University of the Witwatersrand

Faculty of Commerce, Law and Management

School of Accountancy

A comparative study of the tax considerations of traditional funding available to Small, Medium and Micro Enterprises versus alternative sources of funding

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfillment of the requirements for the degree of Master of Commerce (specializing in Taxation)

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Abstract

During the February 2018 National Budget Speech, the 2018 GDP growth projection was anticipated at 1.5% (National Treasury 2018), 0.6% higher than the percentage projected by the International Monetary Fund (IMF) just a month before (Khumalo 2018). In a country with a low GDP and an unemployment rate sitting at a staggering 26.7% (Statistics South Africa 2018), Small, Medium and Micro Enterprises (SMME's), sometimes referred to as small businesses, play a pivotal role in the success of the economy.

Research however shows that most SMME's fail within the first three years of incorporation, largely due to the continuous funding required in sustaining a new business (Mail and Guardian, 2017). This report will analyse the tax considerations of the various types of funding available to SMME's in comparison to debt financing. The various types of funding dealt with in this report include: hybrid instruments, offshore funding, venture capital, group funding and crowd-funding.

Key words: National Budget Speech, GDP, National Treasury, IMF, unemployment, SMME, economy, South Africa, SMME funding, taxation of SMME's, debt financing, hybrid instruments, offshore funding, venture capital, group funding, crowd-funding

Declaration

I declare that this research report is my own unaided work. It is submitted in partial fulfilment of the requirements for the degree of Master of Commerce (specializing in Taxation) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.

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Solomon Ortiz once said, 'education is the key to success in life'. May this be the beginning of greater academic achievement for our families

Roy Blumenthal:

Thank you for supervising me with such excellence

My heirs:

This is for you

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Chapter 1: Introduction

1. Introduction and background

Small business and start-ups often face financial constraints mainly due to an inadequate credit history or tangible credit enhancing collateral (OECD, 2017). With the 2018 downgrades of South Africa's credit rating to 'junk status' from rating agencies resulting in an increase in the cost of borrowing and consequently the cost of lending by banks, it has become increasingly more difficult for small businesses to secure funding traditionally (Jansen van Rensburg, 2017). It is particularly even more difficult for borrowers with minimal personal assets to use as collateral, lack of skills and knowledge to produce financial statements, poor business models and plans, and lack of credit history to secure funding (Mhlanga, T 2018).

Without considering the tax consequences relating to the specific funding, SMME's tend to focus on obtaining the easiest form of funding or, in more common instances, the only source of funding that is available should they not have personal savings. Considering tax may sometimes result in a reduced tax liability and thus an improved cash flow. This report will seek to provide a simplistic and concise comparison of the tax considerations that apply to the five different sources of funding and traditional debt financing, for the use of currently existing, and future (new) SMME's that are incorporated and deemed to be tax resident in South Africa. The research will be from the point of view of the borrower. The six difference sources of funding dealt with in this report are:

- Debt funding,
- Crowd-funding,
- Hybrid instruments,

- Group funding,
- Offshore funding, and
- Venture capital.

Most entrepreneurs who endeavour to incorporate SMME's, are naturally exposed to traditional forms of funding by way of loans from financial institutions. Few of such entrepreneurs are aware of the numerous alternative sources of funding for small businesses which have emerged over the years. Such alternative sources of funding not only may prove to be more readily accessible and require less paperwork for the entrepreneur, but may sometimes provide an element of tax efficiency that some entrepreneurs do not consider when sourcing funds for their SMME's. Tax compliance imposes an enormous burden on SMME's (Chamberlin & Smith, 2006), therefore the full comprehension thereof, is paramount to the success and longevity of SMME's. The primary taxes that SMME's would need to account for include:

- **Value-added tax (VAT).** VAT is applicable to SMME's that meet the definition of a 'vendor' as defined in the VAT Act. The registration for VAT by a vendor is either voluntary or mandatory depending on the value of taxable supplies made or to be made in a period of 12 months. Generally, a SMME may elect to register for VAT if the value of their taxable supplies has exceeded R50,000 in the past 12 months, but have not exceeded R1 million. In terms of VAT Registration Regulations, a person carrying on an enterprise which has not made R50,000 in taxable supplies in a period of 12 months, is also allowed to register for VAT subject to certain criteria (SARS, 2019d). SMME's who's taxable supplies however exceed R1 million, are obliged to register for VAT with the South African Revenue Service. VAT is segregated into output VAT and input VAT. Output VAT is computed based on the invoiced taxable supplies made (services rendered or good sold) at a rate of 15% and is payable to the South African Revenue Service in intervals depending on the vendor's category. Input VAT is computed based on the invoiced taxable supplies received by the SMME at a rate of 15% and is receivable from the South

African Revenue Service. Certain items are zero-rated but theses have not been dealt with here.

The VAT categories described above, are as follows:

Category number	Requirement	Which vendor falls within this category?
A	A vendor must submit one return for every 2 calendar months, ending on the last day of January, March, May, July, September and November	Determined by the Commissioner
B	A vendor must submit one return for every 2 calendar months, ending on the last day of February, April, June, August, October and December	Determined by the Commissioner
C	A vendor must submit one return every calendar month	1. Taxable supplies of vendor have, or are expected to exceed R30 million in any consecutive period of 12 months 2. Vendor has applied in writing to be included in this category, or 3. Vendor has failed to perform any obligations as required by the VAT legislation
D	A vendor must submit one return for every six calendar months, ending on the last day of February and August	1. Vendor carries on farming activities where the total value of taxable supplies is less than R1.5 million for a period of 12 months 2. Vendor is a micro-business that is registered in terms of the Sixth Schedule to the Income Tax Act

E	Vendor must submit one return for every twelve months, ending on the last day of the vendor's year of assessment	Vendor is a company or a trust fund. Additional criteria for this category, can be found on Chapter 3 of the VAT 404 guide

Source: (SARS 2019) https://www.sars.gov.za/TaxTypes/VAT/Pages/Tax-periods-for-vat-vendors.aspx

- **Income Tax.** All SMME's who register their businesses with the Companies and Intellectual Property Commission (CIPC), must concurrently register for Income Tax with the South African Revenue Service. This registration requirement is not dependent on the gross revenue that the SMME is expecting to earn during the year of assessment. Registration with the CIPC is not mandatory for SMME's, particularly for informal or sole proprietors who can be taxed in their personal capacity, however SMME's that seek to engage and transact with the public and private sector, generally register with the CIPC to obtain limited liability. are generally required to be formally registered with the CIPC.

- **Skills Development Levy (SDL).** SDL registration is only applicable to SMME's that are employers (in other words, SMME's who employ staff to render services within their business). Employers who expect that the total salaries they will incur over a period of 12 months will exceed R500,000, are liable for the SDL. The SDL levy, is a monthly levy of 1% of the total salaries paid for the year. 'Total salaries' includes normal contractual pay, overtime pay, and leave pay. Employees that would fall within the ambit of computing 'total salaries' would be employee's whose income meet the definition of 'remuneration' as defined in the Fourth Schedule of the Income Tax Act. 'Remuneration' is defined in the Fourth Schedule of the Income Tax Act as:

> 'any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, super annunciation allowance, retiring allowance or stipend, whether in cash or otherwise, and whether or not in respect of services rendered...'

- **Pay-As-You-Earn (PAYE).** PAYE is a mandatory monthly tax withheld from employees and payable by employers based on the rate of taxable income applicable to the respective employee as a product of their taxable income for the year of assessment, less any applicable rebates. Taxable income can be simply computed as; Gross income *less* deductions *less* exemptions. The taxable income and their applicable tax rates for the year of assessment ended 28 February 2019, is noted below:

Table 2.1: Individuals for the financial years ending between 1 April 2018 and 31 March 2019

Taxable income (R)	Rate of tax (R)
0 – 195 850	18% of taxable income
195 851 – 305 850	325 253 + 26% of taxable income above 195 850
305 851 – 423 300	63 853 + 31% of taxable income above 305 850
423 301 – 555 600	100 263 + 36% of taxable income above 423 300
555 601 – 708 310	147 891 + 39% of taxable income above 555 600
708 311 – 1 500 000	207 448 + 41% of taxable income above 708 310
1 500 001 and above	532 041 + 45% of table income above 1 500 000

Source: (SARS 2019c) https://www.sars.gov.za/Tax-Rates/Income-Tax/Pages/Rates%20of%20Tax%20for%20Individuals.aspx

- **Unemployment Insurance Fund (UIF).** The UIF is a mandatory levy that is required to be paid by employers who employ individuals for a period exceeding 24 hours per month, to the UIF monthly. The UIF is computed as 2% of the employees' gross salary of which 1% is contributed by the employer and, 1% is contributed by the employee.

The Income Tax Act provides several deductions and allowances that may alleviate the tax burden faced by companies, including SMME's. Additional tax benefits in the form of lower tax rates, as well as accelerated allowances are available to SMME's that meet the definition of 'small business corporation' which will be discussed in Chapter 2 of this research report. This research report seeks to address some of these allowances and deductions.

There is currently no distinct definition of 'alternative sources of funding' however, it can simply be defined as 'non-bank lending' (Segal, 2016) or funding that is acquired from a source that is not a financial institution. Alternative sources of funding include, *inter alia*, the following:

- Crowd-funding,
- Hybrid instruments,
- Group funding,
- Offshore funding, and
- Venture capital.

The Income Tax Act provides sufficient tax legislation on the considerations applicable to most of the alternative sources of funding, namely: sections 8E and 8F for hybrid instruments; section 31 (and exchange control) for offshore and group funding; section 24J for debt financing, and section 12J for venture capital. The OECD dealing with group funding will also be studied. South Africa however does not have specific legislation for crowd-funding, thus this study will address the considerations for crowd-funding through examining the provisions of the Income Tax Act that may apply to crowd-funding.

2. Problem Statement

Historically, the concept of entrepreneurship is about the individual's capability to spot opportunities and take relevant action of exploiting such opportunities (Venter, 2010:11). Resources are then mobilised to exploit such opportunities, followed by trading for maximum profit; thus, societies with more entrepreneurial activities are more likely to economically outperform others with lesser entrepreneurial activities (Venter, 2010:11). One of the greatest challenges faced by SMME's however, is the ability to adequately source start-up capital and continuous funding for the first few years of trading (Mail and Guardian 2017). This has created a need for entrepreneurs, particularly SMME's with minimal business history, to identify alternative sources of funding as opposed to traditional funding to fund their business endeavours.

The purpose of this research report is to identify alternative sources of funding available to SMME's and consider the tax considerations of traditional funding (bank lending), versus alternative sources of funding and establish, *ceteris paribus*, the most tax efficient source of funding.

3. Research question

What are the tax consequences for SMME's based on the different sources of funding?

4. Research sub-questions

- What is an SMME?
- What are the different sources of funding and the tax considerations for each of them?
- What is meant by the term 'alternative sources of funding'?
- What alternative sources of funding are available to SMME's?
- What are some of the constraints and challenges faced by SMME's in securing different sources of funding?
- How does the taxation of alternative sources of funding, compare to those of traditional debt financing?

5. Aim and purpose of the study

Estimates of the contribution of SMMEs to the economy vary. In terms of contribution to GDP in 2017, an estimate of 52 to 57 per cent has been quoted by the Deputy Minister of Trade and Industry, Elizabeth Thabethe, who put the number of SMMEs in South Africa at 2,8 million and their contribution to employment at 60 per cent (South African Reserve Bank, 2018). There is still however a need for more SMME's to be established to assist with the state of unemployment in South Africa, and the overall improvement of the economy at large. Research has been conducted individually for the various forms of funding available to SMME's however no existing research has compiled a comprehensive comparison of the tax considerations of various forms of funding. This study will assist entrepreneurs to understand the different tax elements involved in the various alternative sources of funding and provide them with an opportunity to make informed decisions when selecting funding for their respective SMME's.

6. Research methodology

This research will be performed mainly using a qualitative approach and literature review to address the research problem, coupled with statistical analyses performed by Statistics South Africa, the Small Enterprise Development Agency and National Treasury relating to the topic being researched. Further sources will include journal articles, acts, research reports, and dissertations.

7. Structure of the research report

The research report will consist of the following chapters:

Chapter one will give the background to the research report. The chapter will also include an explanation of the significance of the study, the research questions and sub-questions. A hypothetical scenario will be used to illustrate the tax principals and tax effects of the different sources of finance. The chapter will conclude with the tax considerations that will be addressed within the study, with reference to funding available to SMME's.

