an act constitutes the management of a financial product on behalf of the latter. In the case *TriStar Investments v The Chemical Industries National Provident Fund*²⁷¹ the question arose as to whether services provided by a financial services provider only licenced to provide advice constituted intermediary services. The services entailed drafting asset manager mandates the implementation of an asset allocation model, investment strategy and asset manager mandates including the negotiation of certain contractual issues, managing the transition of assets and the monitoring and evaluation of the performance of investments.²⁷²

The Supreme Court of Appeals held that on a grammatical interpretation of the words “intermediary service” meant one who acts between others. Further, the court referred to the definition provided in section 1 of FAISA and stated that a quintessential example of an intermediary service is the role played by an asset manager who is mandated to act on behalf of the client.²⁷³ Further the court stated that the financial service provider did not seek to go between parties in order to bring a certain transaction to fruition but merely sought to manage the mandates of asset managers and therefore a provision of intermediary services had not occurred.²⁷⁴

In addition to the definition of an intermediary service, it is important to consider the difference in tax treatment of an investment trust and an investment company to which section 12J applies and thus proffer a possible argument for the extension of the application of the section to venture capital trusts. It is put forth that tax rules should not unduly hamper or prevent development of investment funds or other financial intermediaries.²⁷⁵ Investments trusts must account for tax at a rate of forty per cent of all income declared. However, the forty per cent is only imposed on the net profits of the trust and not on the gross income. Section 25B(1) of the Income Tax Act subject to the provisions of section 7

²⁷⁰ Section 1 paragraph “financial adviser” Act 37 of 2002.

²⁷¹ *Tristar Investments (Pty) Ltd v The Chemical Industries National Provident Fund* (455/12) [2013] ZASCA 59 (hereinafter referred to as *Tristar Investments (Pty) Ltd v The Chemical Industries National Provident Fund*) page 7.

²⁷² *Tristar Investments (Pty) Ltd v The Chemical Industries National Provident Fund* page 6.

²⁷³ *Tristar Investments (Pty) Ltd v The Chemical Industries National Provident Fund* page 7

²⁷⁴ *Tristar Investments (Pty) Ltd v The Chemical Industries National Provident Fund* page 6.

²⁷⁵ *Zolt Tax of Investment Funds* Chapter 22: *Tax Legislative Process* (1994) in Thuronyi (ed.) *Tax Law Design and Drafting* (Volume 2) International Monetary Fund: Washington DC (hereinafter referred to as *Tax of Investment Funds* V Thuronyi *Tax Law Design and Drafting* Volume 2) page 6.

provides that the income received by or accrued to a trust is deemed to accrue to a beneficiary who has a vested right to it. To the extent to which there is no vested right to such income it is deemed to accrue to the trust.²⁷⁶ Therefore, any dividend distributions made to the investors will not be subject to the 40 per cent tax.

In the case of a company on the other hand, dividend distributions will be taxed at a rate of twenty eight per cent. In addition to this, the company is required to withhold dividends tax at a rate of fifteen per cent when it makes its distribution to the investor, furthermore, if the company has sells its investments in the investee company, the company will be subject to an effective tax rate of 22.6 per cent on the capital gains on such an alienation. Thus the vast disparity in tax treatment between these entities may make it desirable to invest in an investment trust rather than an investment company.

There are a number of revenue concerns that must be given due consideration before a favourable tax treatment is afforded for an investment. This includes the estimation of the revenue consequences of these entities.²⁷⁷ This is of particular importance where the incentive is directed at the investment entity itself. However, it must be noted that the benefits afforded in terms of section 12J result in a favourable tax treatment of the taxpayers who invest through the VCC. Therefore it is worth considering extending this section's application to venture capital trusts.

