KPMG

Tax Alert

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Section 12J Investments – Is it still a worthwhile investment opportunity?

The journey thus far

Securing reliable and sustained financing has always been a challenge for small to medium enterprises. Section 12J[1] was introduced on 1 July 2009 to stimulate the economy and to create employment. Potential investors are natural persons, trusts and corporate taxpayers. It is also important to note that this legislation remains available for non-tax residents too.

The great (tax) attraction

The great attraction with section 12J investments is the tax deduction enjoyed in tax year in which the investment is made. For example, a taxpayer (natural person) invests ZAR1 million in a section 12J Venture Capital Company (VCC). He/she will receive 45%[2] (ZAR 450 000) of that investment back in tax in the tax year during which their capital investment was made. This means that assuming that the taxpayer-investor remains invested for the minimum period (discussed below), only ZAR 550 000 of the investment remains at risk.

A taxpayer-investor is also eligible to receive South African sourced dividend income which is subject to dividend withholding tax but is exempt from income tax.

How does one claim the tax deduction?

The tax deduction is claimed via the income tax return (forms ITR12/ITR12T/ITR14) so the investment does not require an additional tax filing. Many section 12J investments are made in the month in which provisional tax payments are paid to the South African Revenue Service (SARS) since the section 12J investment may be treated as a tax deduction when determining provisional tax liabilities.

Capital gains tax considerations

When a taxpayer disposes of an asset, capital gains tax has to be considered. Capital gains are calculated as the value of *proceeds*[3] less *base cost*[4]. An effective tax rate of 18% applies to taxable capital gains. However, in relation to section 12J share disposals, the value of the base cost of the shares is nil. In other words, the capital gains will be calculated on 100% of the proceeds.

Sunset Clause

Based on current provisions, section 12J deductions will no longer be permitted after 30 June 2021.

What else should a taxpayer-investor consider?

Investment decisions and behaviour should not be driven by tax incentives only. It is recommended that the appropriate tax advice be sought prior to the investment being made and informed decisions be made.

If the taxpayer-investor has to withdraw from the investment within five (5) years of the original investment date, the tax deduction claimed in year one (1) has to be recouped and the taxes refunded are repayable to SARS. So this investment opportunity works for those taxpayer-investors with surplus cash who can set aside funds for at least five (5) years. Minimum investments vary but can start from ZAR 100 000.

— It's worthwhile doing thorough research on the various section 12J vehicles available which vary from healthcare to electronic services, technology, renewable energy, hospitality and asset-leasing businesses etc. Returns seem very attractive and intermediaries will showcase that the returns they are able to achieve for an investor exceed the returns on an elementary savings account.

- Investors need to consider their exit strategies and the consequences thereof.
- Consider the fees[5] which apply: do the benefits and investment returns outweigh the risks and costs?

What does the future hold - the current proposals?

On 21 July 2019, the Draft Taxation Laws Amendment Bill was released. It was proposed that an investment cap of ZAR 2,5 million per tax year per taxpayer applies[6]. It is understood that this proposal would apply to all taxpayers i.e. natural persons, trusts and corporate taxpayers alike. Prior to the released of this Bill, no investment cap applied.

During the recent hearings by the Standing Committee on Finance and Select Committee on Finance in Parliament, it was proposed that the investment limitation per tax year differ between a natural person and a corporate entity. It has been proposed that the investment cap per tax year be limited as follows:

- ZAR2 500 000 per tax year for natural persons; and
- ZAR5 000 000 per tax year for corporate entities.

It is envisioned that these limitations would be applicable retrospectively to 21 July 2019.

Conclusion

It is recognised that section 12J remains an attractive tax incentive for the tax-savvy, well-informed investor who may wish to diversity their investment portfolios. The tax refund received in year one (1) could be used to reinvest in other (more traditional) investments thus making monies go further. More on this topic can be found in the SARS Draft Guide on Venture Capital Companies and the SARS External Guide on Venture Capital Companies.

[1] Income Tax Act No 58 of 1962 (as amended)

2 Assumes a taxpayer who is in the highest (45%) tax bracket

3 As defined

4 As defined

5 Initiation fees, annual fees, performance fees etc.

6 With effect from 21 July 2019

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[4] As defined

[5] Initiation fees, annual fees, performance fees etc.

[6] With effect from 21 July 2019