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TAX & EXCHANGE CONTROL ALERT

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Fundraising to assist start-ups: SARS ruling regarding the lending of funds by a PBO to qualifying entrepreneurs

Under South African tax law, an entity can become an approved public benefit organisation (PBO) under section 30 of the Income Tax Act 58 of 1962 (Act), if, amongst other things, it conducts one or more of the public benefit activities listed in Part I of the Ninth Schedule to the Act (Approved PBO). An Approved PBO can also be approved for purposes of section 18A of the Act, if it conducts one or more of public benefit activities listed in Part II of the Ninth Schedule to the Act, in which case it can receive donations that are deductible in the hands of the donor. In other words, an entity must firstly be an Approved PBO before it can obtain approval for purposes of section 18A of the Act.



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Fundraising to assist start-ups: SARS ruling regarding the lending of funds by a PBO to qualifying entrepreneurs

On 29 July 2020, SARS issued Binding Private Ruling 348 (BPR 348) which deals with the income tax consequences for a PBO lending funds to qualifying entrepreneurs, specifically the application of sections 10(1)(cN)(ii)(aa) and 10(1)(cN)(ii)(dd).

Under South African tax law, an entity can become an approved public benefit organisation (PBO) under section 30 of the Income Tax Act 58 of 1962 (Act), if, amongst other things, it conducts one or more of the public benefit activities listed in Part I of the Ninth Schedule to the Act (Approved PBO). An Approved PBO can also be approved for purposes of section 18A of the Act, if it conducts one or more of public benefit activities listed in Part II of the Ninth Schedule to the Act, in which case it can receive donations that are deductible in the hands of the donor. In other words, an entity must firstly be an Approved PBO before it can obtain approval for purposes of section 18A of the Act.

Income tax exemption applicable to an Approved PBO

This is dealt with in section 10(1)(cN) of the Act. This section states the following, amongst other things, regarding the income tax exemption of Approved PBOs:

There will be exempt from normal tax the receipts and accruals of any PBO approved by the Commissioner in terms of section 30(3) (Approved PBO), to the extent that the receipts and accruals are derived –

- otherwise than from any business undertaking or trading activity (section 10(1)(cN)(i));
- from any business undertaking or trading activity if the undertaking or trading activity –
 - is integral and directly related to the sole or principal object of that public benefit organisation as contemplated in paragraph (b) of the definition of “public benefit organisation” in section 30 (section 10(1)(cN)(ii)(aa)(A);

- is carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost (section 10(1)(cN)(ii)(aa)(B); and
- does not result in unfair competition in relation to taxable entities (section 10(1)(cN)(ii)(aa)(C));
- from any business undertaking or trading activity other than an undertaking or activity in respect of which sections 10(1)(cN)(ii)(aa) to (cc) applies and does not exceed the greater of –
 - 5% of the total receipts and accruals of that public benefit organisation during the relevant year of assessment (section 10(1)(cN)(ii)(dd)(i)); or
 - R200,000 (section 10(1)(cN)(ii)(dd)(ii)).

On 29 July 2020, SARS issued Binding Private Ruling 348 (BPR 348) which deals with the income tax consequences for a PBO lending funds to qualifying entrepreneurs, specifically the application of sections 10(1)(cN)(ii)(aa) and 10(1)(cN)(ii)(dd). We discuss BPR 348 below.

Facts of BPR 348

The applicant is an Approved PBO in terms of section 30(3) and for the purposes of section 18A of the Act. It is approved by SARS to carry on public benefit activities contemplated in paragraphs 4(a) and 4(o) of Part I and paragraphs 3(a) and 3(o) of Part II of the Ninth Schedule to the Act, relating to the provision of education, scholarships and bursaries.

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To promote entrepreneurship amongst the youth, the applicant proposes to solicit funds from philanthropists with which to grant loans to young entrepreneurs who are starting or scaling their businesses.

The applicant's primary and subsidiary objects are directed at the promotion of entrepreneurship through education and training. Its programmes are targeted at the youth. One of the applicant's subsidiary objects is to collaborate with other educational organisations and organisations promoting entrepreneurship and leadership or governance or both.

To promote entrepreneurship amongst the youth, the applicant proposes to solicit funds from philanthropists with which to grant loans to young entrepreneurs who are starting or scaling their businesses. Its loan funding will be provided as complimentary funding of at least an equal amount when the qualifying young entrepreneurs attract funding from other philanthropists or investors. Once the applicant provides funding to the entrepreneurs, the applicant will monitor its investment in their businesses, collect data and disseminate information to existing philanthropists and other stakeholders in the wider philanthropy network to encourage greater participation.

The applicant will target young entrepreneurs who do not have access to funding from conventional commercial lending institutions. Those who apply for funding must have a registered business, a bank account, a business plan, be the founders or have a validated leadership role in the business and be endorsed by the applicant's portfolio manager. Persons who qualify for funding will receive a letter of guarantee that will enable them to seek matching funding from investors.

Conventional interest will not be charged on the loans. Instead, the beneficiaries will repay the loans by paying a small percentage of their monthly revenue (revenue share) to the applicant until 100% of the loan amount plus a very small margin is recovered over the loan term. No revenue share will be payable when the beneficiaries have not generated any revenue. Any income received from the repayment of the loans will either be ploughed back into the programme or otherwise used to further the applicant's public benefit activities.

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Cliffe Dekker Hofmeyr

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BPR 348 illustrates how Approved PBOs must bear in mind that depending on the nature of their activities, they may be liable for income tax in a year of assessment.

SARS' ruling

SARS ruled in BPR 348 that the receipts and accruals of the applicant's entrepreneur loan programme will –

- not qualify to be exempt from normal tax under section 10(1)(cN)(ii)(aa), because the undertaking is not integral or directly related to the applicant's sole or principal object of providing education.
- qualify to be exempt from normal tax under section 10(1)(cN)(ii)(dd), subject to the basic exemption amount calculated under that provision. The basic exemption amount is applicable to the receipts and accruals of all business undertakings and trading activities of the applicant that qualify under that provision during any relevant year of assessment.

Analysis and comment

BPR 348 illustrates how Approved PBOs must bear in mind that depending on the nature of their activities, they may be liable for income tax in a year of assessment. Based on the facts of BPR 348, it appears that in the applicant's hands, income from a business undertaking or trading activity (such as the entrepreneurship loan programme) will only potentially be exempt to the extent that it is below the amounts referred to in section 10(1)(cN)(ii)(dd). This refers to the amount below 5% of the PBO's total receipts and accruals in a year of assessment or R200,000 (whichever is greater).

Entities that are interested in assisting start-ups and small businesses with funding, but wish to be tax-exempt and avoid paying income tax as far as possible, can consider the following options, amongst others, provided for in the Act (aside from the route followed by the applicant in BPR 348):

- The entity could apply to become an Approved PBO that carries on the public benefit activity listed in paragraph 1(p)(iii) of Part I and Part II of the Ninth Schedule to the Act. This activity is described as the provision of training, support or assistance to emerging micro-enterprises to improve capacity to start and manage businesses, which may include the granting of loans on such conditions as prescribed by the Minister of Finance by way of regulation. Only "emerging micro-enterprises" can be assisted in order to comply with the PBO provisions of the Act.
- The entity could consider applying to SARS to become a small business funding entity, in terms of section 30C of the Act. If approved, the entity can provide funding to small, medium and micro-sized enterprises. The phrase "small, medium or micro-sized enterprise" is defined as any person that qualifies as a micro business as defined in paragraph 1 of the Sixth Schedule to the Act or any person that is a small business corporation as defined in section 12E(4) of the Act.

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