Section 12J investments more beneficial than only their tax treatments

By Renier de Wit

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The government's tax-incentive to boost economic growth - Section 12J of the Income Tax Act - gives investors more than a mere tax benefit. Investors and wealth managers advising their clients could diversify their portfolios by including private equity-like investments. As with any other decisions to allocate capital, investors should scrutinise the managers who hold guardianship over their funds.


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First off, let us remind ourselves why the Section 12J tax incentive exists. The dispensation was introduced by National Treasury in 2009. Investors, whether natural persons or companies, may claim the amount invested in venture capital companies (VCC) against their taxable income, thereby reducing their tax bill. National Treasury's aim with VCCs was for them to invest onwards in small- and medium-sized businesses, providing much-needed access to capital to create jobs. National Treasury recently capped the annual Section 12J tax deductions at R2.5m for natural persons and trusts, and R5m for companies. The Section 12J dispensation is up for extension in June 2021 when National Treasury will decide whether to continue with it.

The Section 12J VCCs raised about R9bn since its introduction more than a decade ago, with the bulk raised during the last three tax years. That relates to less than R3bn rand per year. Why, then, have retail investors not flocked to benefit from the tax deductions or to diversify their portfolios? One reason may be that managers of Section 12J VCCs have punted the tax benefit too hard and lost sight of the all-important benefit of portfolio diversification.

Sound investment decisions are based on who you invest with and in what you invest. A Section 12J investment does reduce an investor's capital at risk to say 55% of the amount invested, depending on their tax rate; however, there is R55 of every R100 at risk of loss. Therefore, it is vital to do a thorough due diligence of the team and its ability to generate the expected returns on capital when investing.

Effective capital deployment

This leads to a second point: the effective deployment of capital by VCC managers. When National Treasury considers the extension, it will inevitably ask how the capital was used to meet the aims of the dispensation. Thus, how much of the R9bn remains uninvested in money-market funds awaiting investment into real businesses? Investors in VCCs should also ask this when deciding which Section 12J managers to entrust with their money. Has the manager been able to deploy the capital according to its mandate, or is the capital lying in a bank account earning a 2% return after fees?

The deployment of capital is easy and there are two ways Section 12J managers should go about it. The first is where they raise the capital, park it in a bank or money-market account and hunt for potential investments. Having stellar marketing skills to lure capital for a VCC does not mean a manager is good at identifying and concluding investment destinations for those raised funds. The second is where an investment pipeline is prepared – after careful due diligence by the fund manager and eventual selection – followed by a subsequent capital raise. The latter approach will lead to capital working sooner with the possibility of higher returns.

It takes time and dedication to construct a portfolio of high-quality assets; typically six months from identifying a potential investment to when the VCC makes an investment. It is necessary to identify businesses with a proven track record and the ability to do more of what they do well with the fresh capital. Seeking stable and predictable returns from high-quality assets will limit downside risk and protect investors, which should be the aim of a Section 12J manager and not only the generation of fees. Where a manager is unable to deploy the capital within three years, the tax advantages may be reversed to the investor's detriment. Managers must do the work upfront by identifying viable assets, ensuring VCC investors benefit fully.

Performance fees

The fee structure that a Section 12J manager charges should be transparent, inclusive and fair with no hidden costs. Managers should not earn performance fees above the so-called 'risk capital'. In such cases, performance fees are earned once 55% of the capital has been returned since these managers regard this as part of the return to investors and they share in the capital.

Investors in a Section 12J company need to retain their shares for at least five years to benefit fully from the dispensation, leaving them with an illiquid investment. With South Africa's risk-free return currently around 7% a year, investors should ask whether a hurdle rate – the minimum return above which the manager will share in the performance – of 10% per year is appropriate and an incentive for managers to outperform.

Alternative necessity

A final point is the necessity of private equity-like assets in a portfolio. Many retail investors consider alternative assets – Section 12J VCCs, hedge funds and infrastructure – because of lacklustre returns on traditional assets: equities, interest-bearing instruments and property. Alternative assets provide uncorrelated market returns and resultant diversification. If equity markets experience a downturn – such as March's Covid-19-related stock market crash – alternative assets may not experience the same movement; they may experience no effect or a positive move. By including alternative assets in a portfolio, investors can stabilise returns through cycles in the economy. They are crucial to diversify portfolios and should form part of financial planning.

This diversification is best shown in the underlying assets that Section 12J VCCs target for investment. Infrastructure – especially renewable energy – and primary agricultural enterprises (such as those in our funds) are not readily accessible as investment assets on the stock market. These businesses are high-quality profit generators with long-term returns. They create sustainable job opportunities over an extended period, the crux of the Section 12J dispensation.

The spirit of Section 12J is to boost our economy by providing much-needed startup or growth capital to small and medium enterprises. In turn, jobs will be saved and created.

ABOUT THE AUTHOR

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