23 SEPTEMBER 2016

TAX AND EXCHANGE CONTROL ALERT

IN THIS ISSUE

FUNDING FOR SMALL AND MEDIUM-SIZED ENTERPRISES

The Venture Capital Company (VCC) Tax Regime was introduced into the Income Tax Act 58 of 1962 (Act) to encourage investment into small and medium-sized enterprises (SMEs) and junior mining companies. Since its inception in 2008 and despite subsequent amendments in 2011, there has been limited take-up in the market, with only a handful of VCC funds having become fully funded and operational.

WHEN DEBT AND CREATIVITY MEET – A RECENT TAX COURT DECISION

In the current tough economic times, it is common for companies to consider alternative funding arrangements to fund their activities, which minimise their cash flow obligations to third parties in the short term, while also ensuring that they comply with the relevant tax legislation and utilise it to their advantage.

CUSTOMS AND EXCISE HIGHLIGHTS

This week's selected highlights in the Customs and Excise environment.

CDH
CLIFFE DEKKER HOFMEYR

FUNDING FOR SMALL AND MEDIUM-SIZED ENTERPRISES

Section 12J of the Act provides for the formation of an investment holding company, described as a VCC. Investors subscribe for shares in the VCC and claim an income tax deduction for the subscription price incurred.

The Venture Capital Company (VCC) Tax Regime was introduced into the Income Tax Act 58 of 1962 (Act) to encourage investment into small and medium-sized enterprises (SMEs) and junior mining companies. Since its inception in 2008 and despite subsequent amendments in 2011, there has been limited take-up in the market, with only a handful of VCC funds having become fully funded and operational.

Government is aware that the application of certain provisions of s12J "may result in potential investors abandoning plans to take up this incentive".

Section 12J of the Act provides for the formation of an investment holding company, described as a VCC. Investors subscribe for shares in the VCC and claim an income tax deduction for the subscription price incurred. It was stated in Annexure C to the 2016 National Budget Review that Government is aware that the application of certain provisions of s12J "may result in potential investors abandoning plans to take up this incentive. As such, measures to mitigate this unintended consequence will be explored". National Treasury proposed such a measure in the Draft Taxation Laws Amendment Bill published by on 8 July 2016, which dealt with the revision to the "connected person" test in s12J(3A) of the Act. Although a very welcome measure, this article explores some of the current shortcomings of the VCC regime:

Returns of capital are taxed

Section 12J(9) of the Act provides that "notwithstanding section 8(4), no amount shall be recovered or recouped in respect of the disposal of a venture capital share if that share has been held by the taxpayer for a period longer than five years".

More often than not, the VCC is designed as a finite investment vehicle – the investors subscribe for shares; the VCC invests in qualifying companies; the VCC sells its investments; and the after-tax realisation proceeds are distributed to the investors.

It is therefore intended that the investors will realise their returns by way of distributions from the VCC (and not by way of disposing the shares in the VCC). These distributions could be in the form of dividends or returns of Contributed Tax Capital (CTC). Returns of CTC will trigger a recoupment (in terms of s8(4) of the Act) of the income tax deduction (in terms of s12J(2) of the Act) allowed for the initial investment, even if they occur after five years.

This is problematic in that it dilutes the incentive to investors, and in certain instances would offset the incentive completely and make it tax disadvantageous to invest in the VCC. It is also incongruent with the statement in s12J(9) of the Act that "no amount shall be recovered or recouped in respect of the disposal of a venture capital share if that share has been held by the taxpayer for a period longer than five years".

Our view is that this could be addressed by excluding returns of CTC after five years from the ambit of the recoupment provisions.

Delayed tax relief for natural persons

The s12J investment opportunity is ideal for high net worth individuals who are paying tax at the maximum marginal rate. Many of these individuals are salaried employees whose taxable income comprises mainly of "remuneration" which is subject to employees' tax per the Fourth Schedule to the Act.

CDH
CLIFFE DEKKER HOFMEYR

FUNDING FOR SMALL AND MEDIUM-SIZED ENTERPRISES

CONTINUED

Given the choice of investing directly into a company or investing through a VCC, the former would more likely yield a higher after-tax return, even with the s12J upfront deduction.

