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Changes to venture capital company tax regime

The venture capital company tax regime was introduced in 2008 to incentivise equity investments in small and upcoming businesses. A number of amendments, coming into effect between 24 October 2018 and 1 January 2019, have recently been made to this regime as part of the 2018 legislative cycle. The majority of the amendments are aimed at curbing practices that were considered by the National Treasury to be abusive. There are however some amendments that provide venture capital companies some leeway around complying with the prescribed rules.

The South African National Treasury introduced the venture capital company (VCC) regime in section 12J of the Income Tax Act in 2008 as an incentive for investors to make equity funding available to small and upcoming businesses housed in qualifying companies. Despite the fact that the uptake of the incentive has increased substantially over the past few years, it appears as if some of this growth may have been on the back of structures that were contrary to the original purpose of the regime.

A number of amendments have been made to the regime to exclude these structures from benefitting from the incentive. This article provides an overview of some of these amendments that VCCs and investors should be aware of.

Additional requirements at the investor level

Structures that enabled an investor to individually invest in specific ring-fenced underlying assets of the VCC, as opposed to being one of a pool of investors in the assets of the VCC, are targeted by the amendments. New rules aimed at limiting this practice include:

- If the VCC issues different classes of shares, no single investor can hold more than 20% of the shares of any class after the expiry of 36 months from the date that shares of that class were first issued. This prevents a scenario where a single investor can be the only holder of a particular class of share.
- Where a VCC has subscribed for shares in an investee company and any person who holds a share in that VCC, directly or indirectly together with its connected persons, hold more than 50% of the participation rights of that investee company, the investee company will not be a qualifying company. If a VCC invests in a non-qualifying company this will result in the VCC acting outside its permitted objects and possibly also breaching the thresholds applicable to the deployment of its funds.

Additional requirements at a qualifying company level

An essential element of the incentive is that it characterises the types of investee companies (qualifying companies) to which a VCC needs to deploy funds. The investee companies in which a VCC can invest as qualifying companies have been narrowed by excluding:

- Companies that acquired a venture, business or undertaking from an investor in the VCC or a connected person to an investor. This rule is presumably aimed curbing arrangements where a VCC investor transfers existing businesses owned by it into a qualifying company and enjoys the tax benefit, while continuing to operate the business as it did before.
- Companies that, after 36 months from the date when the VCC has subscribed for its shares, derive more than 50% of its total receipts or accruals of any trade is from investors in the VCC or their connected persons. By implication, a qualifying company should primarily derive its income from dealings with third parties in the long-run rather than depend on related persons.

Relaxation of rules

The application of the requirement that a qualifying company should not not derive more than 20% of its income from investment income has been moved to three years after the VCC first subscribed for shares in the company. A company that does not derive income other than incidental investment income while operations have not yet commenced would therefore still be a qualifying company during the three year period.

Founder and manager shares are no longer considered to be venture capital shares, in respect of which strict requirements apply. These shares can be distinguished from those subscribed for by investors as no deduction is granted to the founder or manager if shares are acquired in exchange for services rendered.

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