Another point of criticism raised by the private sector concerns the limit imposed on the size of the mining company and SMME the VCC is allowed to invest in. In terms of section 12J(6A)(b)(i) and (ii), the VCC is permitted to invest in junior mining companies that have a gross asset value of a maximum of three hundred million rand and SMMEs with a gross asset value of twenty million rand into mining companies. A proposal has been made in the Budget Speech to further increase the maximum values of the qualifying investee companies to five hundred million rand and fifty million rand respectively.²⁷⁸

5 2 5 Shortfalls that may give rise to abuse of the section

In order to provide a comprehensive analysis of section 12J it is important to critically analyse the section not only with the objective of making it more desirable for investors, but also with the objective of making it as effective as possible with the least amount of distortion in the tax system.²⁷⁹ Thus a brief synopsis of the shortfalls of the section that may lead to the abuse of the section is provided.

²⁷⁶ Practice Note Number 23 Taxation of Trusts and Trust Beneficiaries in terms of Section 25B of the Income Tax Act, 1962 (1994).

²⁷⁷ *Tax of Investment Funds V Thuronyi Tax Law Design and Drafting* Volume 2 page 8.

²⁷⁸ *The Budget speech* page 8.

²⁷⁹ *Tax of Investment Funds V Thuronyi Tax Law Design and Drafting* Volume 2 page 7.

Section 12J(1) provides a thorough definition of what constitutes an impermissible trade that an investee company may not embark upon however, this section fails to eliminate the possible subcontracting of business activities by the investee company to subcontracting company. This may result in persons setting up qualifying companies with the purpose of deriving the investment benefits provided by section 12J performing the any of their stipulated business functions themselves. This will defeat the objective of encouraging growth and development of the SMME sector.

As discussed above, section 12J(6) read with subsection (6A) states that the VCC may be deregistered subject to the Commissioner's discretion. This unlimited discretion places the VCC at a disadvantage because what constitutes acceptable steps, taken for compliance with the VCC regime provisions, is left to the Commissioner's discretion. Further, the Commissioner's decision to deregister a company constitutes administrative action,²⁸⁰ which must conform to the principles of administrative justice however, the Income Tax Act makes no provision for the review of the commissioner's decision to deregister a company under the VCC regime. This decision may not be taken on Alternative Dispute Resolutions provided for by the Act, nor can it be taken to a the Tax Court because it does not fall within the jurisdiction of these bodies²⁸¹ and such review would have be taken in terms of the Promotion of Administrative Justice Act.

Discretionary powers where incentives are concerned perpetuate the uncertainty and susceptibility to corruption and abuse.

5 3 Miscellaneous Considerations required to encourage Private Equity Investments into SMMEs

Section 12J is only aimed at encouraging investments into SMMEs through VCCs. It thus fails to proffer similar benefits to investors who prefer to invest directly into the SMMEs (so called angel investors)²⁸² by both natural persons and juristic persons. Thus the creation of an investment scheme that affords benefits for these types of investments should be considered. An example of such investment schemes may be observed from the tax regime of the United Kingdom²⁸³ which

²⁸⁰ Section 1 of the Promotion of Administrative Justice Act 3 of 2000 "Administrative action means any decision taken, or any failure to take a decision, by an organ of state, when exercising a public power or performing a public function in terms of any legislation".

²⁸¹ Section 109 of the Tax Administration Act 28 of 2011.

²⁸² For the definition for angel investor refer to footnote 186.

²⁸³ Task Group of the Policy Board for Financial Services and Regulation *SME's Access to Finance in South Africa* <http://www.treasury.gov.za/publications/other/Access%20to%20Finance%20in%20South%20Africa%20-%20A%20Supply-Side%20Regulatory%20Review.pdf> accessed 17 April 2012 It has been suggested that South African tax authorities should conduct a study of the United Kingdom's approach and experience in order to ascertain the most appropriate approach which caters for local needs and challenges.

encompasses schemes such as the Business Expansion Scheme (hereinafter referred to as the BES) that was introduced in 1983 and the Enterprise Investment Scheme (hereinafter referred to as the EIS). These investment schemes were created in order to fill the equity gap²⁸⁴ that exists in the provision of private equity to SMMEs and afford benefits in the form of tax deductions and capital gains tax exemption to investors who qualify in terms of these schemes.