In an environment of price volatility and low growth in listed investments and other asset classes, high net worth individuals are looking for new investment alternatives for their savings. The VCC provides these individuals with the opportunity to (i) obtain upfront income tax relief for their investment; (ii) have surplus cash available for investment; and (iii) encourages investment in a higher risk investment category (an illiquid, private investment in SMEs) which is important for inclusive economic growth.

However, high net worth individuals increasingly choose to place their investments offshore or in liquid assets instead of investing in VCCs, as they are not prepared to wait until an audit is completed and they are finally assessed and refunded. This creates a material disincentive for salaried investors and is a significant deterrent from a fundraising perspective (i.e. the delay from investment to refund, coupled with the need for an audit, is viewed as a significant deterrent by potential investors).

This can be remedied by allowing employees to reduce their employees' tax by submitting their VCC certificates to their employers. The employees will therefore receive the tax benefit almost immediately by means of reduced employees' tax rather than have to wait until their tax return is assessed.

Double tax

The most fundamental shortcoming of s12J is illustrated when one contrasts an investment into an underlying portfolio company by (i) an individual; and (ii) a VCC. When an individual invests into an underlying portfolio company and disposes of the assets in such company, the taxpayer will pay capital gains tax (CGT) at an effective tax rate of 16.4%. By interposing a VCC to invest in the same company, CGT at the effective rate of 22.4% is paid by the VCC in addition to dividends tax at 15%. As such, the VCC incentive gets eroded because "double tax" is paid when investing through a VCC as compared to investing via fiscally transparent fund structures or directly into the invested company.

Stated differently, given the choice of investing directly into a company or investing through a VCC, the former would more likely yield a higher after-tax return, even with the s12J upfront deduction. This could be addressed in a number of ways, such as extending the VCC regime to partnerships, treating the VCC as fiscally transparent or providing an exemption for one layer of tax.

Conclusion

The VCC regime would probably gain significantly more momentum if the abovementioned shortcomings are addressed.

Mark Linington and Gigi Nyanin

(This article was originally published in the July/August edition of TaxTalk).

WHEN DEBT AND CREATIVITY MEET – A RECENT TAX COURT DECISION

After SARS conducted an audit in 2013, four years after the invoice was raised, it alleged that the requirements of s22(3) of the VAT Act had not been met.

In the current tough economic times, it is common for companies to consider alternative funding arrangements to fund their activities, which minimise their cash flow obligations to third parties in the short term, while also ensuring that they comply with the relevant tax legislation and utilise it to their advantage. One option to consider in this regard, is the creation of a loan account by a debtor in favour of a creditor. In *CLDC v The Commissioner for the South African Revenue Service* (VAT1247) [2016] ZATC 6 (5 September 2016), handed down by the Tax Court on 5 September 2016, the court had to deal with this issue and specifically the consequences of s22(3) of the Value-Added Tax Act. No 89 of 1991 (VAT Act).

The court stated that the question in the current matter was whether the crediting of a loan account constitutes payment of full "consideration" within a period of 12 months after the taxpayer claimed an input tax deduction for the VAT component of the invoice raised

Facts

The taxpayer, CLDC, concluded an agreement with its wholly owned subsidiary, C in terms of which C would develop land owned by the taxpayer. C funded the taxpayer's cash-flow requirements on loan account via inter-company shareholder loans to avoid external finance having to be obtained. C issued a tax invoice to the taxpayer in respect of part of the development. The taxpayer subsequently claimed an input tax deduction in respect of the VAT, which amounted to approximately R10 million. The taxpayer paid the input VAT it received from South African Revenue Service (SARS) to C, which in turn paid this amount to SARS. The remaining liability due to C in terms of the invoice, approximately R72 million, was credited to C's loan account in the taxpayer's books in accordance with the funding arrangement between the parties. After SARS conducted an audit in 2013, four years after the invoice was raised, it alleged that the requirements of s22(3) of the VAT Act had not been met.

Judgment

The Tax Court explained that in terms of s22(3) of the VAT Act, where a vendor has claimed an input tax deduction on the basis of a tax invoice, but has not made payment of the relevant consideration within a period of 12 months, the transaction is effectively reversed. The result is that the benefit of the input tax previously deducted is counteracted because the consideration has not been paid. The court stated that the question in the current matter was whether, having regard to the provisions of s22(3), the crediting of a loan account constitutes payment of full "consideration" within a period of 12 months after the taxpayer claimed an input tax deduction for the VAT component of the invoice raised by C as a related company or not.