Chapter two will establish the residency of companies in the corporate group noted in the hypothetical example in point 7 below, using sections and definitions within the Income Tax Act, and the Organisation for Economic Co-operation and Development Model Tax Convention with respect to taxes on income and on capital.

Chapter three will address the tax considerations of debt financing on the tax computations of the SMME's, considering the provisions of section 24J of the Act. The chapter will also briefly discuss the challenges in obtaining debt financing from financial institutions, which will provide a basis of discussing the tax considerations of alternative sources of funding.

Chapter four will define crowd-funding, provide an overview of the status of crowd-funding in South Africa, and address the tax considerations of crowd-funding. As there is no formal legislation on crowd-funding in South Africa, this chapter will make use of provisions within the Act (including, but not limited to, the gross income definition, section 10, section 11 and section 23).

Chapter five will define hybrid instruments, and address the tax considerations of hybrid instrument funding as per sections 8E and 8F of the Act.

Chapter six will address the tax considerations of group funding and offshore funding, with reference to section 31 of the Act and exchange control policies in South Africa. This chapter will also discuss the possibility of group funding and offshore funding giving rise to base erosion and profit sharing (BEPS) considerations.

Chapter seven will address the tax considerations of private equity instruments, venture capital specifically, applicable to SMME's, in the context of section 12J of the Act.

Chapter eight, the conclusion will provide an outline of the current South African tax considerations of traditional financing versus alternative finance. This chapter will also highlight the limitations of the study and recommend areas for future research.

8. Scope and Limitations of the study

Based on the nature of the research, the research focused on the tax considerations of only five alternative sources of funding available to SMME's namely; crowd-funding, hybrid instruments, group funding, offshore funding and venture capital and provided a comprehensive overview of the tax considerations applicable to the sources of funding in the context of South African tax legislation. Furthermore, the study only focused on a general sector (in other words, clothing and textile industry) and did not address other tax considerations applicable to specific sectors which may have further tax benefits for SMME's. Furthermore, the research did not comprehensively analyze all the deductions and allowances available to SMME's. These are inherent limitations that provide the basis for future research in these fields.

9. Hypothetical example

This research report will be based on the hypothetical example of a small to medium enterprise, Will Bagg (Proprietary) Limited.

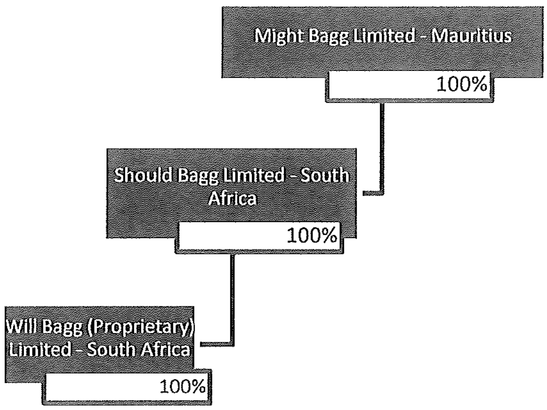


Figure 1: Group structure of the Might Bagg Group.

Might Bagg Group comprise the following entities:

- Might Bagg Limited (MB) – MB is incorporated in Mauritius.
- Should Bagg Limited (SB) – SB is a wholly-owned subsidiary of MB, and is incorporated in South Africa.
- Will Bagg (Proprietary) Limited (WB) – WB is a wholly-owned subsidiary of SB, and is incorporated in South Africa.

WB operates in the clothing and textile industry and purchases clothing from China, to resell in South Africa. WB has 1 000 authorised ordinary share capital, and 1 000 authorised Class A cumulative redeemable preference shares with a coupon rate of 10%.

An extract of the financial results of Will Bagg are as follows:

Taxpayer	Will Bagg (Pty) Ltd
Financial year end	28 February 2019
Taxable revenue	R7000 000
Deductible operating expenses*	R6000 000
Taxable income	R1000 000
Authorised ordinary share capital	R1000 000
Authorised, cumulative redeemable preference shares – 10%	R1000 000
Tax rate	28%
Required funding – 2019 financial year end implications	R1000 000

* Deductible operating expenses excludes any financing deductible or allowable expenses

For purposes of this research report, all indirect taxes will not be analyzed or discussed.

Chapter 2: Tax residency

1. What constitutes tax residency in South Africa

There are two alternative approaches to the taxation of income flows across international borders. In a source-based system, tax is levied on income earned from a source within a country irrespective of whether it was earned by a resident or a non-resident. In a residence-based system, tax is levied on the residents of a country irrespective of where in the world the income is earned (National Treasury, 2000). In 2001, Trevor Manuel, the then Minister of Finance announced in his Budget Speech that South Africa's basis of taxation will be changed from a source basis to a residence basis of taxation (National Treasury, 2001). The residence-based income Tax came into effect on 1 January 2001. Even though South Africa changed their basis of taxation from source to residence, non-residents will be taxed on their actual or deemed source of income according to section 9(2)(a)-(h) of the Income Tax Act (Parumaul, 2013). Subsequently, section 9(2) has been increased from (a)–(l).

The tax liability of a foreign company in South Africa will depend on whether the foreign company is regarded as a resident or non-resident for income tax purposes in South Africa. Where the foreign company is regarded as a resident in South Africa (by virtue of its place of effective management being, or being deemed to be in South Africa), the foreign company will be subject to tax in South Africa on its worldwide income. If however the foreign company is regarded as a non-resident in South Africa, the foreign company will only be subject to income tax in South Africa on income derived from a source in South Africa and subject to capital gains tax ('CGT') in South Africa on the disposal of immovable property in South Africa or a right or interest in immovable property situated in South Africa; and on the disposal of assets attributable to a permanent establishment ('PE') of the foreign company in South Africa. (Camay, 2009)

Section 5 (1) of the Income Tax Act states that:

> Subject to the provisions of the Fourth Schedule there shall be paid annually for the benefit of the National Revenue Fund, an income tax (in this Act referred to as the normal tax) in respect of the taxable income received by or accrued to or in favour of –
>
> ...
>
> (d) any company during every financial year of such company.

On the basis of section 5 of the Income Tax Act, all companies are required to pay income tax annually in respect of the taxable income they receive.

2. Definitions

Section 1 of the Income Tax Act, in the context of non-natural persons, and, where applicable, the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (OECD), defines, inter alia, the terms resident, company, foreign company and permanent establishment. For the purposes of this research, we assume that WB, SB and MB are effectively managed in the country where they are incorporated.

The definitions noted below, are extracted from section 1 of the Income Tax Act, unless indicate otherwise.

2.1. Resident

'resident' means any –

(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic;

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation;

The definition of 'resident' includes an exception to the incorporation and establishment requirement through the use of double tax agreements (DTA's). The purpose of DTA's between the two tax administrators of two countries, is to enable the administrators to eliminate double taxation (SARS 2018d) and to prevent fiscal evasion with respect to taxes on income (SARS 2015). A DTA between South Africa and Mauritius was initially enforced in June 1997 (GG 18111). This DTA was subsequently replaced by GG 38862 which was enforced on 28 May 2015.

To balance the above competing considerations as noted in the definition of 'resident', South Africa has adopted two tests for determining the tax residency of a juristic person. Under the first test, a juristic person is regarded as a tax resident if it is incorporated, established or formed in South Africa. This is a formal test and is generally straightforward in its application. It is however also open to manipulation, particularly in the modern global environment, and may have 'little or no connection to the entity's actual economic and business links'. The second test looks to a juristic person's 'place of effective management'. This test has been recognized as a 'less artificial measure' that looks to 'substance over form'. (Van Der Merwe 2006:122)

A company is defined in section 1 of the Income Tax Act as follows:

'company' includes –

(a) any association, corporation or company (other than a close corporation) incorporated or deemed to be incorporated by or under any law in force or previously in force in the Republic or in any part thereof, or any body corporate formed or established or deemed to be formed or established by or under any such law; or

(b) any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law; or

(c) any association, corporation or company incorporated under the law of any country other than the Republic or any body corporate formed or established under such law; or

A small business corporation is defined in the Income Tax Act section 12E(4) as follows:

(4) For the purposes of this section –

(a) **'small business corporation'** means any close corporation or co-operative or any private company as defined in section 1 of the Companies Act or a personal liability company as contemplated in section 8(2)(c) of the Companies Act if at all times during the year of assessment all the holders of shares in that company, co-operative, close corporation or personal liability company **are natural persons**, where–....

(i) the gross income for the year of assessment does not exceed an amount equal to R20 million:

Provided that where the close corporation, co-operative or company during the relevant year of assessment carries on any trade, for a period which is less than 12 months, that amount shall be reduced to an amount which bears to that amount, the same ratio as the number of months (in the determination of which a part of a month shall be reckoned as a full month), during which that company, co-operative or close corporation carried on that trade bears to 12 months;

(ii) at any time during the year of assessment, no holder of shares in the company or member of the close corporation or co-operative holds any shares or has any interest in the equity of any other company as defined in section 1, other than –

(aa) a company contemplated in paragraph (a) of the definition of 'listed company';

(bb) any portfolio in a collective investment scheme contemplated in paragraph (e) of the definition of 'company');

(cc) a company contemplated in section 10(1)(e)(i)(aa), (bb) or (cc);

(dd) less than 5 per cent of the interest in a social or consumer co-operative or a co-operative burial society as defined in section 1 of the Co-operatives Act, 2005 (Act No. 14 of 2005), or any other similar co-operative if all of the income derived from the trade of that co-operative during any year of assessment is solely derived from its members;

(ee) any friendly society as defined in section 1 of the Friendly Societies Act, 1956 (Act No. 25 of 1956);

(ff) less than 5 per cent of the interest in a primary savings co-operative bank or a primary savings and loans co- operative bank as defined in the Co-operative Banks Act, 2007, that may provide, participate in or undertake only the following –

(A) in the case of a primary savings co-operative bank, banking services contemplated in section 14(1)(a) to (d) of that Act; and

(B) in the case of a primary savings and loans co-operative bank, banking services contemplated in section 14(2)(a) or (b) of that Act;

(gg) a venture capital company as defined in section 12J;

(hh) any company, close corporation or co-operative if the company, close corporation or co-operative –

(A) has not during any year of assessment carried on any trade; and

(B) has not during any year of assessment owned assets, the total market value of which exceeds R5 000; or

(ii) any company, co-operative or close corporation if the company, co-operative or close corporation has taken the steps contemplated in section 41(4) to liquidate, wind up or deregister: Provided that this item ceases to apply if the company, co-operative or close corporation has at any stage withdrawn any step so taken or does anything to invalidate any step so taken, with the result that the company, co-operative or close corporation will not be liquidated, wound up or deregistered;

(iii) not more than 20 per cent of the total of all receipts and accruals (other than those of a capital nature) and all the capital gains of the company, close corporation or co-operative consists collectively of investment income and income from the rendering of a personal service; and

(iv) such company is not a personal service provider as defined in the Fourth Schedule;

In comparison to the definition of a 'company' the definition of a small business corporation is comprehensive. The definition can be segregated in 4 key elements, namely:

- Legal entity requirement
- Holder of shares requirement
- Gross income limitation requirement
- Business activity requirement (SARS 2012a).

The key element with reference to the hypothetical example, is the holders of the shares requirement. All holders of the shares of the small business corporation must be natural persons. Different tax rates apply to different types of companies. For example, companies which meet the definition of a small business corporation, with a taxable income of less than R78 150, are taxed at a rate of 0%. Table 2.2 specifies the tax rates applicable to companies and close corporations whose financial year ends between 1 April 2018 and 31 March 2019.

Table 2.2: Companies and Trusts for the financial years ending between 1 April 2018 and 31 March 2019

Taxable income (R)	Rate of tax (R)
Companies and Personal service provider companies	28%
Foreign resident companies which earn income from a source in South Africa	33%

Source: (SARS 2019a) https://www.sars.gov.za/Tax-Rates/Income-Tax/Pages/Companies-Trusts-and-Small-Business-Corporations.aspx

As a form of incentive to increase the number of small businesses, create employment and aid in the overall cash flow of small businesses, small business corporations incorporated in South Africa are subject to reduced tax rates. The tax rates as indicated in Table 2.3 are applicable to small business corporations whose financial year ends between 1 April 2018 and 31 March 2019.

Table 2.3: Small business corporations for the financial years ending between 1 April 2018 and 31 March 2019

Taxable income (R)	Rate of tax (R)
0 – 78 750	0%
78 751 – 365 000	7% of taxable income above 78 150
365 001 – 550 000	20 080 + 21% of taxable income above 365 000
550 001 and above	58 930 + 28% of taxable income above 550 000

Source: (SARS 2019a) https://www.sars.gov.za/Tax-Rates/Income-Tax/Pages/Companies-Trusts-and-Small-Business-Corporations.aspx

'foreign company' means any company which is not a resident;

Permanent establishment means:

> 'permanent establishment' means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (Convention).