Furthermore the UK venture capital industry does not operate in isolation, but operates as part of a broader funding 'escalator' for start-up companies and consists of investments from seed funding during the start-up phase of an entity all the way to exit stage of venture capitalism as discussed in chapter 4. Therefore venture capital policy needs to be structured so as to maximise the synergies between the different stages of the high-growth business funding structure.²⁸⁵

5 4 Conclusion

Due to the fact that the VCC regime is a relatively new regime in South African law, its failure plausible and its need for reform comprehensible. Despite the several changes have been made to the VCC regime and the addition proposed section that would see the section more successful, it is humbly submitted that the section requires further revision in order for it to yield its desired result. In addition to the substantive factors that require additional consideration, regard must be had to the drafting of regulations that will provide clarity on the issues raised above, in addition to this, section 12J requires more comprehensive definitions in order to eliminate any ambiguity or uncertainty regarding its operation.

²⁸⁴ Equity gap can be defined as the lack of equity financing made available to certain business entities.

²⁸⁵ H Read *Reinventing Venture Capital Towards A New Economic Settlement* (2010) page 7 Demos Some rights reserved by Magdalen House available http://www.demos.co.uk/files/A_Tale_of_Tech_City_web.pdf?1340965124 accessed 17 August 2014.

Chapter 6:

Final Observations and Conclusion

6 1 Introduction

It is evident that the SMME sector is in dire need for capital procurement measures. One such measure is section 12J. However, this section has been unable to provide SMMEs with the alternative capital procurement measure they require. The failure of the VCC tax regime (section 12J) warrants a dire need for reform. It is observed from the comparative studies that a well drafted and effective tax incentive has that capacity to fulfil the objectives for which it was created. In order to successfully fulfil the objective for which this section was created, as observed in the White Paper, substantial changes must be implemented. It is important that legislation be effective and that it achieves the objectives for which it was drafted, at present moment, section 12J fails to achieve this. However, as previously stated, a well comprised study must not merely outline the failures of a section, but must also propose effective and implementable strategies and it is for this reason that the following recommendations are made.

6 2 Recommendations

SMMEs should be provided with an alternative avenue to raise sufficient capital in order to ensure that, in the midst of all the statutory regulations they are required to comply with, and the challenges they are faced with due to a lack of sufficient business experience, they are able to stay afloat. Venture capital companies are an avenue for small business to generate the required funding. The venture capital company regime created in terms of section 12J should be designed in such a manner that encourages investment into small business. In order to accomplish that, the regime will have to be greatly liberalised. This would entail the removal of the provisions which place a business practice limitations on the VCCs (limitation that the VCCs sole objective be that of investing into qualifying companies). In addition the VCC must be required to provide a level of mentorship to the qualifying company because this is an important component of the venture capital process, which affords the investee company the opportunity to be equipped with the necessary skills required to run a business enterprise. Furthermore, the lack of adequate review procedure for an aggrieved individual due to the Commissioner's unlimited discretion to decide what "adequate steps are" leaves the section highly undesirable particularly in light of the hefty penalty that the Commissioner may impose. The VCC regime will have to be reformed in order to cater for investors who chose to invest in foreign VCCs which have substantial investee companies in the republic.

In addition to the VCC regime, further incentives will have to be included in the Act in order to encourage direct investments into SMMEs for investors who do not or cannot make use of VCCs to invest into entities. Furthermore, it is suggested that incentives be created in order to encourage profit retention in order to allow SMMEs to generate sufficient revenue for further growth and development.

6 3 Conclusion

As stated earlier, tax legislation should not be used as a cure for all economic ills, however, where tax legislation has the potential to make a positive impact and is identified as an encumbrance towards a particular objective such tax policy should be reformed. Although the a tax provision cannot exist on its own and must always be considered in light of its circumstances, much is to be observed from jurisdictions with similar provisions, but more successful provisions. It is important to note that provisions of foreign jurisdictions should not be taken and implemented just as they are, but should be tailored to suite South Africa in its current economic condition.

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