In ascertaining whether the crediting of the loan account constituted "payment made…in respect of" and "in response to…the supply" of the "goods and services", in terms of the definition of consideration in s1 of the VAT Act, the court first referred to the decision in

CDH
CLIFFE DEKKER HOFMEYR

WHEN DEBT AND CREATIVITY MEET – A RECENT TAX COURT DECISION

CONTINUED

The court found that the crediting of C's loan account by the taxpayer in the context of the funding arrangement between the two companies amounted to payment of "consideration" in relation to the supply of goods and services invoiced.

Commissioner, South African Revenue Service v Capstone 556 (Pty) Ltd 2016 (4) SA 341 (SCA), where it was held that if a receipt or accrual arises from a detailed commercial transaction, the transaction in its entirety must be considered from a commercial perspective as opposed to breaking it into component parts or subjecting it to narrow legal scrutiny.

The court explained that in terms of the funding arrangement between the taxpayer and C, had C's loan account not been credited in the manner it was, C would have been required to advance funds to the taxpayer to settle its own invoice and could not have sued the taxpayer in the event of non-payment nor claim the amount in question as a bad debt for VAT or other tax purposes. It follows that both C and the taxpayer did not expect that C would be paid in cash for the relevant supply. What the parties contemplated was that the invoice would be settled by crediting the loan account of C in the taxpayer's books as its wholly-owned subsidiary. This argument was corroborated by the evidence of the taxpayer's managing director, and the auditor of the taxpayer and C. According to the court, crediting the loan account did not extinguish the taxpayer's liability to C, but simply changed the liability from a current liability to a long-term liability in the taxpayer's books.

The court referred to the decision in *Commissioner for Inland Revenue v Guiseppe Brollo Properties (Pty) Ltd* 1994 (2) SA 147 (A) and stated that what had to be considered, was the "overriding purpose" for which the loan account liability was incurred. The taxpayer provided undisputed evidence that the purpose of incurring the loan liability was to discharge the invoice debt. The result: what was owing by the taxpayer under the loan account was a different "animal" to what was owing under the invoice. The definition of consideration in s1 of the VAT Act includes "any payment made or to be made" whether "in money or otherwise, or any act or forbearance". The court held that, as long as payment amounts to the discharge of an obligation to another, there is no reason why an obligation under an invoice may not be discharged through the creation of another liability such as one under a loan. Simply put, "the effect is to discharge one obligation through another".

The court referred to the explanatory memorandum to the Taxation Laws Amendment Bill, 1996, which states that the purpose of s22 of the VAT Act was to prevent prejudice being suffered by the fiscus, as prior to the amendment it was possible to deliberately create bad debts with a view to create a tax benefit. According to the court, the intention of

WHEN DEBT AND CREATIVITY MEET – A RECENT TAX COURT DECISION

CONTINUED

The court acknowledged that the funding arrangement would not have been permissible had s22(3A) already been in effect.

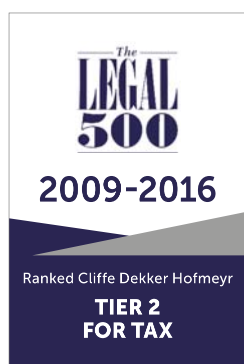
s22(3) was to prevent such deliberate manipulation and not to prevent an invoice from being considered paid through the creation of a loan account liability where a funding arrangement exists between companies within the same group. On the facts before the court, there was no such deliberate manipulation in creating a bad debt with a view to creating a tax benefit either by the taxpayer or C. In light of this, the court found that the crediting of C's loan account by the taxpayer in the context of the funding arrangement between the two companies amounted to payment of "consideration" in relation to the supply of goods and services invoiced.

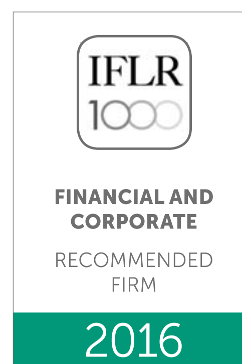
Comment

The court's endorsement and application of the decision in *Capstone*, is likely to be welcomed by many within the tax community. The application of the principles laid down in *Capstone* further entrenches the interpretative approach to tax legislation in terms of which the legislation should be interpreted from a commercial perspective. We discussed the *Capstone* decision in greater detail in our Tax and Exchange Control Alert of 11 March 2016 (Capital v revenue: The taxpayer prevails).

