



*SOUTH AFRICAN REVENUE SERVICE*

**INTERPRETATION NOTE NO. 32**

DATE: 27 June 2005

**ACT : INCOME TAX ACT, 1962 (the Act)**  
**SECTION : SECTION 30(3)(b)(ii)(cc)**  
**SUBJECT : PUBLIC BENEFIT ORGANISATIONS (PBOs): PRUDENT INVESTMENTS**

**NOTE:** This Note is withdrawn with effect from 1 April 2007. Section 30(3)(b)(ii)(cc) of the Act has been deleted by section 24(d) of the Revenue Laws Amendment Act No. 20 of 2006.

**1. Purpose**

The purpose of this Note is to expand on the provisions of section 30(3)(b)(ii)(cc) of the Act and to provide guidelines as to what the Commissioner for the South African Revenue Service (Commissioner) would regard as "other prudent investments in financial instruments and assets" referred to therein.

**2. Background**

It is generally accepted that the funds of PBOs should be utilised to the full extent for carrying on the approved public benefit activities and it is for that reason that exempt status is granted to PBOs. As PBOs enjoy the spending of the public funds which they receive, on a tax free basis, SARS must ensure that these exempt entities utilise their funds solely for such activities and that no funds are applied for the personal gain or private benefit of the founders or those who have fiduciary responsibility. Furthermore, the funds should not be utilised for commercial or unrelated trading activities which are regarded to be in competition with other taxpaying entities. It is, however, accepted that surplus funds may be invested from time to time.

Section 30(3)(b)(ii) of the Act prescribes the manner in which the funds of an exempt PBO are to be utilised. Items (aa) and (bb) of this section

provide for the investment of surplus funds with specific institutions, namely -

- a financial institution as defined in section 1 of the Financial Services Board Act, No. 97 of 1990; or
- any listed financial instrument of a company contemplated in paragraph (a) of the definition of “listed company”.

Item (cc) provides that a PBO may invest funds in other prudent investments in financial instruments and assets which the Commissioner may determine after consultation with the Executive Officer of the Financial Services Board and the Director of Non-Profit Organisations.

### 3. The law

**Section 30(3) of the Act reads as follows:**

“(3) The Commissioner shall, for the purposes of this Act, approve a public benefit organisation which—

(a) ...

(b) has submitted to the Commissioner a copy of the constitution, will or other written instrument under which it has been established and in terms of which it is –

(i) ...

(ii) prohibited from distributing any of its funds to any person (otherwise than in the course of undertaking any public benefit activity) and is required to utilise its funds solely for the object for which it has been established, or to invest such funds –

(aa) with a financial institution as defined in section 1 of the Financial Services Board Act, 1990 (Act No.97 of 1990);

(bb) in any listed financial instrument of a company contemplated in paragraph (a) of the definition of ‘listed company’; or

(cc) in such other prudent investments in financial instruments and assets as the Commissioner may determine after consultation with the Executive Officer of the Financial Services Board and the Director of Non-Profit Organisations:

Provided that the provisions of this subparagraph shall not prohibit any such organisation from retaining any investment (other than any investment in the form of a business undertaking or trading activity or asset which is used in such business undertaking or trading activity) in the form that it was acquired by way of donation, bequest or inheritance;”

### 4. Application of the law

The legislation provides for the Commissioner to exercise his discretion in determining other prudent investments and assets in which an exempt PBO may invest, after consultation with the Executive Officer of the

Financial Services Board and the Director of Non-Profit Organisations. Discussions and subsequent correspondence between the relevant parties have taken place in this regard. As a result thereof, the following guidelines are provided and will be taken into account by the Commissioner in determining whether or not an investment will be regarded as a prudent investment. **Each case will, however, be considered on its merits.**

## 5. Discussion

5.1 The provisions of item (cc) of section 30(3)(b)(ii) of the Act should be seen in context with the requirements that an exempt PBO -

- may not engage in trading activities or business undertakings (other than those which are permitted in terms of the trading rules);
- is required to utilise its funds solely to conduct the approved public benefit activities; or
- is required to invest them in the specific investments prescribed in section 30(3)(b)(ii)(aa) and (bb) of the Act.

5.2 It must be noted that this document deals solely with the investment of funds that are surplus to the needs of an exempt PBO.

