

*Accelerating Impact is an intervention to increase impact investing activity in South Africa by researching barriers and advocating for their removal.*

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# Track 2 - Taxation and public benefit organisations

## Initial policy recommendations

The taxation regime for public benefit organisations (PBOs) in South Africa does not require a wholesale revision along the lines of that proposed by the Katz Commission in 1999, to facilitate greater levels of impact investing. What is necessary however is to take steps to resolve the ambiguity around impact investing and alternative revenue generation, by non-profit entities. As is evident from international examples highlighted in the main report, there are clear, obvious public benefits to allowing more funding to flow into the non-profit sector than merely in the form of variable donations, and the taxation regime needs to adapt to this.

It is well recognised that the South African state has challenges in service delivery; it should therefore seek to maximise the ability of service or non-profit organisations to supplement the country's social service delivery system. Accordingly, impact investing under a clearer and more conducive tax regime for PBOs can be a valuable approach to redirect financial assets into the social sector, thereby alleviating the significant financial grant burden placed upon the state to help meet the basic needs of the indigent.

The underlying premise of how funding flows (or should flow) into the non-profit sector, and what such entities do with this funding, as manifested in sections 30, 18A and 10(1)(cN) and in the 9<sup>th</sup> Schedule of the Income Tax Act, present challenges for philanthropic organisations:

- With endowment funds to invest (mission-aligned investing) or spend their money in ways other than grants (programme-aligned investing);
- That wish to build up endowments as a cushion against future fluctuations in funding; and
- That wish to use their skills and resources to earn alternative revenue streams to secure the financial futures of their operations.

It is interesting that Schedule 1 of the Companies Act (per sub-section 2) clearly permits a non-profit company to "hold securities issued by a profit company" or "directly or indirectly ... carry on any business, trade or undertaking consistent with or ancillary to its stated object" (South Africa, 2008). It is this fairly open approach that the Income Tax Act seeks to restrict when a non-profit entity is granted PBO status.

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The overall thrust of the recommendations of the report is therefore to permit greater flexibility and clarity from the tax regulations in respect of impact investing. More specifically:

1. Increase the thresholds for business or trading activities to the greater of R500,000 or 20% of receipts and accruals in any year.
2. Relax the current requirement for business or trading activities to be linked to the "core" purpose of the PBO, replacing this with a requirement for all profits made from such activities to be reinvested in furthering the mandate and objectives of the PBO.
3. Introduce a new Part III of the 9<sup>th</sup> Schedule of the ITA dedicated to impact investing activities. Establish the working practice that the items listed in these parts are not a definitive, prescriptive list but rather offer guidance when making application to the Tax Exemption Unit for PBO status.
4. Draft and promulgate the regulations for lending activities under Part 1 (1)(piii) and consider the extension of lending to activities other than poverty alleviation, to enable a wider target set of beneficiaries of concessional lending, including small businesses.
5. Further reduce the distribution requirement for a conduit PBO in section 18A from 50% to 25% to align with the similar SBFE requirement. Extend the period in which such distributions need to occur from 12 months to five years.
6. Consider creating a new type of taxpayer – a "social enterprise", as has been introduced in various other jurisdictions. Such an entity would operate as a "dual purpose" business: a profit-making enterprise which is obliged to reinvest all (or a majority of) its profits into the business to further its core social purpose.
7. Update the guidance notes to clarify that a Small Business Funding Entity may undertake a wider range of activities in addition to the provision of funds, such as business support, technical assistance and mentoring.
8. In line with recommendations 2 and 6 above, permit an SBFE to offer emerging forms of concessional financial instrument such as convertible grants and hybrid debt instruments that can convert into equity, provided any future returns from an equity holding are reinvested by the SBFE to further its "funding" mandate.
9. Expand the definition of eligible business that an SBFE can provide "funding" to from the existing SBC-based R20m limit to R50m for for-profit businesses and all social enterprises, per recommendation 6 above.
10. Consider presenting a more public face to the Tax Exemption Unit at SARS, such that the results of its work, and its approach are more visible to the impact investing, PBO and SBFE communities. The use of a public "sandbox" environment to test new funding models and instruments, cases of abuse, examples of unusual or complex cases and statistics, could all prove invaluable in the development of the impact investing market in South Africa.

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