It is important to take note, however, that subsequent to the use of the funding arrangement by C and the taxpayer, s22(3A) of the VAT Act was introduced in 2012, which expressly states that the provisions of s22(3) are not applicable in respect of a taxable supply made by a vendor to another vendor who is a member of the same group of companies. The court also acknowledged that the funding arrangement would not have been permissible had s22(3A) already been in effect. It appears that the court's decision was strongly influenced by the fact that no loss was incurred by the fiscus.

Louis Botha and Dries Hoek





CUSTOMS AND EXCISE HIGHLIGHTS

Please note that this is not intended to be a comprehensive study or list of the amendments, changes and the like in the Customs and Excise environment, but merely selected highlights which may be of interest.

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

This week's selected highlights in the Customs and Excise environment:

- A reduction in duty on "cane or beet sugar and chemically pure sucrose, in solid form" of heading 17.01 to 31,89c/kg;
- Draft forms published relating to the proposed tyre levy, forms:
  - DA178 ("ENVIRONMENTAL LEVY RETURN FOR TYRES"); and
  - DA185.4B2 (amendment to existing application form for "MANUFACTURING WAREHOUSE").

  SARS summary as follows:

  Form DA 178 is being inserted to provide for the environmental levy return on tyres.

  Form DA 185.4B2 is the annexure to Form DA 185, which is being substituted to provide for the warehouse business type for tyres. The amendments to Form DA 185.4B2 must be considered in context of Form DA 185.

  Comments were submitted to: C&E_legislativecomments@sars.gov.za, due date for comments was 20 September 2016.
- Regarding the tyre levy, National Treasury issued a Media Statement on 22 September 2016, in which it "announced the postponement of the implementation of the environmental tyre levy to 1st February 2017".
- The second draft of the Rules to the Customs Duty Act, No 30 of 2014 is available for comment. Comments can be submitted to SAuthar@sars.gov.za. The due date for comments is 30 November 2016.

Petr Erasmus

CDH
CLIFFE DEKKER HOFMEYR

OUR TEAM

For more information about our Tax and Exchange Control practice and services, please contact:

Emil Brincker
National Practice Head
Director
T +27 (0)11 562 1063
E emil.brincker@cdhlegal.com

Mark Linington
Private Equity Sector Head
Director
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com

Petr Erasmus
Director
T +27 (0)11 562 1450
E petr.erasmus@cdhlegal.com

Dries Hoek
Director
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

Ben Strauss
Director
T +27 (0)21 405 6063
E ben.strauss@cdhlegal.com

Lisa Brunton
Senior Associate
T +27 (0)21 481 6390
E lisa.brunton@cdhlegal.com

Heinrich Louw
Senior Associate
T +27 (0)11 562 1187
E heinrich.louw@cdhlegal.com

Mareli Treurnicht
Senior Associate
T +27 (0)11 562 1103
E mareli.treurnicht@cdhlegal.com

Jerome Brink
Associate
T +27 (0)11 562 1484
E jerome.brink@cdhlega.com

Gigi Nyanin
Associate
T +27 (0)11 562 1120
E gigi.nyanin@cdhlegal.com

Louis Botha
Candidate Attorney
T +27 (0)11 562 1408
E louis.botha@cdhlegal.com

Mark Morgan
Candidate Attorney
T +27 (0)11 562 1374
E mark.morgan@cdhlegal.com

BBBEE STATUS: LEVEL THREE CONTRIBUTOR

Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 3 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

This information is published for general information purposes and is not intended to constitute legal advice. Specialist legal advice should always be sought in relation to any particular situation. Cliffe Dekker Hofmeyr will accept no responsibility for any actions taken or not taken on the basis of this publication.

JOHANNESBURG

1 Protea Place, Sandton, Johannesburg, 2196. Private Bag X40, Benmore, 2010, South Africa. Dx 154 Randburg and Dx 42 Johannesburg.
T +27 (0)11 562 1000 F +27 (0)11 562 1111 E jhb@cdhlegal.com

CAPE TOWN

11 Buitengracht Street, Cape Town, 8001. PO Box 695, Cape Town, 8000, South Africa. Dx 5 Cape Town.
T +27 (0)21 481 6300 F +27 (0)21 481 6388 E ctn@cdhlegal.com

©2016 1314/SEPT

CDH
CLIFFE DEKKER HOFMEYR