5.3 As exempt PBOs enjoy the benefit of spending public funds which they generate from the general public or the State on a tax-free basis, they are expected to be accountable for the financial management of their funds. For this reason the Act provides for various requirements to be met before the exempt status of an entity may be confirmed or for such entity to retain its exempt status. The following basic guidelines are used in the determination of what would constitute "prudent investments":

- Tax avoidance - The funds must be applied for the public benefit and not to fund or finance non-approved public benefit activities or utilised for tax avoidance schemes.
- Personal enrichment – The abuse of funds intended for public spending should not be used for the personal enrichment or benefit of founders or persons holding fiduciary responsibility.
- Risks – Investments in financial transactions that are potentially a risk with no predictable or guaranteed yield are prohibited. The onus should be on PBOs to guarantee that publicly provided resources are efficiently and wisely employed in secure stable investments with a certain fixed investment yield with limited risks involved.

- Liquidity – The funds or resources of a PBO should be readily available for the PBO to utilise in carrying on the public benefit activities. Illiquid investments are therefore not acceptable.
- Types of investments - An “investment” in the context of section 30 of the Act is distinguishable from trading or business activities. By investing its funds, the PBO would be regarded as passively involved in the investment transaction, whereas business or trading activities reflect an active participation in the venture. The investments prescribed in items (aa) and (bb) of section 30(3)(b)(ii) of the Act are investments in relation to which the PBO is a passive investor in financial instruments. Investments in private companies, close corporations and business operations are excluded. Likewise an investment in immovable property is not acceptable as the rental income derived is regarded to be trading income. Furthermore, an investment in immovable property is either a long-term investment (and therefore illiquid) or, be regarded as a speculative transaction (trading income). The term “prudent” in the context of item (cc) signifies whether the investment is “wise” by acting with care and thought to ensure proper security for public funds.

- 5.4 It must, however be noted, that the proviso to section 30(3)(b)(ii) of the Act allows for any investments, other than investments in the form of a business undertaking or trading activity or asset which is used in such business or trade, which are received/acquired by the exempt PBO by way of donation, bequest or inheritance to be retained in the form acquired.

**Example:** In terms of his will, K bequeathed 500 shares he owned in a private company, the Coffee Bean (Pty) Ltd, to the ABC Orphanage, an exempt PBO. Upon receipt of the bequest, the PBO will be entitled to retain the investment in the unlisted company notwithstanding the fact that it is not regarded as a prudent investment. ABC Orphanage may, however, not increase its holding in the Coffee Bean (Pty) Ltd, nor provide any financial assistance to the company.

## 6. Investments generally not regarded as prudent ( non-prudent investments)

The following general guidelines are given:

### 6.1 Stokvels

A stokvel is a type of informal credit-rotating saving scheme based on trust, in which members contribute a fixed amount of money to a common pool and then take turns in drawing the full saving. It does not have legal status unless it is registered as a legal entity (such as a company, bank, friendly society, close corporation). There are different types of stokvels which may include savings clubs, investment schemes and burial societies.

In light of the informal structure and risks attached to the manner in which it operates, an investment in a stokvel will not be regarded as a prudent investment.

### 6.2 Pyramid schemes

Pyramid schemes are high-risk schemes which promise fast easy money provided other people are enrolled, thereby creating a hierarchy of participants resembling a pyramid as newer layers of participants join the structure at the bottom. Pyramid schemes focus on the exchange of money and recruitment where the marketing of a product or service is only of secondary importance. Consequently these schemes are regarded as being illegal and high risk.

The investing of funds in pyramid schemes by PBOs is not acceptable for purposes of qualifying for, or continuing to enjoy an exemption from income tax.

### 6.3 Shares in a private or unlisted public company

The investment of surplus funds by an exempt PBO in a private or unlisted public company by way of share capital or loan account is not acceptable. In the absence of a market price and general lack of transparency and information, a fair value of the shares cannot be readily determined. Consequently such investments are regarded as high-risk investments.

It must be noted, however, that, as indicated under “**Discussion**” in paragraph 5.3, the Act provides that where such shares were donated or bequeathed to the PBO, the investment may be retained.

The investment of funds by way of shares and/or loan accounts in property investment schemes (private companies acquiring fixed properties) is not acceptable, even though they may be considered to be low-risk and providing capital growth.