Within the Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on, or an agent acting on behalf of the company has, and habitually exercises in a territory, authority to do business on behalf of the company (OECD 2015). For example, if an overseas business has a UK permanent establishment then the profits of the business that are attributable to that PE, either directly or indirectly, are chargeable to UK tax (Tax Innovations, n.d..). The same principle applies if a foreign business has a South African permanent establishment. Thus, based on the tax impact of creating a permanent residence, it is important to determine whether a foreign business has created a PE in South Africa.

3. Conclusion

From the above definitions, we note that it is important to determine the tax residency of a company so as to determine where the tax is liable, and at what rate. WB and SB are wholly owned subsidiaries incorporated in South Africa. Therefore, based on the definition of 'permanent establishment' and 'company' sub-section (a) read with the definition of 'resident', both WB and SB meet the Income Tax Act definition of 'resident' in South Africa, and, due to section 5(1) of the Income Tax Act, would be subject to tax on income received worldwide.

MB is not incorporated, established or formed in South Africa, and does not have a fixed place of business in South Africa or an agent acting on its behalf as noted in the definition of 'permanent establishment'. MB therefore falls outside of the definition of 'resident' and 'company' in the Income Tax Act and 'permanent establishment' in the Convention. MB is therefore a foreign company as it is a company that is not a resident. Foreign companies are only subject to tax for income sourced from South Africa.

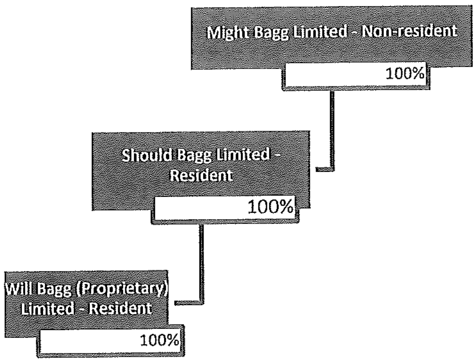


Figure 2: Tax residency in South Africa of Might Bagg Group

WB has been determined as a company whose tax residence is in South Africa, and therefore would be taxed at 28%, or, if the definition of a small business corporation is met, at a reduced tax rate. As discussed above, there are four key criteria that need to be met by a company in order to qualify as a small business corporation and enjoy the benefits of reduced tax rates.

Key requirement	Application to hypothetical example	Definition of small business corporation met?
Legal entity requirement	WB is a proprietary limited company (private company)	Yes

Gross income limitation	WB's gross annual income is below R20 million for the year of assessment	Yes
Business activity requirement	WB does not have investment income and income from rendering a personal service exceeding 20% of the total receipts and accruals no receipts and accruals not of capital nature as part of their gross income for the year.	Yes
Holder of shares requirement	WB is wholly owned by a resident company (SB)	No

WB thus meets three of the four key criteria required for small business corporations. Therefore, it does not meet the definition of a small business corporation as it is not owned by a natural person (section 12E(4)(*a*) of the Income Tax Act). WB will therefore not qualify for the reduced tax rate for small business corporation or the acceleration allowances within the Income Tax Act. The computed taxable income earned, will be taxed at the normal company rate of 28%. The requirements of a small business corporation need to be assessed and met annually.

An alternative tax that is available to small businesses is the 'turnover tax'. Turnover tax is an alternate, simplified method of business tax in South Africa. It is a tax for small business in South Africa with an annual turnover of R1,000,000 or less. It replaces corporate income tax, VAT, capital gains and dividends tax in South Africa, although there is an option to remain in the VAT system (Expactica, 2019). WB is not eligible to make use of the turnover tax.

Taxpayers with the intention of making use of the small business corporation reduced tax rates, should ensure that all four key criteria are met annually, failing which the tax rate will revert to 28% of taxable income.

Chapter 3: Debt funding

1. Definitions

Debt financing generally takes the form of bank loans, revolving lines of credit and even use of credit cards (Marz, M n.d.). Section 1 of the Income Tax Act contains the main definitions in the Act, but does not define 'debt' (Niekerk, S 2015). In the absence of the definition of 'debt' in the Act, the definition thereof ought to be interpreted by use of statutory interpretation rules. It is important to understand the definition of debt in the context of the Income Tax Act in order to determine the tax considerations applicable to it.

> Consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed, and the material known to those responsible for its production (*Natal Joint Municipal Pension Fund v Endumeni Municipality 2012*).

The Oxford Dictionary defines 'debt' as 'a sum of money that is owed or due' (Oxford English Dictionary n.d.). Debt financing involves borrowing funds from creditors with the stipulation of repaying the borrowed funds plus interest at a specified future time (Yoo, 2018).

From the dictionary definitions of debt, coupled by the views of Mars and Niekerk, one is able to conclude that debt can be defined as a form of loan which needs to be repaid by the recipient. A 'loan' is also not explicitly defined in the Income Tax Act, however forms part of the definition of a 'financial instrument'.

Section 1 of the Income Tax Act defines 'financial instrument', with the following definitions that would be in line with debt financing:

'financial instrument' includes –

(a) a loan, advance, debt, bond, debenture, bill, share, promissory note, banker's acceptance, negotiable certificate of deposit, deposit with a financial institution, a participatory interest in a portfolio of a collective investment scheme, or a similar instrument;

...

(d) any interest-bearing arrangement;

A 'financial instrument' is defined twice in the Income Tax Act. The definition of 'financial instrument' linked to hybrid instruments, will be discussed in chapter 5 of this research report. As the definition of 'financial instrument' includes an interest-bearing arrangement, and most debt financing will include a form of interest repayment, the Income Tax Act definition of 'interest' will need to be assessed.

Section 24J(1) of the Income Tax Act defines 'interest' as follows:

'interest' includes the –

(a) gross amount of any interest or similar finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
(b) amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and
(c) absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party,

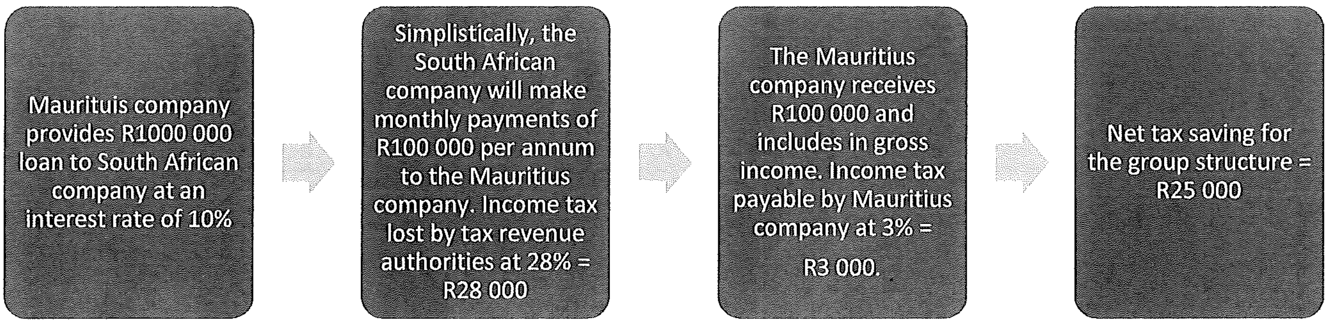
irrespective of whether such amount is –

(i) calculated with reference to a fixed rate of interest or a variable rate of interest; or
(ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement;

2. Debt funding challenges faced by SMME's

Former Finance Minister, Malusi Gigaba, stated in the Budget Speech in 2018 that: 'The deductibility of interest payments on debt acts as an incentive to use debt rather than equity funding, and can be used to strip profits from high tax countries' (Chong, 2018). An example of this principle can be seen through a company incorporated in South Africa (28% tax rate) that is 80% owned by a company incorporated in Mauritius (a low tax jurisdiction, 3% effective tax rate) and has the option of receiving funding from its holding company in the form of equity (to increase shareholding to 100%) or in the form of debt funding at an arms-length interest rate. The following tax considerations would transpire:

Figure 3 - Flow of transactions: Loan from foreign company



The following have been noted by the OECD as some limitations faced by SMME's in relation to debt financing (OECD, 2015):

- Lack of infrastructure for information provision (e.g. generalized and accessible data warehouses for credit/risk assessment),
- Lack of performance track records, benchmarks,
- Limited buy-in by institutional Investors and patient capital,
- Limited internal infrastructure (due diligence, monitoring, modelling and evaluating SME – related credit risk and financing).

Arguably, one of the leading reasons as to why SMME's face difficulties receiving traditional funding, is due to the infancy of most of the businesses having no previous track record of financial performance. SMME's are generally seen as high-risk investments, and if funding is granted, it is generally at a high interest rate which is not favorable, particularly from a cash flow perspective, on SMME's.

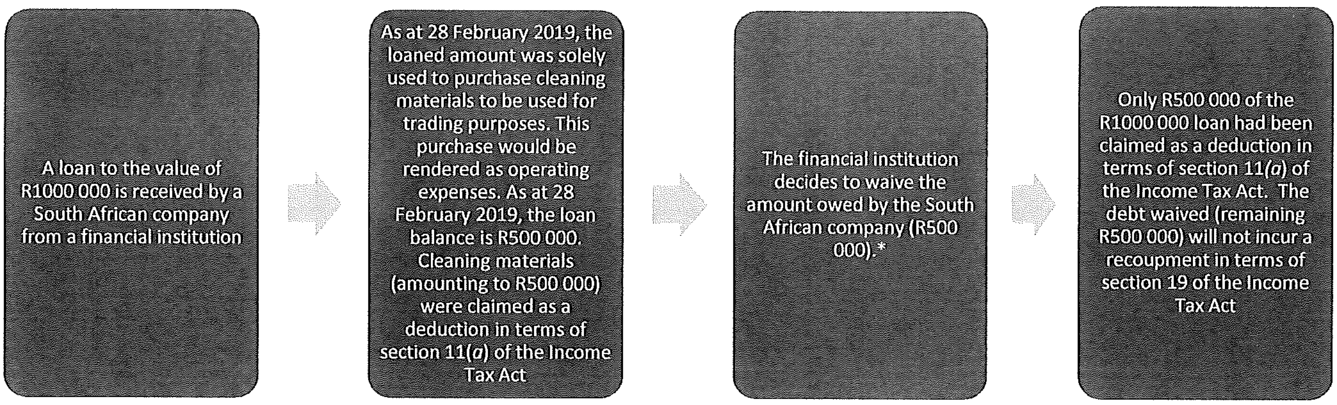
3. Tax considerations of debt funding

Whilst the legal nature and label of debt and equity normally dictates the tax consequences of the returns, the Act incorporates specific sections to overcome perceived abuse of the tax base of the country and to tax instruments according to their true substance. Sections 8E and 8F serve to re-characterise the returns on debt and equity. Sections 23M and 23N serve to impose limitations on interest deductions particularly where the use of debt is deemed to be excessive. Section 24O, on the contrary, allows for interest deductions in circumstances that would not normally qualify in terms of the general deduction formula (Wortmann, 2015).

The deductibility of expenditure for income tax purposes should be considered in terms of the general deduction formula contained in section 11(*a*) and 23(*g*), of the Income Tax Act (Rudding, J 2014). The Act does, however, contain provisions which are specially tailored for the deduction of specific expenditure. Section 24J of the Act ('section 24J') is one such provision and allows taxpayers to claim a deduction specifically for interest expenditure (Matlatla, 2015). Section 24J applies where a person is the issuer of an 'instrument' or the holder of any 'income instrument' during a year of assessment. The application of section 24J is therefore founded on the definition of 'instrument' (Fourie, 2014). Although section 24J would have no impact on the issuer or holder of an instrument that is a non-interest-bearing debt (as there is no interest to be spread over the term of the instrument), there is still an onus on the taxpayer to apply section 24J to each and every instrument (including all debt instruments) and prove that there is no impact on their taxable income (Fourie, 2014). The interest expense on debt is allowed as a deduction under section 24J provided, inter alia, that it is incurred in the production of the income (Wortmann, 2015).