#### **6.4 Close corporations**

The same principles applicable to a private or unlisted public company as indicated in paragraph 6.3 are applicable to a close corporation. A close corporation may only have natural persons as members and membership may not exceed ten persons. As a result of the affairs being restricted to a limited number of natural persons who derive a direct benefit from the financial affairs of the corporation, a PBO may not invest funds in a close corporation and as a PBO is not a natural person it cannot become a member.

#### **6.5 Off-shore investments**

The activities of a PBO must be carried out for the benefit of persons in the Republic and the funds must be utilised and readily available in the Republic. It is therefore not acceptable for a PBO itself, to invest surplus funds in off-shore investments as there is no control over the funds and no guarantee that the funds will become available to conduct the public benefit activities. However, where a PBO invests funds with an approved financial institution, as described in items (aa) or (bb) of section 30(3)(b)(ii), and such financial institution in turn, invests the funds in an off-shore portfolio, the PBO will be regarded as having complied with the provisions of section 30(3)(b)(ii)(aa) and (bb) of the Act. The acquisition of shares on an overseas stock exchange by a PBO is not acceptable.

#### **6.6 Loans**

The granting of loans is not acceptable. This includes debentures issued by any entity but excludes listed financial instruments contemplated in item (bb). No funds or capital may be used to set up a new business or to effect capital improvements to an existing business. Likewise, an exempt PBO will not be permitted to advance loans to directors and office bearers.

### **7. Investments that may be considered to be prudent**

The types of investments outlined below are not exhaustive and merely serve as general guidelines. Each investment will however, be considered separately on merit and receipt of the specific facts and circumstances pertaining to it.

#### **7.1 Pre-listed shares in an unlisted company**

The subscription for shares by a PBO in a company which is to be listed on a South African stock exchange as defined in section 1 of

the Securities Services Act No. 36 of 2004, is acceptable subject to the following conditions -

- a prospectus has been issued;
- documentary evidence has been provided from the listing authorities that the application to list had already been made and that there is potential for the company to be listed;
- the company must be listed within six months of the application; and
- A written guarantee must be provided that the funds so invested will be returned to the PBO should the listing not take place within the six month period

## **7.2 Collective investment schemes (unit trusts)**

With the coming into operation of the Collective Investment Schemes Control Act, No. 45 of 2002 the restriction of investments in hedge funds has been removed. There are five different categories of collective investment schemes which are defined in the above-mentioned Act. However, only collective investment schemes, of which full particulars have been received and which have been approved by the Registrar of Collective Investment Schemes of the Financial Services Board, will receive consideration.

It must be noted that in terms of the Collective Investment Schemes Control Act, a foreign collective investment scheme may be approved and registered by the Registrar of Collective Investment Schemes. If such foreign investment scheme has been approved and registered, the investment will be accepted as being prudent.

## **8. Investment of surplus funds in immovable property**

The investment of surplus funds by PBOs in fixed property will be reviewed once the legislation has been passed relating to the partial exemption for PBOs engaged in business activities.

## **9. Compliance and tax avoidance**

Where any concession relating to prudent investments is abused or where the PBO is used as part of any transaction, operation or scheme to avoid, reduce or postpone the liability of any tax payable in terms of any Act administered by the Commissioner, the PBO may become liable to the tax that would have been payable including the relevant prescribed penalties.

In circumstances where an exempt PBO controls business or trading activities in a separate taxable entity or is itself involved in conducting the

day to day business activities, care should be taken that these activities are conducted within the parameters of section 30 of the Act. The sole object of the PBO must be to conduct approved public benefit activities and where this is no longer the case, the exempt status of the PBO could be placed in jeopardy.

In instances where the PBO is the shareholder of a private or unlisted public company and profits are not distributed to the shareholder by way of dividend but are donated or, where a tax-deductible receipt is issued for section 18A purposes in respect of donations to the shareholder, the transaction will be regarded to be the avoidance of the payment of STC on dividends that may have been declared and the PBO will be guilty of an offence which is subject to penalties and the PBO will furthermore, lose its exempt status.

#### 10. Conclusion

Requests for approval for investments to be regarded as prudent should be submitted to the Tax Exemption Unit together with full particulars and motivated reasons.

Contact details of the Tax Exemption Unit are as follows:

<b>Postal Address:</b>	The Tax Exemption Unit P O Box 11955 HATFIELD 0028
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