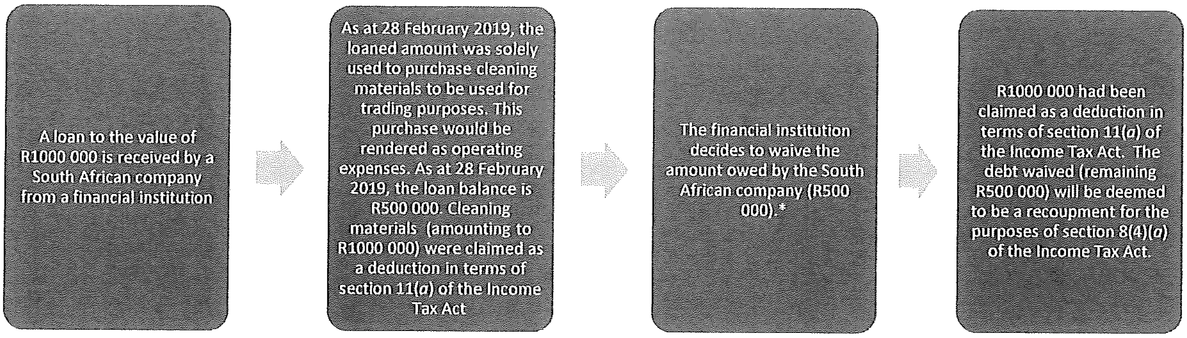
Taxpayer's must however take note that there are consequences in debt issued being waived, cancelled, reduced or discharged. The tax implications arising in respect of the reduction of a debt, depends mainly on whether the loan funding was used to fund tax deductible expenditure such as operating expenses or alternatively capital or allowance assets. The debt reduction rules apply only to the extent to which the waiver, cancellation, reduction or discharge of a debt gives rise to a 'reduction amount', in other words, the amount, by which the decrease in debt exceeds the consideration received by the creditor in return (Brink, J 2017). The debt reduction principles can be illustrated through an example as below:

<u>Figure 4: Debt reduction – portion of loan used to fund operating expenses</u>



*For purposes of this illustration, the effects of compound interest are ignored

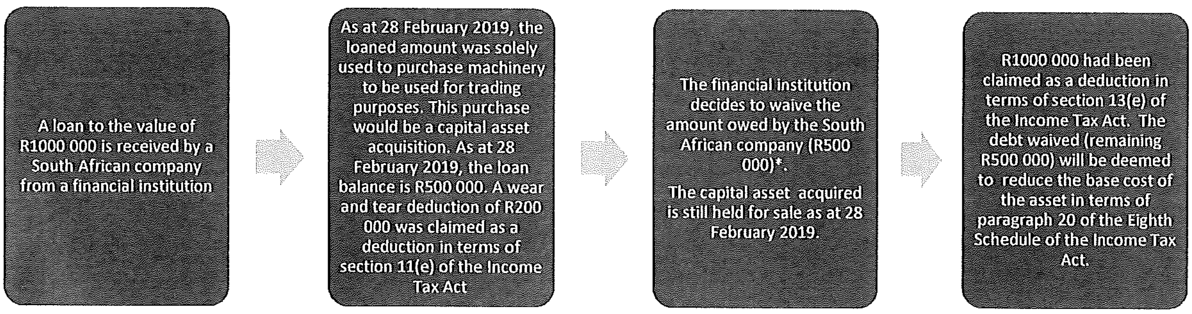
<u>Figure 5: Debt reduction – full amount of loan used to fund operating expenses</u>



*For purposes of this illustration, the effects of compound interest are ignored

Taxpayer's should not only refer to section 19 of the Act and paragraph 12A of the Eighth Schedule of the Act, but should note that donations tax per section 54 to 64 of the Act, may be applicable and therefore should be considered (Dachs, P 2014). Paragraph 12A of the Act works similarly to section 19 of the Income Tax Act as noted in the illustration below

Figure 5: Debt reduction – full amount of loan used to fund machinery (deductible in terms section 13(e))



*For purposes of this illustration, the effects of compound interest are ignored

4. Normal tax computation: Debt funding

If WB were to receive funding from a financial institution to the value of R1000 000 (lump sum received 1 March 2018, at an interest rate of 12% per annum, based on section 24J of the Income Tax Act, WB would be allowed an annual interest deduction of R120 000.

The tax calculation of WB for the 2019 year of assessment would be:

	Amount	**Income Tax Act reference/ Calculation**
Gross income	R7000 000	Section 1 (Gross income definition)
Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Debt financing deduction	(R120 000)	Section 24J
Taxable income	**R 880 000**	
Tax payable	R 246 400	(R880 000 * 28%)

The computed tax payable for WB for the 2019 year of assessment would be R 246 400.

5. Conclusion

Debt has not been defined in the Income Tax Act. Debt is however defined in the Oxford Dictionary as a 'sum of money that is owed or due' (The Oxford Dictionary). Based on the definition of debt in The Oxford Dictionary, debt can deduced to meet the definition of 'financial instrument' in the Income Tax Act and could be eligible for the section 24J deduction.

Traditional financing in the form of debt from financial institutions is generally considered the most difficult form of funding to get from financial institutions due to the numerous requirements that are required by the financial institutions such as prior annual financial statements, prior credit records, and trading history which most SMME's do not have. The tax considerations of debt funding are however favorable to a taxpayer. Subject to the provisions of sections 8E, 24J and 31 of the Income Tax Act, a taxpayer could qualify for a tax deduction based on the arms-length interest percentage charged on the loan.

Chapter 4: Crowd-funding

1. Definitions

The Income Tax Act does not define crowd-funding. The Oxford Dictionary defines crowd-funding as 'the practice of funding a project or venture by raising money from a large number of people who each contribute a small amount, typically via the Internet' (Oxford Dictionary). The definition of crowd-funding from Whatis.com is:

> 'Crowdfunding is a financing method that involves funding a project with relatively modest contributions from a large group of individuals, rather than seeking substantial sums from a small number of Investors. The funding campaign and transactions are typically conducted online through dedicated crowdfunding sites, often in conjunction with social networking sites. (Whatis.com).

The definition of crowd-funding from Merriam Webster is 'Crowdfunding is the practice of obtaining needed funding (as for a new business) by soliciting contributions from many people from the online community' (Merriam Webster).

The Income Tax Act does not however define 'crowd-funding'. From the definitions however, we note three common requirements for funding to be regarded as crowd-funding which can be used to determine the tax consequences, namely:

- Business venture/project,
- Large group of Investors, and
- Funding sourced from online platforms.

Though the concept is similar, crowd-funding should not be confused with 'crowdsourcing'. Crowdsourcing is the act of obtaining non-financial benefits from a large number of people, such as knowledge, goods or services.

2. Crowd-funding in a South African context

Crowd-funding is becoming an increasingly popular alternative for small to medium enterprises (SMEs) to raise capital. Now entrepreneurs no longer have to rely on banks or public funding institutions, they can now rely on the kindness and business savvy of strangers (Pillay, 2014). Globally crowd-funding has been used by SMME's since 2008 through the launch of Indiegogo (Company that aids in Crowd-fund innovations in tech and design before they go mainstream and support entrepreneurs that are working to bring their dreams to life) and would not be characterized as a new form of funding, however in the context of South Africa it is still relatively new. Crowd-funding allows entrepreneurs and creators to draw 'relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries' (Andsten, 2018).

There is no tax legislation specifically for crowd-funding within the Income Tax Act, however one can use the principles within the Income Tax Act to deduce the tax considerations for crowd-funding. The fundamental requirement to establish the tax consequences of crowd-funding, is to establish and analyze the type of contract that exists between the Investor and the recipient. There are three types of crowd-funding, namely:

- Reward-based crowd-funding,
- Debt-based crowd-funding, and
- Equity-based crowd-funding.

Reward-based crowd-funding is funding whereby the Investor provides finances to the recipient in return for goods or services. Debt-based crowd-funding is funding whereby the Investor provides finances to the recipient by way of a loan, whereby the recipient must repay the loan with interest. Equity-based crowd-funding is funding whereby the

'Company' as defined in chapter 2 of this research report, does not include a 'partnership'

Therefore, the Income Tax Act, does not see a partnership as a separate legal person as partnerships are 'tax transparent'. Section 24H of the Income Tax Act however sheds light on the tax considerations of a partnership.

Section 24H reads:

> (5) Where any income has in common been received by or accrued to the members of any partnership or foreign partnership, a portion (determined in accordance with any agreement between such members as to the ratio in which the profits or losses of the partnership are to be shared) of such income shall, notwithstanding anything to the contrary contained in any law or the relevant agreement of partnership, be deemed to have been received by or to have accrued to each such member individually on the date upon which such income was received by or accrued to them in common.

Therefore, if the taxpayer and the Investor's agreement is to form some sort of partnership whereby the Investor will accrue profits or losses from the partnership as part of an agreed percentage in exchange for the funding, and the funding will be used towards the production of income, the total amount received by the taxpayer may be regarded as capital in nature.

Scenario (2)

In this case, the intention of the taxpayer may result in the total amount received by the taxpayer being regarded to be capital in nature, as the funding provided would be used to purchase assets in the normal course of production of income, which would later be distributed to the Investor by virtue of being a shareholder in the company (i.e. distribution in specie).

Scenario (3)

In this case, the intention of the taxpayer may result in the total amount received by the taxpayer being regarded to be revenue in nature, as the funding provided by the Investor could be concluded to be revenue received in advance (pre-payment). Based on the definition of gross income, the total amount received or accrued would need to be included in the gross income calculation of the taxpayer. According case law *B v CSARS,*

> advance payments are not matched by deductible expenditure, resulting in the full amounts of the advance payments being subjected to tax.

The onus remains on the taxpayer to prove that the total amount received is capital in nature. This is in terms of section 102 of the Tax Administration Act 28 of 2011.

Section 24C

There is relief in the Income Tax Act for revenue received in advance, which would be applicable to reward-based crowd-funding whereby the total amount received by the taxpayer could be revenue received in advance and therefore included within the gross income of the taxpayer. Section 24C relates to an allowance provided to taxpayer's in respect of contracts which give rise to amounts received in advance which will be utilized in future by the taxpayer for future expenditure incurred in the performance of the taxpayer's obligations for this said contract.

Section 24C(2) of the Income Tax Act reads:

> If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilized in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract, there shall be deducted in the determination of the taxpayer's taxable income for such year, such

> allowance (not exceeding the said amount) as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion relates to the said amount.

Section 24C(3) of the Income Tax Act reads:

> The amount of any allowance deducted under subsection (2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.

Therefore if the full R1000 000 funding is received by way of the Scenario (3) method, and, for example, 100% of the amount received would be utilized in future for the purchase of goods or trading stock or the provision of services, the full funding could be allowed as a deduction in terms of section 24C(2) of the Income Tax Act.

Donations tax

Section 54 of the Income Tax Act defines 'donation' as *any gratuitous disposal of property including any gratuitous waiver or renunciation of right.* 'Gratuitous' is not a term defined in the Income Tax Act, however it is defined in the Oxford Dictionary as something that is done without good reason; uncalled for; given or done free of charge (Oxford English Dictionary). The South African courts have considered the meaning of donation in numerous cases and have held that the critical element is the motive of the donor which must be one of benevolence, sheer liberality or gratuity. This view was expressly confirmed in the leading case of *Ovenstone v Secretary for Inland* where the court held that in a donation the donor disposes of the property gratuitously out of liberality or generosity, the donee being thereby enriched and the donor correspondingly being impoverished, so much that, if the donee gives any consideration at all therefore, it is not a donation (Kretzmann, 2011). As discussed above, reward-based crowd-funding involves the receipt of funding in exchange for goods and services. If the contractual agreement between the Investor and the taxpayer is however one where the good and services are provided, in exchange for funding, the transaction cannot be seen as one that is 'gratuitous'. Thus, based on the definitions of 'donation' in the Income Tax Act and the Oxford Dictionary, donations tax would not be applicable to reward-based crowd-funding.

Dividends Tax

Reward-based crowd-funding may give rise to dividends tax. The Income Tax Act section 64E notes that:

> (1) there must be levied for the benefit of the National Revenue Fund a tax, to be known as the dividends tax, calculated at the rate of 20 per cent of the amount of any dividend paid by any company other than a headquarter company.
> (2) .....
> (3) Where a company declares and pays a dividend and that dividend consists of a distribution of an asset in specie, the amount of the dividend must, for the purposes of subsection (1) be deemed –
> (a) .....
> (b) In the case of an asset which is not an asset contemplated in paragraph (a), to be equal to the market value of the asset on the date that the dividend is, in terms of subsection (2), deemed to be paid.

The South African Revenue Service defines 'dividend in specie' as a distribution to shareholders in a form other than cash.

If the contract of the reward-based crowd-funding entails that the Investor receives goods, trading stock or services continuously as per Scenario (2), the transactions may be regarded as distributions to a shareholder in a form other than cash (in other words, a dividend in specie). The liability for the dividends tax is on the company declaring the dividend. Section 64G(1) notes that,

> a company that declares and pays a dividend must withhold an amount of dividends tax from that payment calculated as contemplated in section 64E except to the extent that-
>
> (a) the dividend consists of a distribution of an asset in specie;

(b) .....

The exemption of a dividend in specie however requires that the provisions of section 64FA of the Income Tax Act are met. Section 64FA(1) of the Income Tax Act notes:

> Where a company declares and pays a dividend that consists of a distribution of an asset in specie, that dividend is exempt from the dividends tax to the extent that it constitutes a distribution of an asset in specie if-
>
> (a) the person to whom the payment is made has, by the date of payment of the dividend, submitted to the company-
> (b) the beneficial owner forms part of the same group of companies, as defined in section 41, as that company;
>
> (i) a declaration by the beneficial owner in such form as may be prescribed by the Commissioner that the portion of the dividend that constitutes a distribution of an asset in specie would, if that portion had not constituted a distribution of an asset in specie, have been exempt from the dividends tax in terms of section 64F; and
>
> (ii) a written undertaking in such form as may be prescribed by the Commissioner to forthwith inform the company in writing should the circumstances affecting the exemption applicable to the beneficial owner referred to in subparagraph (i) change or the beneficial owner cease to be a beneficial owner;
>
> (c) the dividend constitutes a disposal as contemplated in paragraph 51A of the Eighth Schedule; or
> (d) the dividend constitutes a disposal as contemplated in paragraph 67B(2) of the Eighth Schedule.

Therefore, taxpayer's who received funding by way of a reward-based crowd-funding, should ensure that they meet the exemption requirements of section 64FA(1) to avoid having to withhold dividends tax.

Value-Added Tax

The Value-Added Tax Act 89 of 1991, provides guidance and further tax considerations on the value-added tax (VAT) consequence of goods and services supplied by a vendor. VAT falls out of the scope of this research report and will not be addressed.

4. Debt-based crowd-funding

The tax computation and tax considerations for debt-based crowd-funding, would mimic that tax considerations and computations of a traditional loan issued to the taxpayer, resulting in section 24J of the Income Tax Act being applicable. This is due to debt-based crowd-funding being deemed as an instrument as it would be regarded as a form of interest-bearing arrangement or any debt. The considerations, and the tax computation thereof, has been included as part of Chapter 3 of this research report.

5. Equity-based crowd-funding

Equity-based crowd-funding involves the Investor providing funding to the taxpayer in exchange for equity shareholding in the company and dividends once the taxpayer is profitable. This would give rise to several tax considerations, namely; dividends tax, and securities transfer tax.

Dividends tax

Equity-based crowd-funding may give rise to dividends tax.

Section 64F(1) of the Income Tax Act provides exemptions in respect of dividends other than dividends in specie as discussed within reward-based crowd-funding.

Deductions – Section 11(*a*) read with section 23(*g*)

Notwithstanding case law, section 11(*a*) and section 23(*g*) of the Income Tax Act (general deduction formula) can be used to assess whether expenditure incurred can be deducted. The general deduction formula applies to taxpayer's carrying on a trade.

Section 11 of the Income Tax Act reads:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;

'Carrying on any trade' is arguably the most important aspect of the definition of section 11 of the Income Tax Act which taxpayers must adhere to claim deductions in terms of section 11(a) of the Income Tax Act.

'Trade' is defined within the Income Tax Act as:

> 'Trade' includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property.

In chapter 1 of this research report, it is noted that WB is a company operating in the retail and textile industry and would therefore meet the definition of a 'business' and therefore be eligible to make use of the provisions of section 11(*a*) of the Income Tax Act.

The second vital aspect of the section 11(a) definition that taxpayers must meet, is that expenditure is 'not capital in nature'. For purposes of expenses and losses , expenditure that would be regarded as not being of a capital nature, are expenses and losses that are not long-term in nature such as every day expenses. 'Expenses' are not defined in the Income Tax Act, however it is described in the International Financial Reporting Standards (IFRS) and referenced in case law. In *Joffe & Co Ltd v Commissioner for Inland Revenue*, Watermeyer J held that:

> All expenditure, therefore necessarily attached to the performance of the operations which constitute the carrying on of the income-earning trade, would be deductible and also all expenditure which, though not attached to the trading operations of necessity, is yet *bona fide* incurred for the purposes of carrying them on, provided such payments are wholly and exclusively made for that purpose and are not expenditure of a capital nature.

Capital expenditure would be regarded as expenses that are long-term in nature such as the purchase of assets. Depending on the nature of the asset, and what it is used for, certain deductions may be applicable per the Income Tax Act. Manufacturing assets may qualify for a section 13 deduction. In chapter 2, it was noted that WB is not a small business corporation as defined in the Income Tax Act. As such, WB would not qualify to receive deductions per section 12E for manufacturing assets that are accelerated allowances (50% of the cost of the asset for the first year the asset is bought into use; 30% for the second year and 20% for the third year).

Tax practitioners and advisors to SMME's should read section 11(*a*) along with section 23(*g*) of the Income Tax Act, as some expenses and losses which may meet the definition of section 11(*a*), may be prohibited as a deduction in terms of section 23(*g*).

Pre-trade and Post-trade expenditure

SMME's generally incur expenses prior to the commencement of trade. It must be noted that pre-trade expenditure can be deducted under section 11A of the Income Tax Act (Majola, 2017). Section 11A of Income Tax Act provides for a deduction of expenses that are incurred in the production of income, prior to the commencement of trade.

‘Pre-trade expenses’ refers to expenditure and losses actually incurred by a person before the commencement of and in preparation for carrying on a trade per SARS Interpretation note 11 (SARS 2017). ‘Post-trade expenses’ refers to expenditure and losses actually incurred after the commencement of the trade per SARS Interpretation note 11 (SARS 2017).

Section 11A of the Income Tax Act reads:

> For purposes of determining the taxable income derived during any year of assessment by a person from carrying on any trade, there shall be allowed as a deduction from the income so derived, any expenditure and losses—
>
> (a) actually incurred by that person prior to the commencement of and in preparation for carrying on that trade;
> (b) which would have been allowed as a deduction in terms of section 11 (other than section 11(x)), 11D or 24J, had the expenditure or losses been incurred after that person commenced carrying on that trade; and
> (c) which were not allowed as a deduction in that year or any previous year of assessment.
>
> (2) So much of the expenditure and losses contemplated in subsection (1) as exceeds the income derived during the year of assessment from carrying on that trade after deduction of any amounts allowable in that year of assessment in terms of any other provision of this Act, shall not be set off against any income of that person which is derived otherwise than from carrying on that trade, notwithstanding section 20(1)(b).

For purposes of the tax computation, WB would be assumed to have no pre-trade expenditure.

6. Normal tax computation: Crowd-funding

Reward-based crowd-funding

Scenario (1) – Partnership

	Amount	Income Tax Act reference or calculation
Gross Income	R7000 000	Section 1 (Gross income definition)
Deductible expenditure (excluding reward-based crowd-funding)	(R6000 000)	Section 11(a)
Taxable income	**R1000 000**	
Tax payable	R280 000	(R1000 000 * 28%)
Net income after tax	R720 000	

For purposes of the partnership, the taxable income would be apportioned between the partners in line with the partnership agreement (in other words, the profit sharing ratio). Each partner will be liable for taxation on their share of the taxable income in addition to any income earned from other sources. (Perry,n.d.)

WB would be liable for tax of R280 000 for the 2019 year of assessment apportioned in line with the partnership agreement.

Scenario (2) – Shareholding

	Amount	Income Tax reference/ Calculation
Gross income	R7000 000	Section 1 (Gross income definition)
Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Taxable income	**R1000 000**	

Tax payable	R280 000	(R1000 000 * 28%)

The computed tax payable for WB for the 2019 year of assessment would be R 280 000. Dividends may be paid out of net income after tax.

Scenario (3) – Goods and services

	Amount	**Income Tax Act reference or calculation**
Gross Income	R8000 000	Section 1 (Gross income definition); Case-law (R1000 000 deemed to be revenue in nature, therefore included in gross income computation). *B v CSAR*
Deductions (excluding reward-based crowd-funding)	(R6000 000)	Section 11(a)
Allowance – reward-based crowd-funding	(R1000 000)	Section 24C
Taxable income	**R1000 000**	
Tax payable	R280 000	(R1000 000 *28%)

WB would be liable for tax of R280 000 for the 2019 year of assessment

For the purposes of the section 24C of the Income Tax Act computation, it was assumed that 100% of the income was received in advance (included in the gross income), and would be utilized in future for future expenditure relating to a contract between the Investor and the taxpayer. The full allowance would need to be included in the income tax computation for the following year of assessment.

Debt-based crowd-funding

If WB were to receive funding from a financial institution to the value of R1000 000 (lump sum received 1 March 2018), at an interest rate of 12% per annum, based on section 24J of the Income Tax Act, WB would be allowed an interest deduction of R120 000.

	Amount	**Income Tax Act reference/ Calculation**
Gross income	R7000 000	Section 1 (Gross income definition)
Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Debt financing deduction	(R120 000)	Section 24J
Taxable income	**R 880 000**	
Tax payable	R 246 400	(R880 000 * 28%)

Equity-based crowd-funding

	Amount	**Income Tax Act reference/ Calculation**
Gross income	R7000 000	Section 1 (Gross income definition)

Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Taxable income	**R1000 000**	
Tax payable	R280 000	(R1000 000*28%)

The computed tax payable for WB for the 2019 year of assessment would be R 280 000. Dividends may be paid out of net income after tax.

7. Conclusion

There is currently no formal legislation for crowd-funding in South Africa. Current tax legislation, including case law has been used to determine what the tax consequences would be for SMME's when crowd-funding is received from Investors.

Crowd-funding in South Africa can be disaggregated to 3 types, namely:

- Reward-based crowd-funding;
- Debt-based crowd-funding; and
- Equity-based crowd-funding.

If R1000 000 in funding is received as crowd-funding, debt-based crowd-funding may result in greater tax efficiencies *ceteris paribus*, due to the following:

- Reward-based crowd-funding will not result in a separate tax deduction or allowance;
- Debt-based crowd-funding would result in an additional section 24J deduction;
- Equity-based crowd-funding will not result in a separate tax deduction or allowance.

Taxpayers must however consider that reward-based crowd-funding may result in the following additional tax considerations:

- Dividends Tax;
- Donations Tax;
- Value-added Tax.

Chapter 5: Hybrid instruments

1. Overview of hybrid instruments

Hybrid instruments can be disaggregated into three: hybrid debt, hybrid equity and preference shares. The hybrid debt rules were introduced into the Income Tax Act in 2014 by way of specific anti-avoidance provisions contained in section 8F of the Income Tax Act. (Reifarth, M 2017)

A hybrid instrument is understood to be an instrument that combines the characteristics of two financial instruments, namely, a debt instrument and an equity instrument (Essop,H 2016). In the Income Tax Act, debt and equity have difference tax treatments and allowances. Interest incurred in the production of income, may be deducted in a taxpayer's taxable income in terms of section 24J of the Income Tax Act. Dividends received from holding equity shares in another entity, may be exempt in terms of section 10(1)(*k*) of the Income Tax Act.

Hybrid instruments are generally more prevalent in cross-border transactions between an entity in a tax haven such as Mauritius with an effective corporate tax rate of 3% and an entity in South Africa with an effective corporate tax rate of 28%. Owing to the different treatment of debt and equity, it is tempting to disguise equity instruments as debt instruments, especially in cross-border transactions (Janse van Rensburg, J 2017).

The legal definitions of debt and equity are simple to understand and classify. Companies however regularly structure instruments (for various commercial reasons) in such a manner that they do not exhibit the standard hallmarks and characteristics of a debt or equity instrument as defined in the Income Tax Act. This results in judgement and subjectivity into the tax classification of financial instruments and brings about tax uncertainty (Van der Merwe, D 2012).

Tax treatment: Debt (cross-border transaction)

In the hypothetical scenario used, if MB were to loan WB R1 million (coupon rate: 10%) at arms-length, the following would be noted:

- If the loan is deemed capital in nature, no amount would be included in the gross income of WB;
- WB may be eligible to deduct an amount of R100 000 in terms of section 24J;
- Interest of R100 000 (untaxed) is therefore transferred to the jurisdiction with a lower tax rate resulting in an effective lower tax for the Group.

It is thus tempting for foreign Investors to fund the South African company using large amounts of debt. This structure allows untaxed profits of the South African company to be distributed to the foreign parent company in the form of interest payments instead of dividends (Janse van Rensburg, J 2017).

Tax treatment: Equity (South African transaction)

In the hypothetical scenario used, if SB were to increase its equity by purchasing additional shares (equity) from WB for R1 million, the following would be noted:

- The equity receipt would be deemed as capital in nature; therefore no amount would be included in the gross income of WB;

- Dividends paid to SB by WB, would not be eligible for an allowance or exemption in terms of the Income Tax Act and case law as dividends paid would not constitute an expense incurred in the production of income (section 11(*a*));
- WB would be exempt from paying over dividends tax on the amount of dividends paid to SB in terms of section 64E of the Income Tax Act;
- SB would be able to claim a dividends exemption on dividends received from WB in terms of section 10(1)(*k*) of the Income Tax Act.

The anti-avoidance rules contained in sections 8E of the Income Tax Act are aimed at penalizing debt instruments that have been disguised as equity to avoid tax due to the local dividends tax exemption (Ernst and Young, 2016). Where section 8E of the Income Tax Act applies, dividends received are deemed to be income in relation to the recipient and therefore taxable and not subject to a dividend exemption but remain dividends in relation to the issuer (Ernst and Young, 2016). Section 8E of the Income Tax Act applies to *inter alia* deem a share to be a hybrid equity instrument if certain requirements are met, with the result that otherwise exempt dividends paid in respect of that share are deemed to be fully taxable income in the hand of the recipient. (Nortje, 2018)

One of the requirements that must be met for purposes of section 8E to apply is that the issuer of the share must be obliged to redeem the share in whole or in part, or the share may at the option of the holder be redeemed in whole or in part, within three years from the date of issue of the share. Section 8E therefore requires a 'redemption' of the relevant shares (Nortje, 2018).

Preference shares

The definition of hybrid debt instrument, also includes preference shares which are redeemable within three years from date of issue. It is common in South Africa for companies to obtain financing by the issue of redeemable preference shares subscribed for by financial institutions for periods exceeding three years. Such preference share investments do not usually fall within the ambit of section 8E because they do not qualify as 'hybrid equity instruments', due to there being no obligation on the issuer to redeem the shares, nor any right of the holder to redeem them at its option, or to dispose of them, within a period of three years from the date of issue thereof (Seligson, M 2011).

There are six difference preference shares that can be issued namely:

- Redeemable preference shares;
- Cumulative redeemable preference shares;
- Non-cumulative redeemable preference shares;
- Non-redeemable preference shares;
- Cumulative non-redeemable preference shares;
- Non-cumulative non-redeemable preference shares.

The main difference between the six difference preference shares, is the convertibility of the shares from preference shares to equity shares thereby resulting in a change in voting rights, voting power and dividends ranking. Preference shareholders generally have no voting rights/power (as opposed to equity shares), however they are the first to receive dividends when declared. Cumulative preference shares have similar rights to non-cumulative preference shares, except they have an additional right of receiving dividends in arrears.

Non-redeemable preference shares, whether cumulative or non -cumulative are generally not seen as hybrid instruments as they are not redeemable to equity shares. Redeemable preference shares have the same tax consequences of debt if they do not fall within the ambit of section 8E of the Income Tax Act (in other words, they are not redeemed after a period of three years). For purposes of this research report, the preference shares are in substance and in form, non-redeemable and therefore have the same tax consequences of normal debt (in other words, section 24J of the Income Tax Act).

2. Definitions of hybrid instruments – Income Tax Act

The classification of financial instruments from a tax perspective is governed by the provisions of the Income Tax Act.

Section 8E of the Income Tax Act notes the following definitions:

'hybrid equity instrument' means—

(a) any share, other than an equity share, if—

i. the issuer of that share is obliged to redeem that share in whole or in part; or

ii. that share may at the option of the holder be redeemed in whole or in part,within a period of three years from the date of issue of that share;

(*b*) any share, other than a share contemplated in paragraph (a) if—

(i)(*aa*) the issuer of that share is obliged to redeem that share in whole or in part within a period of three years from the date of issue of that share;

(*bb*) that share may at the option of the holder be redeemed in whole or in part within a period of three years from the date of issue of that share; or

(*cc*) at any time on the date of issue of that share, the existence of the company issuing that share—

(A) is to be terminated within a period of three years; or

(B) is likely to be terminated within a period of three years upon a reasonable consideration of all the facts at that time; and

(c) any preference share if that share is—

(i) secured by a financial instrument; or

(ii) subject to an arrangement in terms of which a financial instrument may not be disposed of, unless that share was issued for a qualifying purpose;

Section 8EA of the Income Tax Act notes the following definitions:

'preference share' means any share—

(*a*) other than an equity share; or

(*b*) that is an equity share, if an amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money;

3. Normal tax computation: Hybrid instruments

The tax calculation of WB for the 2019 year of assessment would be:

Debt instrument (hybrid debt) – WB:

	Amount	**Income Tax Act reference/ Calculation**
Gross income	R7000 000	Section 1 (Gross income definition)
Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Interest paid (deemed a dividend paid)	(R 0)	Section 8E – interest paid by issuer treated as dividends. No deduction on dividends paid.
Taxable income	**R1000 000**	
Tax payable	R 280 000	(R1000 000 *28%)

Debt instrument (non-hybrid debt)/ Non-redeemable Preference Shares

	Amount	Income Tax Act reference/ Calculation
Gross income	R7000 000	Section 1 (Gross income definition)
Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Debt financing deduction	(R120 000)	Section 24J R1000 000 at 12%
Taxable income	**R 880 000**	
Tax payable	R 246 400	(R880 000 * 28%)

Equity instrument (hybrid equity) – WB:

	Amount	Income Tax Act reference/ Calculation
Gross income	R7000 000	Section 1 (Gross income definition)
Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Debt financing deduction	(R120 000)	Section 24J – Section 8F (dividend is deemed to be interest paid)
Taxable income	**R880 000**	
Tax payable	R246 400	(R880 000 *28%)

Equity instrument (non-hybrid equity) – WB:

	Amount	Income Tax Act reference/ Calculation
Gross income	R7000 000	Section 1 (Gross income definition)

Deductible expenses (excluding financing deductions)	(R6000 000)	Section 11(a)
Dividends paid	(R 0)	No tax deduction on dividends paid
Taxable income	**R1000 000**	
Tax payable	R 280 000	(R1000 000*28%)

4. Conclusion

Anti-avoidance measures have continued to be at the forefront of the National Treasury regarding hybrid instruments. Sections 8E and 8F are anti-avoidance measures introduced to help to identify the substance over form of instruments with both debt and equity features. Some taxpayer's have used the provisions of section 24J to claim deductions for instruments that are equity in nature, resulting in tax losses for the South African fiscus.

If an equity instrument has debt-like features, and, by virtue of section 8E can be seen as debt, the provisions of section 24J apply and the taxpayer may claim a deduction on their interest expense. A debt instrument that has equity-like features, and by virtue of section 8F can be seen as equity, may not make use of the provisions of section 24J as the instrument would be seen as an equity instrument. There are currently no deductions on equity instruments with the exception of section 10(1)(k) of the Income Tax Act that provides a deduction on dividends received. Section 10(1)k deduction will net the dividend income that will be included in the gross income of the taxpayer; therefore, no actual tax benefit is gained. Equity instruments whereby dividends are declared may also give rise to dividends tax, unless the exceptions per section 64E of the Income Tax Act are met.

Chapter 6 – Group and offshore funding

1. Definitions

'Group of companies', 'controlled group company' and 'controlling group company' is defined within section 1 of the Income Tax Act as:

> 'controlling group company' means a controlling group company contemplated in the definition of 'group of companies';
>
> 'Group of companies' means two or more companies in which one company (hereinafter referred to as the 'controlling group company') directly or indirectly holds shares in at least one other company (hereinafter referred to as the 'controlled group company'), to the extent that –
>
> (a) at least 70 percent of the equity shares in each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
> *(b)* the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company;

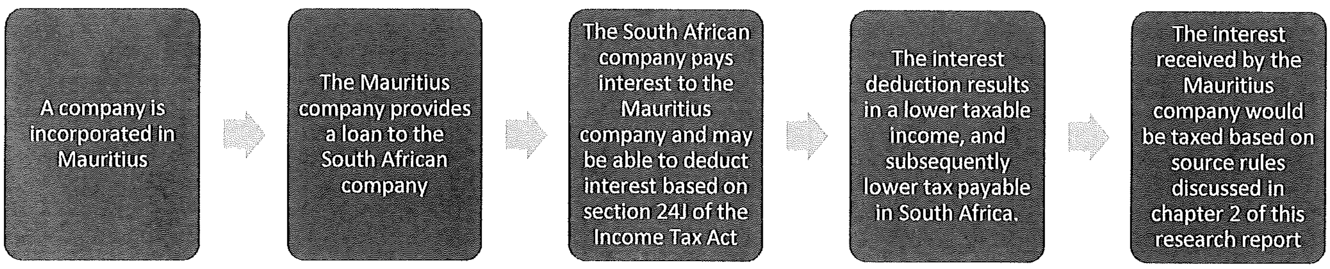
In chapter 2 of the research report, it has been established that WB and SB are resident companies, and MB is a foreign company. Therefore, in the context of the definition of 'group of companies',

- At least 70% of the equity shares of WB are held by SB;
- MB holds at least 70% of the equity shares of SB;
- MB indirectly holds at least 70% of WB.

Therefore, MB is the controlling group company and SB and WB are both controlled group companies as defined in the Income Tax Act. There is no definition of 'offshore' company within the Income Tax Act. The business dictionary defines an 'offshore' company as a firm registered or incorporated outside the country where it has its main offices and operations, or where its principle Investors reside (Business dictionary). The dictionary definition of 'offshore' closely resembles a company that is not a resident (in other words, a foreign company as defined in the Income Tax Act). For purposes of the hypothetical example, MB can be concluded to be an offshore or foreign company, as it is incorporated outside of South Africa.

2. Base erosion and profit shifting

It is not uncommon for companies incorporated in South Africa to seek funding from offshore companies within the same group. Over the years however, the South African Revenue Service has seen a number of taxpayers trying to avoid tax by shifting profits from one jurisdiction to the next. Establishing a group of companies with a controlling company in a jurisdiction such as Mauritius with a low company tax regime of 3% versus 28% in South Africa, could imply that the taxpayer with the higher country tax rate is trying to avoid tax. An example of the tax avoidance as noted in the prior statement, is as follows:



Arranging one's affairs in a manner that is most tax efficient (the 'choice principle') using principles of the Income Tax Act (for example, tax avoidance principles) in itself is not illegal, however general anti-avoidance rules (GAAR) have been put in place in the Income Tax Act to curb the use of impermissible tax avoidance arrangements (Sections 80A to 80L). Lord Tomlin, the judge in the *IRC vs Duke of Westminster* case, noted the following:

> Every man is entitled if he can to arrange his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure that result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

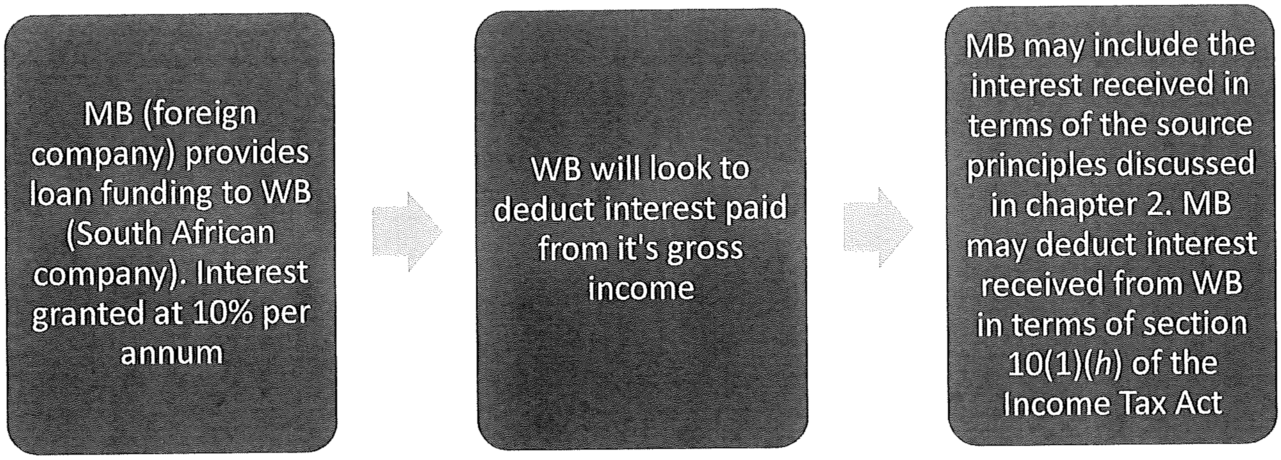
The court case notes that the onus is on the taxpayer to determine tax efficiency however taxpayers need to be cautious that the arrangement of one's affairs does not result in the Commissioner being of the view that the arrangements are solely for impermissible tax avoidance. Tax avoidance can be disaggregated between permissible and impermissible tax avoidance. Permissible tax avoidance is concerned with the organization of a taxpayer's affairs so that they give rise to the minimum tax liability (Satumba, R 2011).

Under international tax legislation, an enterprise generally is not taxed in a country in which it does not have a physical presence. With the economy having evolved so that business can be conducted over the internet with no physical presence in a country, companies have been able to avoid taxation in many jurisdictions from which they generate significant income (Gianni, M 2018). Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations (OECD, 2015b) and equip governments with domestic and international instruments to address tax avoidance (OECD, n.d..). BEPS Action Plans are soft law legal instruments and are not legally binding.

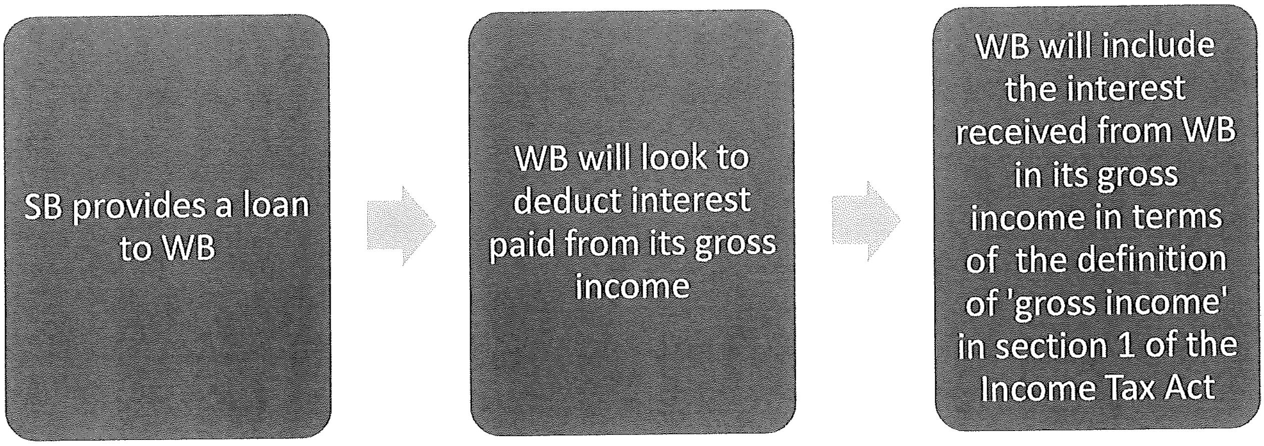
3. Tax considerations for group funding and offshore funding

Group funding would entail one company part of a group of companies, providing funding to another company, generally, in the form of a loan or through the purchase of equity shareholding. For the context of this chapter, the scenario will look at the provision of a loan. The scenarios below would be applicable in the context of the hypothetical scenario:

Scenario 1: Loan provided by MB (foreign company) to WB (South African company)



Scenario 2: Loan provided by SB (South African company) to WB (South African company)



Of the two scenarios above, the one with the greater tax payable in South Africa and for the group of companies and may be flagged as a potential anti-avoidance measure, would be the loan provided by MB to WB. The loan provided by SB to WB would have no impact as the interest paid by the one company, would be interest received by the other company whereby both companies would be taxed at the same rate of 28%. The loan (or financial instrument) provided by MB to WB may be subject to transfer pricing and thin capitalization rules.

Section 31 of the Income Tax Act was introduced into the Income Tax Act with effect from 19 July 1995 to counter transfer pricing practices which may have adverse tax implications for the South African tax revenue. This section consists of a combination of transfer pricing and thin capitalisation provisions. The measures to combat transfer pricing schemes are contained in section 31(1) and (2). The provisions of section 31(3) are more specifically aimed at countering thin capitalisation schemes (SARS 1999). Section 31 of the Income Tax Act allows the Commissioner to adjust the interest rate for financial assistance provided by a non-resident company, to a resident company, if the interest rate is below or above the 'official rate' as defined in section 1(1) of the Income Tax Act. This is to combat interest levied at rate that substantially differs from the arms-length particularly by an offshore company that has a lower judicial tax rate, to a resident company that has a higher tax rate.

Section 31(2) deals with transfer pricing and defines the rules of operation where goods or services are supplied in terms of an international agreement between connected persons and the price at which such goods and services are supplied or acquired is greater or less than the price expected if the parties to the transaction had been independent persons dealing at arms-length. In such instances, the Commissioner is empowered in determining the taxable income of either the acquirer or the supplier to adjust the consideration in respect of the transaction to reflect in the arms-length price (Masithela, 2006). Section 31 of the Income Tax Act, is not applicable between resident companies.

The 'official rate' as defined in section 1(1) of the Income Tax Act is linked to the repurchase rate plus one per cent. The official rate is adjusted at the beginning of the month following the month during which the Reserve Bank changes the repurchase rate (SARS, 2019b). As at 2018, the official rate is 7.75% (6.75% + 1%). The principle mainly caters to an interest rate charged by a non-resident to a resident that exceeds the official rate as this would result in reduced tax payable within South Africa.

Section 10(1)(*h*) deals with the tax exemption of interest payable by a South African company, to a non-resident. The provisions of section 10(1)(*h*) specifically notes that:

> Interest earned by non-residents who are physically absent from South Africa for at least 181 days during the 12 month period before the interest accrues and the debt from which the interest arises is not effectively connected to a fixed place of business in South Africa, is exempt from income tax.

From the criteria, it can be deduced that the criteria closely mimics that of determining whether a non-resident is subject to taxation as a resident or a non-resident (in other words, the resident, non-resident and permanent establishment definitions noted in chapter 2 of this report).

4. **Normal tax computation: Group funding (local)**

SB, a resident South African company, provides a loan of R1000 000 to WB at an interest rate of 10% per annum, also a resident South African company.

The taxable income and tax payable for WB would be as follows:

	Amount	**Income Tax Act reference or calculation**
Gross Income	R7000 000	Section 1; case-law
Deductions (excluding group funding)	(R6000 000)	Section 11(a)
Interest deduction	(R100 000)	Section 24J
Taxable income	**R900 000**	
Tax payable	R252 000	(R900 000*28%)

WB would be liable for tax of R252 000 for the 2019 year of assessment.

The taxable income and tax payable for SB would be as follows:

SB will have gross income of R100 000, being interest income. If SB does not have any other taxable income and no other expenses, the tax payable would be R28 000 (R1000 000*28%). SB would not be able to claim a deduction in terms of section 10(1)(*i*) of the Income Tax Act. Refer to Note 1 below.

__**Note 1**__

Only interest by a **natural person** from a South African source, is exempt per annum, up to an amount of R34 500 as at 28 February 2019 for some natural person 65 years of age and older, and R23 800 for a natural person under the age of 65.

The R100 000 would cancel itself out from a total Group perspective (SB gross income of R100 000 and WB deductible expense of R100 000). The net tax payable, from the Group perspective, will be nil.

5. Normal tax computation: Group funding (offshore)

Loan of R1000 000 provided by MB to WB at an interest percentage of 10%, is, at the Commissioner's discretion, amended to the official interest rate of 7.75%. For purposes of this research report, the loan is made in South African rands and therefore no foreign gains or losses will arise from the loan in terms of section 24I of the Income Tax Act.

The taxable income and tax payable of WB, with section 31 adjustment, would have been as follows:

	Amount	**Income Tax Act reference or calculation**
Gross Income	R7000 000	Section 1; case-law
Deductions (excluding group funding)	(R6000 000)	Section 11(a)
Offshore debt instrument	(R 77 500)	Section 24J, Section 31 (1000 000*7.75%)
Taxable income	**R 922 500**	
Tax payable	R258 300	(R922 500 *28%)

WB would be liable for tax of R258 300 for the 2019 year of assessment.

The taxable income and tax payable of WB, with no section 31 adjustment, would have been as follows:

	Amount	**Income Tax Act reference or calculation**
Gross Income	R7000 000	Section 1; case-law
Deductions (excluding group funding)	(R6000 000)	Section 11(a)
Interest paid - Offshore debt instrument	(R100 000)	Section 24J, Section 31 (1000 000*10%)
Taxable income	**R 900 000**	
Tax payable	R252 000	(R900 500 *28%)

The taxable income and tax payable of **MB**, without section 31, would have been as follows:

	Amount	**Income Tax Act reference or calculation**
Interest income from WB	R100 000	Source rules
Interest income deduction	(R100 000)	Section 10(1)(*h*); Note 1
Taxable income	**R nil**	

Note 1

A final withholding tax at a rate of 15% will be charged on interest from a South African source payable to non-residents. The tax is withheld by the South African company; however, the responsibility lies with the non-resident company. A reduced rate can however be applicable if there is a double-tax agreement (DTA) between South Africa and the country where the foreign interest is being paid to. South Africa currently has a signed DTA with Mauritius which notes the following:

> Interest arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State, provided such resident is the beneficial owner of the interest

The rate in the DTA between South Africa and Mauritius notes an interest withholding tax, of 0%. Therefore, MB would be subject to an interest withholding tax of 0%.

6. Conclusion

SMME's can fall within the ambit of being within a group of companies. A group of companies is defined as one or more controlled companies whereby the controlling company has indirect or direct control over one or more controlled companies, and holds equity shares of at least 70% in the controlled company and indirectly in any other controlled company within the group.

Offshore funding, whereby a foreign/offshore group company provides financial assistance to a resident company, gives rise to the provision of section 31 of the Income Tax Act. Section 31, read with BEPS Transfer Pricing (non-binding provisions), requires that all financial instruments between a resident and a non-resident be provided at an interest rate which is arms-length. SARS provides guidance on what the arms-length interest rate should be. Funding that is provided at an interest rate below and above the arms-length interest rate, would result in the Commissioner amending the interest rate and penalties being levied to the funding provider. Taxpayers should ensure that the interest rate is an arms-length one.

Chapter 7 – Venture Capital

1. Definitions

Many game changing firms started out as small entrepreneurial firms receiving venture capital, with Microsoft and Google being, perhaps, the most famous examples (Finborud, 2011). 'Venture capital' is not defined in the Income Tax Act. The Collins Dictionary, in the context of finance, defines venture capital as 'money that is invested in projects that have a high risk of failure, but that will bring large profits if they are successful' (Collins Dictionary n.d..). Venture capital is financing that Investors provide to startup companies and small businesses that are believed to have long-term growth potential. Venture capital generally comes from well-off Investors, investment banks and any other financial institutions. It does however not always take just a monetary form; it can be provided in the form of technical or managerial expertise (Investopedia, 2018). Venture capital is often, especially in Europe, seen as synonymous with 'private equity'. In this connection, venture capital refers to investments (with private equity) made by institutions, firms and wealthy individuals in the early and expansion-stages of the newly established firm (Isaksson a, 2006)

Section 12J in the Income Tax Act, titled 'Deductions in respect of expenditure incurred in exchange for issue of venture capital company shares' provides the following definitions in subsection (1):

> **'impermissible trade'** means-
>
> (a) any trade carried on in respect of immovable property, other than a trade carried on as an hotel keeper;
>
> (b) any trade carried on by a bank as defined in the Banks Act, a long-term insurer as defined in the Long-term Insurance Act, a short-term insurer as defined in the Short-term Insurance Act and any trade carried on in respect of money-lending or hire-purchase financing;

(c) any trade carried on in respect of financial or advisory services, including trade in respect of legal services, tax advisory services, stock broking services, management consulting services, auditing or accounting services;

(d) any trade carried on in respect of gambling;

(e) any trade carried on in respect of liquor, tobacco, arms or ammunition;

(f) ....

(g) any trade carried on mainly outside the Republic;

'qualifying company' means any company if-

(a) that company is a resident;

(b) the company is not a controlled group company in relation to a group of companies;

(c) the tax affairs of the company are in order and the company has complied with all the relevant provisions of the laws administered by the Commissioner;

(d) the company is an unlisted company as defined in section 41 or a junior mining company;

(e) the company is not carrying on any impermissible trade; and

(f) the sum of the investment income, as defined in section 12E(4)(c), derived by that company during any year of assessment does not exceed an amount equal to 20 per cent of the gross income of that company for that year;

'qualifying share' means an equity share held by a venture capital company which is issued to that company by a qualifying company, and does not include any share which

(a) ....

(b) would have constituted a hybrid equity instrument, as defined in section 8E(1), but for the three-year period requirement contemplated in paragraph (a) of the definition of 'hybrid equity instrument' in that section; or

(c) constitutes a third-party backed share as defined in section 8EA(1);

'venture capital company' means a company that has been approved by the Commissioner in terms of subsection (5) and in respect of which such approval has not been withdrawn in terms of subsection (6) or 6A

Section Section 12J(5) notes the following approval that needs to be obtained for a qualifying company to meet the definition of a 'venture capital company':

The Commissioner must approve a venture capital company if that company has applied for approval and the Commissioner is satisfied that-

(a) the company is a resident;

(b) the sole object of the company is the management of investments in qualifying companies;

(c) ....

(d) ....

(e) the tax affairs of the company are in order and the company has complied with all the relevant provisions of the laws administered by the Commissioner;

(f) ....

From the above definitions, we note that there are three key criteria that need to be met in order for small businesses to be eligible for the deductions available in section 12J. The key elements are discussed below.

2. Venture capital in South Africa

The Venture Capital Company (VCC) tax regime was introduced into the Income Tax Act in 2009 and is aimed at encouraging investment into small and medium-sized enterprises and junior mining companies. Although the regime was introduced in 2009, a surge of popularity was noted in 2015 when the legislation was changed whereby if qualifying venture capital shares were held for a period exceeding 5 years, no recoupment on the deduction was incurred by the investor. Section 12J of the Income Tax Act encompasses the relevant legislation governing VCCs and provides for the formation of an investment holding company, described as a VCC, where Investors subscribe for shares in the VCC (venture capital shares) and claim an income tax deduction for the subscription price incurred. The VCC, in turn, invests in 'qualifying companies' (i.e. investee companies) (Nyanin, G 2018). Taxpayers should however note that although there is a tax deduction for the subscription of shares, the scheme still gives rise to the holder owning equity share. This means that the risk associated with the fluctuation of the share price, still rests with the taxpayer.

Section 12J deals with the 'connected person test' which aims to prevent the possible recycling of funds among 'connected persons'. A connected person includes someone who holds more than 20 percent of the VCC shares without another majority shareholder. A connected person will not enjoy the tax benefit.

Dividends tax

Venture capital investments (or shares) may give rise to dividends tax for the taxpayer. Dividends tax is withheld by the venture capital company and the net amount is paid out to the taxpayer. The amount withheld is paid over to SARS.

3. Tax considerations for venture capital

The general narrative when it comes to debt versus equity funding, is that debt funding is generally 'cheaper' than equity funding as with debt funding (Naidu, 2011), recipients carrying on a trade can claim a section 24J deduction for interest expenditure incurred. Section 12J of the Income Tax Act however changes this narrative for venture capital shares. Venture capital is a form of equity provided through venture capital funds, which, unlike angel capital organizations which are companies who provide capital for a business startup in exchange for equity, are financial intermediaries. Venture capital funds usually invest in young firms, whose products or services are either in development or are commercially available but have yet to establish a commercial organization and start selling. They also invest in established firms and products that need more capital to expand the business. This latter point about venture capital investments shows the overlap with growth capital investments (Metrick 2007). Section 12J of the Income Tax Act provides guidance on the deductions in respect of expenditure incurred in exchange for the issue of venture capital company shares. From the very title of the section, one can note that any deduction relating to venture capital, would only relate to the value of shares given by a venture capital company to a taxpayer. On the basis of section 12J and the definitions noted above, the following criteria would need to be met in order to qualify for a tax deduction:

- A company needs to be a qualifying company per section 12J of the Income Tax Act. This entails that the company has been approved by the Commissioner by virtue of meeting the definition of a 'qualifying company', and the approval thereof by the Commissioner, has not been withdrawn.
- A company needs to meet the definition of a 'venture capital company' per section 12J of the Income Tax Act.
- A company must not be carrying on an impermissible trade.

Subject to the criteria above being met, a taxpayer would be eligible to claim as a deduction, the full amount invested in a venture capital (section 12J (2) of the Income Tax Act) which however would be subject to the recoupment provisions of section 8(4)(*a*) of the Income Tax Act should the shares be sold within a period of 5 years (section 12J(9)). The deduction of expenditure for venture capital purposes, is limited to the risk the taxpayer (investee/investee company) is exposed to (Section 12J(3)(*b*)) on the last day of assessment. The risk that the taxpayer may be exposed to involves the following:

1. The expenditure incurred (in other words, the cost of the investment); or
2. The repayment of any loan or credit used by the taxpayer for the payment or financing of expenditure in relation to the venture capital share.

Section 8(4)(*a*) of the Income Tax Act reads:

> (a) There shall be included in the taxpayer's income all amounts allowed to be deducted or set off under the provisions of sections 11 to 20 ... or under the corresponding provisions of any previous Income Tax Act, whether in the current or any previous year of assessment which have been recovered or recouped during the current year of assessment:

The provisions of section 12J therefore do not give tax relief of any form of funding, however it provides a tax deduction for taxpayer's investing into a venture capital company. Venture capital companies do not receive tax relief for venture capital shares issued as the issuance is capital in nature, in terms of section 12J. WB itself would not be regarded as a venture capital company as the company is trading in retail, and is not an investment company as required by section 12J(5)(b). Furthermore, WB is not a qualifying company as it is a controlled group company as seen in the group structure. WB would therefore only be able to receive tax relief on investments made into a VCC (in other words, WB would receive a tax benefit for an investment made into a VCC company). Prior to investing in a venture capital company, taxpayer's must insure that the venture capital company complies with the requirements of section 12J (5).

As previously noted within this research report, a tax deduction in terms of section 24J would be possible provided the loan is used in the production of income.

Assessed loss

Based on the generous provisions of section 12J(3)(*a*), a deduction for an investment made into a venture capital company, may result in the creation of an assessed loss.

Section 20(2) of the Income Tax Act defines as assessed loss as:

> any amount by which the deductions admissible under section 11 exceeded the income in respect of which they are so admissible.

The definition requires the assessment of whether section 12J would fall within the parameters of section 11. Section 11(*x*) notes:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –
>
> ……
>
> (*x*) any amounts which in terms of any other provision in this Part, are allowed to be deducted from the income of the taxpayer.

Section 11(*x*) of the Income Tax Act therefore allows for a section 20 assessed loss for any section 12J deductions that exceed the taxable income of a taxpayer. The assessed loss of the taxpayer, can be rolled forward to the following year of assessment to be offset against the taxable income of the taxpayer, provided the provisions of section 20A of the Income Tax Act are met.

4. Normal tax computation: Venture Capital

Assuming WB took out a 6-year R1000 000 loan (interest of 12% per annum; annual repayment of R 200 000) and used the amount to finance a R1000 000 equity investment into an approved venture capital company in South Africa (in other words, the purchase of qualifying shares as defined in section 12J of the Income Tax Act), the following tax considerations would be applicable:

	Amount	Income Tax Act reference or calculation
Gross Income	R7000 000	Section 1
Deductions (excluding venture capital investment)	(R6000 000)	Section 11(*a*)
Debt funding deduction	(R0)	Note 1
Venture capital share deduction	(R1000 000)	Section 12J(3)(*b*)
Taxable income	R0	

Note 1

Interest on debt borrowed to acquire shares has historically (in the absence of the taxpayer being deemed to be a share dealer or there being an ulterior purpose for the acquisition) not been deductible, as shares cannot be said to generate taxable income, only exempt dividend income (Deetlefs, 2014). It is important to note that taxpayers who purchase qualifying shares in VCC's, unless the primary business is that of a share dealer in which case WB would fall out of this category, would not be eligible to claim a section 24J deduction on interest paid. In other words, the section 24J interest deduction of the Income Tax Act cannot be used in conjunction with the section 12J deduction.

In the normal tax computation above, the taxable income is Rnil. If however the deductions had exceeded the gross income and created an assessed loss, an assessed loss would be rolled over to the following year of assessment, provided the provisions of section 20A of the Income Tax Act, are met.

Although WB would be paying an amount of R200 000 per annum towards the repayment of the loan, the risk that WB would be exposed to at the end of the year of assessment, would be equivalent to the total amount of the loan that is yet to be repayable. Therefore, based on section 12J(3)(*a*) of the Income Tax Act, the total deduction allowed for the investment, is limited to the extent of the incurred expenditure on the investment.

Therefore, the total amount of the loan can be claimed as a deduction in terms of section 12J(3) in the year that the investment is made. Taxpayers who invest in VCC should however remain cognizant of the recoupment on the deducted expenditure that would be applicable should they opt to dispose of their shares within a period of 5 years from date of purchase.

5. Conclusion

Section 12J of the Income Tax Act provides immediate tax relief to taxpayer's who make investments into approved venture capital companies. A tax deduction for the full investment into the venture capital company, may be provided to the taxpayer if they keep the venture capital shares for a period of at least five years. Failure to do so, would result in a recoupment per section 8(4)(*a*) of the Income Tax Act.

The onus is on the taxpayer to ensure that the venture capital company is approved.

Chapter 8: Conclusion

1. Conclusion

The research report has provided an outline of six sources of funding namely;

- Debt funding
- Crowd-funding
- Venture Capital
- Group funding
- Offshore funding and,
- Hybrid instruments

Traditional financing, though generally the most difficult to secure for SMME's, can result in the second highest tax efficiency of the six funding options discussed in this report. Depending on whether funding was used to pay expenses or purchase capital assets, taxpayers must remain cautious of the capital gains tax implications, and the recoupments of previously claimed deductions per section 19 of the Income Tax Act and paragraph 12A of the Eighth Schedule regarding debt that is waived or cancelled.

There is currently no direct legislation for crowd-funding with the Income Tax Act. There are however provisions within the Income Tax Act that can be used to determine what the potential tax considerations are for funding received through a crowd-funding source. Crowd-funding is disaggregated into three different types, namely; reward-based crowd funding, debt-based crowd funding and equity-based crowd-funding. Debt based crowd-funding mimics the tax considerations of debt or traditional funding as an 'instrument' as defined in section 24J of the Income Tax Act, and thus is the most tax efficient funding option.

The use of sections 12J of the Income Tax Act through the investment of qualifying shares in an approved venture capital company, could provide the highest tax efficiency for a taxpayer which could result in a loss being carried forward to the following year of assessment that would be offset against the taxable income of the taxpayer. Taxpayers should however ensure that they invest in approved venture capital companies, and hold the qualifying shares purchased for a period of at least 5 years, failing which, they may be subject to a recoupment on previous deductions claimed. The deduction that is claimable by a taxpayer is limited to the risk that the taxpayer is exposed to as at the end of the year of assessment, which, if the taxpayer made use of debt to fund the purchase of the shares, would be the total expenditure incurred in the purchasing of the qualifying shares, or the total loan repayable.

Taxpayers must carefully assess their debt and equity contracts or agreements, particularly the clauses regarding the period that the equity or debt instrument is held for, and the substance over form of the said equity or debt instrument, to ensure that they do not fall within the ambit of 'hybrid instrument' that could change the nature of the instrument held and may have adverse consequences for the taxpayer. For example, where a taxpayer holds a hybrid debt instrument, the interest paid by the taxpayer, would be characterized as dividends paid for which there is no normal tax deduction in the Income Tax Act.

It ought to be further highlighted that the onus remains on the taxpayer to prove that they meet the requirements of all provisions within the Income Tax Act. As previously noted, it does appear as though the most tax effective and efficient source of funding of the six assessed in this research report, an investment into a venture capital company for a minimum period of five years. Traditional funding is the second most tax efficient source of funding of the six assessed in this research report.

A close third to the traditional funding, would be crowd-funding which is generally easier to source than traditional funding. The taxpayer must however ensure that they are aware of the type of crowd-funding that they will receive as different forms of crowd-funding result in different tax consequences, some of which are unfavourable.

From the research performed, the funding with the least tax efficiency is funding received locally from a company within the same group of companies.

2. Recommendations

Primary research to be conducted

It would be recommended that a comprehensive, largely quantitative, primary research of all alternative sources of funding be conducted in respect of the tax considerations of traditional sources of funding as opposed to alternative sources of funding. Once this has been completed, the results would provide a more accurate and verifiable conclusion of whether alternative sources of funding do provide more efficient and effective tax benefits for SMME's. Although quantitative research should be the main focus of the research, some qualitative research should also be conducted to assess the practicalities of the quantitative research, particularly in the context of South Africa.

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